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Edgar S. Furniss

DEAN OF THE GRADUATE SCHOOL

YALE UNIVERSITY

HAROLD D. KOONTZ
Colgate University

Government Control of Business



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TO

MY MOTHER AND FATHER

EDITOR'S INTRODUCTION

THE subject treated in this book is of the first importance to students of the modern economic system. Indeed, it is not too much to say that the relationship of public authority to economic enterprise presents the largest single problem of present-day society. The problem has both its practical and its theoretical aspects. From the point of view of practical business operations the regulatory activities of governmental agencies, the attitude of the courts toward the rights of property-owners and investors, the safeguards of labor and the consumers established in the legal system, comprise a group of factors which equal in importance any other set of forces with which the business executive has to deal. And from the broader point of view, the influence of these developing functions of government on the essential character of our economic institutions and consequently on the body of theory which describes and interprets them constitutes a major problem in the formulation of economic principles.

This subject to be handled adequately requires not only that an enormous mass of factual detail be presented in a form intelligible to the student but that this accumulation of descriptive material be prevented from obscuring the broad issues of policy which underlie the entire problem. Unless sufficient descriptive matter is incorporated into the account the student will fail to grasp the realities of the situation as it exists today. Unless these factual materials are presented against a background of historical development and in the light of sound economic principle they will leave the student without insight into the long-run aspects of the subject.

It is an outstanding merit of Dr. Koontz's book that it combines these two approaches to the subject in an effective manner. The book supplies the essential facts regarding the actual operations of governmental agencies in the various branches of the business world and the rulings of the courts with respect to these activities of government, so organized that the student acquires an accurate working knowledge of bulky and complex data. At the same time the author's emphasis on institutional history and his application of economic analysis to the specific topics under discussion raise the book above the level of a mere compendium of information. Accordingly, it serves the needs of students in courses on applied economics, as well as those whose primary interest is in the broader aspects of the subject. Teachers in both types of courses will find it admirably adapted to classroom use.

E. S. F.

PREFACE

THE increasing government control of business in the United States is an interesting aspect of the world-wide tendency to limit private rights. While American traditions support the maintenance of individual rights in business as in other social relationships, there has been a growing trend toward subordination of individual action to government control, on the ground that curtailment of rights of the few enlarges the meaning of liberty for the many. Perhaps the public is best served if government policy encourages efficient functioning of the economic system or the solution of social problems, whether or not private rights are preserved. But government control policies necessarily influence the operation of economic machinery and the extent of individual liberty. Restrictions placed by government upon business are consequently of significance, not only to persons actually in business, but also to the general public, whose material wants economic organization is designed to satisfy and whose political freedom is partially contingent upon economic independence. Therefore, the citizen or student who would follow his own self-interest and who wants to play an intelligent part in molding political policies will find it necessary to understand the essence and implications of government control of business.

This book is designed to describe and analyze comprehensively the field of government control of business in the United States. The word "control" has been interpreted to apply not only to outright regulation, but also to the restraints which government exercises by its aids to business and its ownership of business. The author has attempted to obtain unity and order by presenting the manifold instances of control as directed toward particular areas of economic relationships. The causes, legislative treatment, administrative methods, objectives, and results of control are discussed for each area, and the implications for the economic system and for public welfare are indicated. In the opening section of the book, before treatment of individual areas, the author discusses the nature of the problem of control. In the closing section he presents conclusions on the problem. Thus it is believed that divergent issues arising from present relations of government to business may be brought into focus for the student.

The primary purpose of this book is to help the student understand the American experience with government intervention into business and to help him appreciate the significance of these controls. In planning his presentation the author has had to make difficult decisions on two main points.

In the first place, not every instance of government control could be included without making the book encyclopedic. But it has been possible to make the coverage of state and federal government controls broad, and consequently to include most of the cases in which there is a general interest. As a matter of fact, some may believe that the book is too inclusive for certain semester courses. In such courses, the author believes that the student will gain more from a substantial treatment of fewer areas of control than from a sweeping study of the entire field. The organization of the book into self-contained parts makes such a plan pedagogically feasible.

A second decision has had to be made with respect to evaluating government control policies. The author recognizes that there are valid differences of opinion on practically every policy. But he feels that if the student is to obtain an appreciation of the meaning of government controls, they should be evaluated in the light of their economic implications and their bearing upon public welfare. In most cases the author has presented divergent opinions, but he has not hesitated to state critical conclusions which seem to him valid from the point of view of sound economic and social policy. In doing so, the author has not meant to be dogmatic, but he believes that those who disagree will find the issues sharpened by his having taken a considered position.

In spite of the disturbed state of international affairs, the present time seems to be opportune for an analysis of government control of business in the United States. Many aspects of control have been recently clarified. The permanent nature of most government control policies has been established by public support of the reforms of recent years. Issues of constitutionality have, for the most part, been settled. Moreover, the scope of government control is increasing, and will probably continue to do so, as the result of the defense program, imposition of a wartime economy, and the certain necessity for post-war adjustment. But this increase is not so much in the establishment of new kinds of control as in the broadening of the application of existing controls. Under such circumstances, a study of the kind undertaken in this book seems to be especially timely.

In preparing this book the author has received assistance from so many persons that it is impossible to acknowledge his debt to all by name. The research work of many scholars has been utilized and abundant footnotes call attention to their specific contributions. Numerous officials of government agencies and business associations have given courteous consideration to requests for information. In teaching some of the manuscript in preliminary form, the author has had the assistance of the challenging curiosity of his many students in the classroom.

Colleagues at Colgate University have read portions of the manuscript and have contributed valuable advice and criticism. For assistance on chapters which lay in their field of special interest, the author is indebted to

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Although much assistance has been enjoyed in the preparation of this book, all responsibility for any errors in fact or opinion obviously belongs to the author.

HAROLD D. KOONTZ

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Part One

THE PROBLEM OF CONTROL

CHAPTER

1

THE PROBLEM AND ITS EVOLUTION

INDIVIDUAL freedom is under attack on all fronts. In perhaps no other field has this attack been more vigorous than in the sphere of economic life. Totalitarian nations have insisted that economic efficiency can be brought about only by submergence of the individual and glorification of the group. Democratic nations have curtailed freedom in business as a means of enlarging the liberty of the many and of meeting critical social and economic problems. With the apparent willingness of individuals, even those with the political power to decide the form and substance of their government, to give more authority to government in economic matters, it would appear to be important to understand the nature and implications of government controls over business.

The advantage of democracy is not only that it enhances the position of the individual, but, what is more important, that the operation of democratic principles makes it possible for individuals to decide when freedom should be curtailed in the interests of the group. Through the right to vote and to express themselves freely, Americans have the power to decide the character of government controls over their economic activity. In order that these controls may be guided into economically and socially desirable channels, an understanding of the bases, policies, techniques, problems, and economic effects of government intervention into business seems necessary. It is the purpose of this book to contribute to that understanding.

The primary function of business is the production and distribution of economic goods. Decisions upon the advisability of government control of business should not overlook this simple fact. If any government control shows evidence of impairing the ability of the economic system to function efficiently, the restriction upon business should be clearly justified by some compelling social or political need. Thus, a minimum-wage law or a maximum-hour requirement may tend to reduce the material output of the eco-

nomic system, but may easily be justified as a socially desirable measure. Or, government assistance to water transportation may be of questionable economic worth, but may have military advantages to offset the costs. Whatever may be the reason for government intervention into business in the United States, the traditional respect for the integrity of the individual and his freedom, which seems to be so fundamental in the philosophy of American democracy, should mean that government control of business ought not be undertaken except in response to some pressing problem.

As the term is used in this book, government control of business involves more than outright regulation. While a definite regulatory program, such as the fixing of railroad rates, is generally acknowledged to be government control, the government may also exercise control over business by promotional activities and by ownership. The granting of tariff protection, patent rights, subsidies for operation, or other aids not only affects the course of businesses, but gives the government the power to control recipients of aids through the granting or withholding of the assistance. When government enters business it often alters the shape of business policies. It has proved to be an exacting buyer and seller, and a formidable competitor.

Government control of business is not new. Despite a tendency on the part of the public to regard it as a New Deal phenomenon or a national defense policy, the exercise of government restrictions on business is virtually as old as business itself. The bases, policies, techniques, and objects of such control may change with the times, but control of individual economic activity has ever been a characteristic of organized society. At times and in certain places this control has been slight. At other times and places, if one makes allowances for differences in economic development, it has been as great as that experienced today.

A. THE DEVELOPMENT OF CONTROL

The significance of present government control may be better appreciated if it can be seen in perspective. Although it is obviously impracticable to trace here the development of all public control of economic activities, the relations of government to business in certain outstanding periods may be noted. We may pass over the control exerted by moral force in the economic activity of primitive tribes, the slave economies of Greek and Roman antiquity under control of landowners and royalty, and the controls of the Catholic Church during the Middle Ages. Although a code of law governing economic relations was developed under the Roman Empire and many principles were deduced and applied to business by early governments and the early Catholic Church, these controls were taken into the government regulations of the Middle Ages. From the point of view of modern government control of business in the United States, the significant developments of intervention by

public authority date largely from the rise of towns and trade in the eleventh century.

The instances of government control of business are so numerous during the years since the eleventh century that it may seem hopeless to draw any significance from them. However, there are three important periods in this development the regulatory characteristics of which may be brought into rather sharp focus. The first period dates from the latter eleventh century to the fifteenth century and may be regarded as an era of medieval business regulations. It is characterized by a maze of regulations by the church, the guilds, the territorial rulers, and the towns and villages, designed primarily to protect consumers from fraud and deceit, and to protect merchants of one town against the business men of another. It is also a period of extensive regulation from which few business men escaped.

A second significant period dates from the fifteenth century to the eighteenth century and coincides with the development of strong nationalist states. It is characterized by wide business regulation, dominated by the large states rather than the town groups, and characterized by the desire to make the state economically wealthy and politically strong.

A third broad period dates from the latter eighteenth century to the present day and may be regarded as the modern age of control. Beginning with a revolt against the excessive regulations of the nationalistic states, this period was characterized at first by the glorification of individual freedom in business and by the repeal of governmental restraints upon economic activity. But as the industrial revolution gained momentum, economic life became more complex. The introduction of the factory system brought on controls to protect labor from excessive hours and unhealthy working conditions. The development of modern transportation, in response to the market needs of the factory system and its specialized production, brought government into business and caused it to institute controls over business. The increased significance of organized industry raised problems of competition and monopoly, and the enlarged volume and extent of trade made other business problems assume social importance. The modern period of control, then, has been one of developing governmental intervention into business in response to popular demand that government help solve the problems brought on by an ever more complicated industrial system.

1. Medieval Business Regulations. The medieval craftsman or trader was exposed to regulation by the church, the town authorities, the guild, and the ruler of his country, as well as by the force of custom. The character of the regulations in each case varied somewhat with the authority concerned. The church was dominated by precepts of Christianity, the town by the desire to protect consumers, the guilds by the interests of their members, and the ruler by the need for revenue or to exalt his position or the standing of the territory over which he ruled. The force of custom was partly an outgrowth of

the dogmas of the church and partly an evidence of the conservative characteristics of the Middle Ages. A practice was generally regarded as good, and hence to be observed, if it had been adhered to in the past.

a. Regulations of the church. In condemning avarice and deceit and glorifying the Golden Rule, the church undertook regulation in two special instances. Lending money for gain, in other words the charging of interest on borrowing, was at first held to be sinful, and such a practice subjected the lender to danger of expulsion from the church. But the growth of trade and the need for borrowing led to the church's allowing certain exceptions to its principle that charging interest was usury and hence wicked. If a lender assumed risk by lending his money, he might be paid for the risk of loss. If a borrower did not repay a loan when due, the lender might justly be paid compensation for the loss or injury he suffered. And if a lender had to forego making a profit by lending his funds, the borrower might pay him for the loss involved.

A second economic regulation of the church arose from the doctrine of "just price." Under this concept, goods were to be sold in accordance with what the producer or seller needed by way of income to maintain him in the economic status in which he was born. Although this principle was supported by town and guild authorities, some difficulty was encountered in applying it. Local handicraftsmen could well be held to a just price, and be assured of such a price. But when commodities came from distant countries or towns, the lack of knowledge of economic status there, the dangers and costs of transportation, and the disregard for a "foreigner" generally meant that the concept of just price was not applied.

b. Regulations of town authorities. Most of the regulation of business in the medieval town was undertaken by the merchant and craft guilds, to be discussed presently. Often these guilds were synonymous with town government and their regulations were enforced by the town authorities. They enforced the doctrine of just price in every trade and administered regulations to enforce fair dealing. Forestalling — purchasing commodities in advance outside the market — was forbidden. Likewise, traders were forbidden to regrate — to buy commodities in bulk to sell again in the same market. And engrossing — buying in quantities in order to "corner" the market — was unlawful.

Almost every English town in the thirteenth century had a market in which local trade was carried on. Fewer towns were permitted to hold fairs, although there were hundreds of fairs in England. The fair was simply a large market, mostly wholesale in character, in which merchants from several towns, and frequently from outside the country, came to sell their wares. Held usually only by permission of the king or some high noble, the fairs were limited to a number of days and trading in nearby towns was ordinarily suspended during that time. In addition to the ordinary markets and fairs, certain towns

were selected in the thirteenth and fourteenth centuries for the carrying on of foreign trade in such commodities as wool, leather, hides, and tin. These towns were called staple towns and were generally chosen by the king for this function so that their number might be limited, central places for trading furnished, and collection of export and import duties made easier.

In both the fairs and the staple towns trade was closely supervised. A body of rules, called the law merchant and based largely upon custom, was administered in the fairs by a Court of Piedpoudre and in the staples by a Staple Court. These rules were for the most part business regulations covering weights, measures, just price, fraudulent sales, business contracts, and such trade practices as forestalling, regrating, and engrossing. Because merchants were transient, these courts had complete jurisdiction, dealing with both criminal and civil cases. The law merchant, a sort of business common law, developed over the years until it covered not only the law of contracts, notes, and bills of exchange, but widespread regulation of prices, service obligations, and liabilities of those in "common," or public, and "private" callings.

The whole law merchant did not come down into modern law through the English common law. Largely as the result of legal accident, the common-law records carry few of the decisions of the fair and staple courts.[1] Since these courts had fairly complete jurisdiction and appeals were seldom taken to the King's Courts, the English Year Books, which contain only those cases arising in the King's Courts, did not transmit the entire law merchant to posterity in the form of the English common law. Under the law merchant practically all activities which could be called business were "common." But owing to the fact that only certain cases got into the common law, it has often been erroneously assumed that in the earliest times there was a division between private and quasi-public businesses. Because certain callings, such as carrier, innkeeper, and wharfinger, had an insurer's liability for loss of goods entrusted to them, and because cases involving this liability reached the King's Courts, the common law has been misinterpreted to mean that these businesses were subject to a peculiar and much more complete type of regulation than were other businesses. This incorrect belief, that in the earliest periods of English trade businesses were divided between public and private, has had some interesting effects in the interpretation of American constitutional law respecting business and government.[2]

c. Regulation by the guilds. The guilds were associations of men engaged in the same occupation, motivated by the desire to encourage freedom of opportunity for members through regulation of individual conduct. Our interest is with guilds of the period after the eleventh century and guilds in England particularly. In the western world in the medieval period there were two

[1] This point and the following discussion are based on Adler, E. A., "Business Jurisprudence," 28 *Harvard Law Review*, pp. 135–62 (December, 1914).

[2] See *infra*, Chapter 13.

types of guilds, the merchant guild and the craft guild. The merchant guild was simply a local association of traders organized for mutual protection and advancement of interests. Although known in continental Europe in the ninth century, their real rise dates from the eleventh century, and by 1300 merchant guilds could be found in practically every town in England and western Europe. The craft guild was an association of handicraftsmen, formed for much the same reasons as were the merchant guilds, but rising to prominence somewhat later.

Besides the economic purposes of guild organization, both the merchant guilds and the craft guilds were organized for social and charitable reasons. If a member became sick or encountered hard times, the association gave him aid. If a member died, the guild saw that he received a good funeral and that his dependents were cared for. The guilds often held social events, generally with a curious combination of religious and convivial purposes, and supported their worship of a patron saint with brotherly cordiality induced by feasting and drinking.

In the case of both merchant guilds and craft guilds, entrance requirements were at first not very strict. The guilds were usually open to anyone who could pay the dues and meet certain minimum requirements of trade or craft competency. But as they gained monopoly power they also made entrance requirements more strict, thereby strengthening their monopoly position.

Some of the guilds grew up as voluntary associations and later fell under the control of town and territorial authorities. Others were chartered by the nobles or the king, or even the head of a town government, usually for compensation. Since the guilds represented the most powerful groups in the towns, their regulations and those of the town authorities generally coincided. But additional regulation came from the guilds by the strict codes under which they operated, and which were usually designed with a view to protecting the members against competition from without or unscrupulous competition from within.

In addition to market controls, the merchant guilds imposed certain other regulations. Members selling goods on behalf of non-members were punished. The purchase of goods by any guildsman had to be shared with other members, if they were present and wished to participate. Sales to consumers by non-members of the guild and by traders from other towns were closely supervised, if not prohibited.

The craft guilds had a very complicated regulatory code, with elaborate rules dividing the craft lines and limiting sales by outsiders. Strict regulations were imposed upon the personal conduct of apprentices and their duties were definitely prescribed. Work on Sundays and holy days was forbidden. The guilds rigorously inspected work, and use of faulty materials and poor workmanship were subject to penalty. Profits on sale of raw materials were forbidden. Aggressive selling methods and advertising were either forbidden or

closely restricted. Introduction of innovations or inventions was limited so that no producer could obtain a cost advantage over another. Both prices and wages were subject to close regulation along the lines of just price principles. Occasionally, guilds which attempted to take advantage of their monopoly position and raise prices above those the town regarded as fair were punished by the town authorities.

d. Regulation by the territorial rulers. Until the rise of nationalist states in the fifteenth and sixteenth centuries, the towns were not subject to very extensive regulation by the territorial rulers. These rulers, whether they were kings, princes, or lords, did exert some control as feudalistic landowners and did pass some regulations which applied widely to the town and guild authorities. Such regulations, aside from various kinds of controls to obtain tax revenues, were generally supplementary to local business controls, and were usually passed to make possible general application of some rule regarded as desirable by local authorities. Thus, the English Crown and Parliament fixed the price of bread and ale in the thirteenth century, allowing the size of loaves to vary with change in costs of raw materials and fixing a definite relationship between the price of ale and the grains from which it was made. In 1351, Parliament also attempted to regulate the wages of labor when labor became scarce following the Black Death of 1349–1351. The statute provided that workers should be paid only the wages they received in 1346, and also forbade laborers to move from the manors for other work unless the lord of the manor did not need them.

e. Custom. The whole system of business regulation of the medieval period was dominated by the regard for custom. Workers were expected to follow in the path of their fathers. Prices were supposed to be based upon previous prices, and the producer was entitled only to a wage which would allow him to maintain himself in the customary standard of living for his class. In many other ways the desire to maintain status influenced the regulations of business conduct.

2. Regulation by Nationalist States. With the rise of strong nationalist states in the fifteenth and sixteenth centuries, the attitude of government toward business came to be dominated by the fiscal interests of these states. Needing revenues to support armies for increasing national power, the rulers endeavored to subordinate local economic policies in order to build up national revenues and national unity. This growth of nationalism throughout Europe, and the adoption of a state policy to make the state powerful and self-sufficient, have been referred to as mercantilism.

Business regulations of nationalist states were derived largely from the national government and reflected the desire to strengthen the state. Indeed, in spite of the years of relative business freedom which followed mercantilism, the student will recognize that certain phases of mercantilism have prevailed, and that many recent economic policies are but a brand of mercantilism.

Mercantilist regulations were closely bound up with foreign trade, for it seemed to those European countries which had not been able to get bullion directly from the New World, that only by exporting goods of more value than would be imported could money come into the country. Since precious metals were the most acceptable medium of exchange, they were looked upon as being the most desirable form of wealth for a nation to have.

In order to encourage manufacture and the securing of a favorable balance of trade, regulations of several kinds were formulated. Higher import duties were placed on manufactured articles than had previously existed, and imports of some goods were prohibited. The export industries were often subsidized and export of raw materials was discouraged or prohibited, while their import was encouraged. Nationalist states forbade the export of manufacturing tools and machinery and the emigration of skilled workers. On the other hand, state authorities made efforts to induce skilled workers from other countries to immigrate. In England, to encourage grain cultivation at home, so that food need not be imported and excess crops profitably exported, domestic grain prices were regulated at heights conducive to expansion of production. Furthermore, foreign merchants were usually required to spend within the country all or part of the money they made by sales in that country. And, of course, the export of precious metals was closely regulated or prohibited.

Nationalist states also encouraged navigation and colonization. Higher duties were generally charged on goods coming into a country on foreign ships than those handled on domestically owned ships. Bounties were granted for the construction of ships. In England, a series of navigation acts provided that all foreign trade to and from England should be carried only in English ships. Colonization was also promoted so that a ready source of raw materials could be had, and trading companies were chartered with exclusive privileges for colonization.

Additional encouragements were given to manufacture. Bounties were granted to producers of goods of military importance. Patents of monopoly were often bestowed upon enterprisers who introduced new processes of manufacture. To keep labor costs low for manufacturing, wages were regulated in England in great detail, with an elaborate system of classifying trades. On the other hand, manufacturers themselves were subject to regulation, the states often providing for strict inspection of goods, especially those to be exported, and control of deceptive or unethical business practices, so that the country's reputation would be enhanced abroad.

In some respects, the very authoritarian nature of the mercantilist regimes led to improvement in local business freedom. To encourage trade within the country, the national authorities curtailed or eliminated local tariffs and other barriers to free domestic trade. With encouragement to business enterprise, the stranglehold of many guild monopolies became broken, and many customary restraints upon output were removed.

In studying the problem of government control of business in the United States, mercantilism is of great significance. As a revolt against excessive regulation under it, the *laissez-faire* theory of control of business arose.[1] English mercantilist policies did much to cause the American Revolution in the eighteenth century. For England roused the ire of the American colonists by forcing them to trade with the mother country on English ships, by attempting to keep the colonies as sources of raw material through forbidding the importing of machinery, and by tax policies designed to enrich English treasuries. Because *laissez-faire* and American freedom were reactions against mercantilism and because both occurred at the same time, a prejudice against government control over business probably influenced those who wrote the American Constitution and colored the character of early American business morality.

Mercantilism also contributed to individualism by encouraging the rise of a class of business enterprisers. Through the emphasis on manufacturing and trade, and the elimination of many domestic trade barriers, it aided in the development of a commercial and industrial class of business men. Although unwilling to extend free trade to foreign commerce, mercantilists saw economic advantages in breaking down local imposts, road and bridge tolls, and other barriers to free internal trade. The economic success of this domestic policy led enterprisers to desire the extension of freedom to other phases of economic activity.

3. The Modern Period of Control. In contrast to the controls in the medieval town economy and the nationalist states, the modern period of control is one in which the character and extent of government intervention in business have been undergoing change. Beginning with an individualistic revolt against mercantilism in the latter part of the eighteenth century, the modern period has witnessed the introduction of business controls largely for the purpose of curtailing what have been regarded as the abuses of individual business freedom. Most of the government controls which have been introduced in the United States and in England have resulted from the problems following the industrial revolution. As business has become more complicated and social welfare has become more dependent upon large privately owned industries, the shortcomings of the economic system led to public insistence upon government regulation, aid, and ownership of business. The industrial revolution raised problems which caused departure from *laissez-faire* in the United States, as elsewhere, and the development of monopolies in transportation and other industries formed the basis for positive regulation of business. Although these positive controls have been introduced to protect individuals from the power and abuses of business groups, the interventionist policies of government in the United States have continued until virtually every aspect of economic activity feels the influence of the government.

[1] It should be noted that under *laissez-faire* the control emanates primarily from competition and self-interest, rather than from the government.

a. Laissez-faire. The development of *laissez-faire* in the latter part of the eighteenth century has both a practical and an ideological basis. The rise of industry and trade and a class of enterprisers looking for means of increasing their profits led to a revolt against the restrictions of the mercantilist states and the local controls which had survived nationalism. The search for laws of Nature in the physical and biological fields led to the belief that "natural" laws might be found in human relationships. To those who found the restrictions of mercantilism burdensome, it was not difficult to conceive that such restraints interfered with the natural and beneficent action of economic forces. It remained, however, for Adam Smith, a Scottish professor, to popularize this point of view and show that the traditional mercantilist approach really hampered the very development of wealth it was supposed to encourage.

In his *Wealth of Nations*, published in 1776, Adam Smith called attention to certain economic principles based upon natural law [1] and indicated the proper duties and functions of government toward business. These principles, in so far as they relate to governmental economic policy, constitute what has been called *laissez-faire*, because the conclusion drawn from them was that, on the whole, wealth will be increased by letting the individual alone in his selfish quest for profit. Adam Smith, like the mercantilists, desired a strong and healthy nation. But, in contrast to them, he claimed that the wealth of nations would be greatest under a system in which government does as little as possible, particularly in the business field.

Adam Smith's works and those of other economists who made refinements in his compilation of economic principles were widely read, and did much to influence government policy. Smith himself was at one time engaged as an adviser to the government. The time was ripe for a revolt against mercantilism. The growth of capitalism, the rise of a class of business men who chafed under mercantilist regulation, and the existence of a period of intellectual revolt, all contributed to the popular success of Adam Smith's teachings.

According to Adam Smith, the duties and functions of government are few. It should protect the nation against foreign violence or invasion. It should protect the individual through the administration of justice. It might establish and maintain certain public works, such as streets, canals, and harbors. It might contribute to schools and churches. If absolutely necessary for national defense, import duties might be levied to insure self-sufficiency in such things as war supplies and shipping. The liberty of those engaged in banking might be restrained in the interests of liberty of the whole society. Interest

[1] The idea of natural law permeates Smith's work. He felt that men had been endowed with a self-interest by which public good would be promoted. Self-interest, if allowed freely to influence actions, would act as a sort of "invisible hand" to promote greater wealth. Thus, the natural propensity to trade and barter leads to a division of labor and this to greater efficiency in production. The natural desire for profit leads business men to invest capital in enterprises for production of goods which society wants. For a discussion of this philosophy in Smith's works, see Bonar, James, *Philosophy and Political Economy* (New York: The Macmillan Company, 1893), bk. II, chaps. VIII and IX.

rates might be fixed by law to prevent usury. The government might provide free schools for those who could not afford private education. Certain regulations in favor of labor might be fair and equitable.

It is difficult to say how much further Smith would have gone in increasing the scope of governmental activity. One can say that he did favor governmental assistance to encourage the production in his home country of such goods as might be needed to repel an invasion, and which would not be produced domestically without assistance. Moreover, he favored government operation of such enterprises as might be needed by the people but which would not be undertaken privately because of lack of prospective profits.

However, Adam Smith and the *laissez-faire* economists of the eighteenth and nineteenth centuries placed their main reliance on the individual. An individual, left to his own desires, would buy what he wanted as cheaply as possible, sell for as much as he could get, engage in work most profitable to himself, produce goods in which the greatest profit lay, and conserve those goods the scarcity of which made their prices high. Thus he would gain the greatest material income with the least cost. From this position, it was deduced that a nation of such individuals would be a nation in which there would be the maximum of satisfaction with a minimum of pain.

To safeguard the community against adverse effects of individual selfishness, competition among sellers, buyers, and producers, including workers, would furnish the necessary control. In other words, if competition could be made free and governmental restraints reduced or eliminated, individuals could intelligently exert force to keep human greed in check.

b. Industrial revolution and laissez-faire. The exponents of economic freedom, although standing at the very threshold of the industrial revolution, did not visualize the evils of the factory system, the development of the business corporation, or the effects of huge enterprises, such as the railroads and other public utilities, or great industrial combinations, upon public welfare. *Laissez-faire* had no chance for trial, even though the restrictions of the mercantilist period were swept away in favor of a high degree of free trade, free competition, and free private enterprise. For as soon as a measure of freedom was introduced, the advance of productive technique and the increased scale of business operations raised problems which called for regulation. Before Great Britain had razed the last barrier to free foreign trade, government regulation of factory labor conditions had started. In 1846, the protective import duties on grain were repealed, bringing to success the efforts of the free-traders. But as early as 1802 the national government had begun to regulate the hours of work of factory apprentices. By 1853 England had passed a whole series of factory acts designed to limit the working hours and to improve the conditions of work of women and children.

In America, also, *laissez-faire* has never been fully tried. Protection to American industry was granted in the very first tariff measure passed in 1789,

and by 1824 the protective tariff as a governmental aid to industry was strongly imbedded in American politics and legislation. As early as 1791 the national government chartered the United States Bank as a semi-publicly owned bank. Various states also engaged in banking in the early nineteenth century. Congress prohibited foreign-owned ships from engaging in the coastal trade. State governments, with state funds, built turnpikes, canals, and railroads, or contributed heavily to those enterprises.[1] In order to protect its investment in the Erie Canal, New York prohibited certain railroads from carrying freight until 1851. Charters granted to canal and railroad companies also usually included direct regulation of rates.

The United States of the nineteenth century has been thought of as genuinely individualistic. But at no time has a *laissez-faire* policy been tried fully. The very development of business, beginning with the demand of industry for the protective tariff, has been accompanied by the growth of governmental control through ownership, subsidy, or regulation. To be sure, labor regulation and regulation of railroads, beyond that found in the early charters, came in the last half of the nineteenth century. But the industrial revolution was hardly in effect before that time in this country. Even banking regulation, tried in various forms since the founding of the republic, did not become very effective until after 1850.

c. The Granger Movement. As early as 1836, Rhode Island created a commission with power to inquire into railroad "transactions and proceedings" so that the people of that state might "secure . . . the full and equal privileges of the transportation of passengers and property . . . granted . . . to the citizens of another state or states." Commissions with like powers were established before 1860 in New Hampshire, Connecticut, Vermont, New York, and Maine. The Massachusetts commission, created in 1869, was little more than a group to advise the state whether the railroads were living up to their charters, to suggest policies of public interest to them, to require uniform accounts and reports, and to recommend needed legislation.

The real stimulus for more positive regulation came with the Granger Movement of the late sixties and the seventies. Farmers in the West and South, disgruntled at high transportation rates which reduced their profits, inflamed at paying higher rates than industrialists did at competitive railroad points, and aroused by the arrogant attitude of railroad executives whose roads the money of small communities had helped to build, took political action to curb the railroads. In 1871 Illinois passed laws that set maximum rates and prohibited discriminating fares or charges by railroads and grain elevators. Similar laws were passed in Minnesota, Wisconsin, and Iowa in the same decade.

Using the interstate commerce power for the first time for positive regulation, the federal government, stimulated by the Granger Movement and the failure

[1] For a discussion of these excursions into business, see Persons, W. M., *Government Experimentation in Business* (New York: John Wiley and Sons, Inc., 1934), chap. III.

of Granger laws to regulate railroads extending their lines over state borders, entered the field of railroad regulation in 1887. This recognition of the failure of *laissez-faire* is important, not only because it marked the placing of one of the nation's largest industries under federal control, but also because the experience with railroad regulation has made the country realize how powerful the interstate commerce power can be in regulating businesses which affect interstate commerce.

d. Monopoly and "trust-busting." The Granger Movement brought about regulation of rates and practices in those businesses which have come to be regarded as "affected with the public interest" and in which monopoly is not only likely but often desirable. A few years later, with passage of the anti-trust laws around 1890, the cloak of regulation was thrown over businesses other than quasi-public ones. However, the policy used was fundamentally different. While railroads were ordinarily regulated by limiting rates and prohibiting certain practices, the anti-trust laws were aimed at breaking up combinations of business so that freer competition might be restored to safeguard public interest.

The growth of business combinations after the Civil War was a natural result of business development and of the apparently unlimited opportunities for the exploitation of natural resources. Paced by the privateering tactics of the Standard Oil combination, the combinations in tobacco, steel, whiskey, sugar, and other fields gained virtual control of the production and marketing of many commodities of general use. To meet this threat to the competitive system, individualistic America, although claiming that it was promoting business freedom, threw overboard practical belief in *laissez-faire*. For with state and federal laws passed in 1887 to 1914, the dislike of freeborn Americans for the power of "trusts" was crystallized into a vigorous legislative policy to break these combinations into competitive parts. When industrial leadership found new ways to conspire against the consumer and to monopolize business, new regulations were devised, often belatedly, to further the policy of "trust-busting."

Contend as one might that the anti-trust laws were designed to restore economic individualism and free competition, in reality they represented an excursion into the field of government control which has not been retracted, and which has led to further government control through regulation of unfair competition. For the attempt to control big business and to keep it from conspiring to restrain trade has brought about the regulation of trade practices of smaller business men as well.

e. Modern period of control. The increased tempo of government control of business has led some persons in recent years to believe that New Deal laws represent nothing less than a revolution. To the extent that a revolution is really the accentuation of forces set in motion at an earlier date, this is a fair characterization. Actually, the roots of this new day of government control over business may be found in earlier developments.

Regulation of public-utility holding companies is an outgrowth of public-utility regulation, which in turn may be traced to the unwillingness of nineteenth-century American shippers to see railroad businesses operating according to free competition. New Deal subsidy policies in myriad fields are little more than a large-scale application of principles incorporated in tariff policies and in earlier subsidies to road, canal, and railroad-building. Strict banking regulation, credit-control measures, stock-exchange regulation, and even security-issue restrictions are not unnatural developments of the century-old struggle for sound money, banking, and investment within the framework of private enterprise. Motor-vehicle, aviation, and water-carrier regulations are understandable as expansions of transportation control. Laws to enforce competition begin with breaking up large monopolies, and proceed to regulations to keep all business from interfering with what comes to be regarded as "fair" competition. Labor laws, first designed to keep women and children from working unconscionably long hours, grow into regulations to keep the employer from working men too long, setting wages too low, or interfering in any way with what popular opinion comes to regard as labor's rights.

One could go over the entire field of present control and find in nearly all, if not all, cases regulation of the last century which embodied somewhat similar principles. Once a people has come to the conclusion that the *laissez-faire* code does not give the protection claimed by the eighteenth-century economists, the natural impulse is to turn to political measures to gain that protection. Daniel Boone may have been a rugged individualist, but the freedom-loving American of the eighteenth and nineteenth centuries early forsook economic individualism. Since progress brings new business techniques, new economic problems, and greater danger to the person-to-person higgling of eighteenth-century competition, it has been only natural that government control over business should increase. Whether it has gone too far is much more than an academic question. Whether it should or will go further is an important problem of the future. Whatever may be the answers to these questions, the fact remains that we have definitely, and probably irretrievably, broken with *laissez-faire*.

B. SOCIAL ORGANIZATION AND CONTROL

In sketching the development of the problem of control, reference has continually been made to individualism as a governmental policy in dealing with business. The typical individualistic philosophy of the eighteenth- and early nineteenth-century economists has been dealt with as a policy of *laissez-faire*. Although the evolution of government control indicates that such individualism was never completely or consistently adopted by this country, lip service at least has been given to a system of free private enterprise, predominately individualistic in character. An understanding of the policy of the govern-

ment toward business in the United States can be aided by noting the basic nature of representative philosophies of government.

1. Basic Philosophies of Government. While it is impossible here to differentiate in detail between philosophies of the place of government in economic life, some insight may be obtained by a brief examination of the leading types of philosophies of economic-social organizations. They range from extreme individualism to extreme collectivism. They have sometimes been classified as anarchism, individualism, collectivism, socialism, and communism. However, the fundamental philosophies can be represented by noting the principles of individualistic and collectivistic organizations.

a. Individualistic organization. In general, individualistic philosophies glorify the individual and regard the state as an evil, though usually necessary, means of control. Extreme individualism would be anarchy, for the anarchist believes in the abolition of the state, or its extreme minimization, and in reliance for control on moral influence and the innate desire of human beings to do good. The classical individualism of the eighteenth- and nineteenth-century liberals disapproved of governmental interference and regulation, but recognized that for some purposes the protection of the state must be called upon. However, in business matters classical individualists believed that human self-interest and freedom of competition would bring about a maximum of satisfaction with a minimum of pain. They believed that the state might limit an individual's liberty if by doing so liberty of action of the mass of society would be increased. However, according to them, this limitation when applied to protect private property and free competition should not go so far as to restrict ordinary business dealings. It is interesting in this connection that advocates of increased governmental interference in business since the first World War have often based their position on the proposition that, by new regulation, the state was actually increasing liberty of action for the many at the expense of the few.

The type of individualism often referred to as "rugged" individualism, which has been current in the twentieth century, and of which Herbert Hoover has been regarded as the spokesman, is hardly individualism. While extolling free private enterprise, individual freedom of action, and non-intervention of government in business, a high degree of governmental interference has been encouraged. Rugged individualists approve regulating public utilities, enforcing anti-trust laws, maintaining tariff protection, subsidizing waterways and other public works, furnishing statistical and other business aids such as standards of measurement, lighthouses, and consular services, and protecting labor against unhealthful hours and working conditions. Indeed, the difference between the rugged individualist and some collectivists is only one of degree.

On one point the rugged individualists are in pretty fair agreement. While regulation of business to "promote" individual freedom is acceptable and

necessary, actual government ownership of business, where private initiative has a chance of serving adequately, fairly, and profitably, is not to be countenanced. Even so, some present-day individualists have gone so far as to claim that the basis for government ownership or subsidy should be whether or not, taking into account all costs, including taxes, the government can produce a desired service more cheaply than can private enterprise.[1]

One can hardly recognize the Herbert Hoover type of individualism as belonging to classical *laissez-faire*. The admission of government intervention in business, even on the scale found in 1929, is evidence of the failure of *laissez-faire* as a practical political program in a period of complex social and economic relationships.[2] For as business grows more complex, the safeguards of individual action through competition and discrimination become less effective. The increase of governmental interference is a recognition of the fact that what is good for the individual may be harmful to society.

b. Collectivist organization. Collectivism is based upon the principle not only that the state is a necessary instrument of control but that state promotion and ownership of business are desirable.[3] Thus twentieth-century individualism tends to shade off into collectivism, for government aids to business, regulation for business welfare, and ownership of public utilities, the post office, waterways, and power dams are essentially collectivist.

Many types of collectivism exist. Wherever authoritarian control by government over business is found, the state may be regarded as collectivistic. Some persons would point to trade associations, trade unions, the corporation, and other organizations under which a group joins together for a common purpose as being somewhat collectivistic. Within their spheres they are; but a collectivist social organization implies that the state assumes a rôle whereby it acts in the benevolent interests of its members. The common classification of collectivist organizations is socialism and communism, although there are many types of each to be found in political-economic theory and in actual governmental programs.

Socialism implies the ownership of productive goods by society. It varies from state socialism, which advocates government ownership of key productive industries, and guild socialism, which advocates organization of the state into guilds of workers and consumers for the ownership and control of productive property, to complete government ownership of all property. A thoroughgoing socialism approaches communism, the only clear distinction being that

[1] See quotation from speech of Professor F. R. Fairchild in *Nation's Business* (June, 1938), p. 42.

[2] One might claim that in its underlying principles the rugged individualism of 1929 was the same as the *laissez-faire* policy supported by Adam Smith. But the occasions for government interference became so numerous as to cause exceptions to free action to be great enough to modify the substance of individualism.

[3] In a broader sense, the writer would regard as collectivistic in character those policies by which industry is socially controlled through some sort of central agency established by group interests as against individual interests.

communism places social ownership over consumers' goods as well as producers' goods, while typical socialism would retain private ownership of income, although abolishing private rights to some or all productive property.

2. Social Organization in Practice. In looking at the government and business relationships of the leading countries of the world, one finds a predominance of collectivistic philosophy in practice, and yet many remnants of individualism. The broad authoritarian programs of Soviet Russia, National Socialist Germany, and Fascist Italy are prime examples of the operation of many collectivistic principles. Soviet Russia has gone furthest in its application of collectivistic principles with its universal public ownership of business in mining, agriculture, trade, manufacturing, transportation, and other fields of economic activity. But it has retained some of the individualistic features of private ownership in income and unequal compensation, piecework wages, and bonuses. Fascist Italy maintains private ownership of business and private ownership in income, but circumscribes this ownership with such controls that it has little meaning. Through "corporate" associations of workers and employers, the state dominates the economic system, fixing prices, regulating wages, limiting profits, directing the allocation of capital resources into industries, and determining the quantities of goods which should be produced. National Socialist Germany has followed the principles of Fascist Italy. Private ownership in property and income still predominates over government ownership of business. But through national organizations called "estates," controlled by the government, and in which membership is compulsory for all business enterprises, the production of goods and services is made to follow the dictates of the state.

Even the so-called democratic nations, such as Great Britain and the United States, have adopted collectivistic principles, although far more individualism may be found in these countries. In both these countries, private ownership of property and income predominates; yet the governments own many business enterprises. They also exert many regulations over private business and undertake many promotional programs to encourage private enterprise in certain industries. These activities are essentially collectivistic, in that they are based on the desirability of government control of business as a means of protecting and promoting the public welfare. Even so, the application of collectivistic principles in the United States and Great Britain has not gone nearly to the extent which has been prevalent in the authoritarian or totalitarian countries. Business men still enjoy much freedom. Many goods are sold at prices and in quantities desired by individuals. Most wages are free of government control. The way in which things are produced, the places they are produced, and the persons who produce them are among some of the fundamental aspects of economic activity which are still subject to much individual freedom.

American social organization, then, represents a combination of collectiv-

istic and individualistic principles and practices. It is individualistic in the sense that much freedom is still enjoyed by business men, workers, and consumers. The many regulations, aids, and cases of government ownership are collectivistic in nature. The development of income and inheritance taxes, relief, pensions, and wage regulations, by modifying private property in income, may be regarded as similar to certain communistic tenets. Perhaps American social organization is in flux and a new form of organization will be built from certain components of individualistic and collectivistic organizations. However this may be, the social organization which is now being formed can be, and should be, molded by the force of an enlightened public opinion operating in a system with free expression and free use of the ballot.

C. THE PROBLEM OF CONTROL

The nature, limits, and means of government control of business present a problem of the greatest magnitude. What is the appropriate field for regulation? When should the government subsidize industry by outright grants? What is the economically and politically desirable kind of aid the government should give to business? When is it wise for government to enter business as an owner? What sort of policies should it pursue once it has intervened in business? To what extent is it desirable for it to reduce economic productivity to gain non-material happiness for the masses? What are the appropriate means of exerting control? Since government is not an abstract institution, but one whose actions are those of the human beings executing them, and since human beings are limited in intelligence and ability, how can the real social welfare be perceived, and, if found, attained?

These are problems of vital importance to the members of society. If satisfactory answers are not discovered, and an intelligent citizenry developed to cope with the problems, perhaps those who see civilization plunging into a new Dark Age are more than hollow pessimists. Because government control is so susceptible to human frailties, nothing can be more vital to those controlled than to see that the controls are designed to promote both material and non-material welfare. Through the fundamentally democratic nature of American government, there is a possibility for individuals to guide group policies.

One must recognize that the problem of control is complicated by the failure of "ideal" representative government. Under one widely accepted theory of representative government, lawmakers are selected by the people to act in the best interests of the entire nation or state in accordance with the judgments of these legislators.[1] But government in the United States has apparently become increasingly subject to pressures of interested groups. Manufacturers press for tariff laws to keep out foreign competition with no thought that the

[1] See Coker, F. W., and Rodee, C. C., "Representation," 13 *Encyclopedia of Social Sciences* (New York: The Macmillan Company, 1934), p. 313.

consumer should get the most satisfaction from his purchasing power. Farmers press upon legislators to pass laws which will give them as a class a greater proportion of the national income. Labor groups force lawmakers to enact legislation which will place them in a more monopolistic position. Disillusioned investors push for regulation of banks, trust companies, stock exchanges, and issues of securities so that they may be better protected. Many more examples of pressure groups, of which the greater number are much smaller than those referred to here, could be given. While often the objectives of these groups are in the wider public interest, the system of legislating in accordance with group interest rather than general social interest is, in the opinion of the writer, a dangerous kind of democratic government. The difficulty is that the problem of control is not viewed in its entirety, and that the interests of various groups may be conflicting as between themselves and in conflict with public welfare.

The scope of governmental control is defined by conflicts. Prevailing mores not only shape the sort of government interference which may be enacted, but set some limits beyond which the government should not go. Price competition was looked upon as the "life blood of the American system" some years ago, but became a source of danger during the depression of 1929 because it was "unbridled" and "destructive." Even then, with the advent of price-control devices under the National Recovery Act, public opinion shrunk from government enforcement of a code of "fair competition" which caused a small shopkeeper to go to jail because he charged a price which seemed reasonable to him.

Although ultimately shaped by public opinion, constitutions limit governmental control of business. Legislators can pass laws calling for any sort of business regulation. However, such laws cannot be enforced if they are not in accord with constitutional powers as interpreted by the courts. Even though public opinion may desire this regulation, the lag between court interpretation or constitutional amendment and public opinion, as well as the traditional respect in this country for constitutions, circumscribes attempts at control.

The scope of government control is also limited by the difficulty of regulating one part of the social machine without interfering with other parts. Thus, if the government passes a tariff bill, the interests of the protected manufacturers clash with the interests of consumers, and of industries producing for an export market. Regulation of free entry into the public-utility business and of public-utility rates protects consumers against the inefficiency of cut-throat competition, but places a premium on padding operating expenses and investment accounts so that high rates may be supported. A program of competitive building of public-utility plants by the government conflicts with the investors and managers of privately owned plants. Taxing chain stores is a method of protecting independent merchants from burdensome competition, but it may

well make groceries, drugs, and shoes expensive to the consumer. Passing labor laws requiring minimum wages, maximum hours, or collective bargaining introduces a conflict between the desires of labor and the time-honored rights of private property.

As a matter of fact, it is difficult to conceive of a case of governmental intervention in business which does not clash with some existing property right. One of the major tasks of legislation is to balance the interests involved in these conflicts. If those interests likely to be affected are at all articulate, the very necessity of balancing them is a limitation on government interference with business.

It is the aim of the succeeding chapters of this book to examine the problem of government control of business in the United States from the point of view of legal, administrative, and economic principles. If it appears that much of the emphasis is placed on the analysis of government control measures which preceded the New Deal, let it be remembered that an understanding of present policies and of future possibilities of policy depends upon principles which have been employed and problems which have already been met. New extensions of government control very often follow patterns which have been worked out in the past. Thus, new measures for price regulation are likely to encounter the same problems and the same techniques as has price regulation in public utility regulation. The concept of an unfair competitive practice included in legislation in 1914, and its administration by the Federal Trade Commission form a pattern for the concept of unfair labor practice under the National Labor Relations Board. A study of the basis, principles, and problems of present government control of business is a vital need for the intelligent citizen, and should serve to show what to expect if new types of control are undertaken.

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CHAPTER

2

PROPERTY, CONTRACT, AND THE GOVERNMENT

A STUDY of government control of business is basically an analysis of the relationship between the state and the individual in respect to the bounds of individual rights. Because the concern in this book is primarily with government and business, the discussion of the relationship is limited to those rights upon which private business depends. If any degree of free private enterprise is to exist, the institutions of private property and contract are essential. Government control of business, then, is really a limitation on the free functioning of these institutions, for one cannot conceive of any government aid, regulation, or ownership which does not invade the privacy of property and contract. As government intervention in business matters recedes, progresses, or changes in any way, the meaning of property and contract is affected.

Recognition of property and contract rights as fundamental legal institutions is found in the American Constitution (to be analyzed presently in its relationship to control). But just as the law is a reflection of the mores of society, and because property and contract are *social* institutions as well as legal, the definition of these rights in law and in fact follows the course of social custom. The change in these institutions may be recognized belatedly by the law, for legislative or constitutional change and judicial interpretation are notoriously slow. But if the mores change, the legal concept cannot long resist following suit.

A. WHAT IS PROPERTY?

Property is often thought of as tangible wealth which a person, corporate or real, holds as his own. In reality, property is a complex of rights to all things, tangible or intangible, which have some exchangeable value to the person possessing these rights. It is essentially ownership. As Justice Cardozo once said, employing the concept of the law, " . . . ownership . . . is only a

bundle of rights and privileges invested with a single name." [1] This "single name" may be that of a real person, or a corporate person owned by real persons. Or it is entirely feasible to think of ownership as invested in a government. If the former is the case, the property is private property. It is with private property, rather than public property, that we are concerned here, for private property rights are those which are limited by expansion of governmental control.

What is this "bundle" of rights? To answer this question accurately is really to describe the whole system of government control over property, for in so far as this control is in the hands of public authority, private property rights do not exist. Traditionally, the rights of private property involve several things. They imply the power to prevent others from using the tangible or intangible object, power to dispose of the object as the possessor sees fit, power to use it in whatever way he desires, and power to require certain concessions as a condition for use by others. Notice that the existence of these rights implies an obligation on the part of others to abide by the rights. If this obligation is not enforceable, the rights cannot be said to exist. For certain periods, government may enforce rights which the mores do not support. But history is replete with examples of bringing rights into agreement with the prevailing mores; in extreme cases, revolutions have occurred and blood has been shed to make rights consonant with that which the group has regarded as essential to its welfare.

The objects over which property rights are held may be tangible or intangible. The accepted basis is that these things must have an exchange value, but this has not always been the legal interpretation of objects of property. As Professor Commons has pointed out, the United States Supreme Court did not finally recognize that property consisted of exchange value, rather than use value, until 1890.[2] The use-value concept of property was that it included only those physical objects which an individual held for his own use and enjoyment. Thus, a person's labor was not property nor his freedom to charge what he desired for his services. The exchange-value concept implies that property covers anything which has a value of a salable nature. Consequently a person's labor, the good-will of a business, an individual's credit, his knowledge, especially when patented or copyrighted, and even his liberty to make a contract concerning any of these things, have been regarded as property.

In the field of economic activity, the very definition of property gives a clue to the meaning of liberty. Property rights imply freedom to enjoy the powers given by the rights. The property rights which Smith holds impose a restriction on the liberty which Brown has, for Brown must respect Smith's rights.

[1] *Steward Machine Co. v. Davis*, 301 U.S. 548, 581 (1937).

[2] Commons, J. R., *Legal Foundations of Capitalism* (New York: The Macmillan Company, 1924), p. 14.

When Smith's liberty attaching to his use of property conflicts with Brown's liberty obtained from his property, the clash must be resolved in line with principles which society approves. Thus, if an oil refinery in the free use of its property pollutes a stream which curtails the free use of the property of individuals living on its banks, some solution of the respective boundaries of property rights must be effected.

B. WHAT IS CONTRACT?

From a business point of view, a contract is an agreement between two or more parties to do or not to do certain things which is enforceable by law. Contracts usually involve the transfer of property rights, and to be legally enforceable must fulfill several conditions. In the first place, the parties to a contract must be legally capable of making it. Minors, imbeciles, and undischarged bankrupts may not enter into a business contract. A person may not contract away property rights which he does not possess. Thus, if Smith agrees to sell Brown's car to Jones, the contract is not legally enforceable, since Smith is not capable of disposing of Brown's property. Moreover, agreements obtained under duress or misapprehension are said to incapacitate at least one maker of the contract.

In the second place, the contract must be in accordance with existing laws of the state in which it is performed. If a state has a law forbidding the sale of alcoholic beverages, Smith cannot make an enforceable contract binding Brown to sell him such liquor. It is even held that contracts are made subject to any future laws which a state may find necessary to make in order to care for the health, safety, morals, and welfare of its members. Hence, if Smith has a contract with Brown for the sale of alcoholic beverages and later a state passes a prohibition law, the contract is subject to the law. Moreover, a contract to be enforceable must not be inconsistent with sound public policy. Thus, an agreement to monopolize must be held unenforceable because monopoly is regarded as an unsound policy. Or an agreement whereby Smith promises to pay Brown five dollars if a certain horse wins a race would be found unenforceable where gambling was regarded as inconsistent with desirable public policy.

A third condition for a business contract to be enforceable is that it must be for a valuable consideration. This is to assure the binding of the contract and to give evidence that a mutual exchange of things of value has been made. In other words, a "consideration" is evidence that the minds of the parties have really met, for no one can be presumed to make an agreement unless he gets an advantage from it. As is commonly known, however, there is nothing in the law to insure that the "valuable consideration" will result in an equal and fair exchange.

Contracts may be written, oral, or merely implied. The embossed contract

attested to by notaries and covered with seals and red ribbons is no more a contract than the mutual agreement between two or more parties which is not even put into writing. To be sure, the carefully drawn contract may be more easily enforced because its existence and provisions can be more easily proved. But the individual who drops a dime in the fare box of a passenger bus has made a contract with the driver as agent of the bus company for the performance of a transport service. Although this contract is not even oral, but has only been implied, it is nonetheless enforceable if all the conditions for entering the contract have been fulfilled.

For practical purposes, business contracts grow out of property. If there were no property rights, freedom to contract and enforceability of contracts would be practically devoid of meaning. In the case both of property and of contract, the rights involved not only are interdependent but rely for their effective existence upon the willingness of the state to see that they are protected.

Economic life under a system involving any freedom of individual action would be impossible without contracts. Every purchase and sale involves one. The deposit of funds in a bank, the borrowing of funds, investment in securities, and engaging brokerage service constitute contractual obligations. The state which grants a charter to a corporation makes a contract. The corporation officers who are duly empowered to act make a contract when they hire labor, buy materials or supplies, or lease land. The individual who has dental work done, or has a telephone placed in his house, or orders a pound of coffee from the corner grocery store, enters into a contract. Indeed, taking business in its broadest meaning, it is difficult to think of business relationships without the existence of contracts.

If these contracts were not enforceable, business as it is generally known could not continue. But the very fact that the state enforces contracts means a great degree of governmental control; for the establishment of principles upon which contracts can be made, the interpretation of contracts, and the application of legal relief for their non-performance open a large field for control. In one direction alone, that of determining when contracts are made in accord with sound public policy, the possibilities for legislative and judicial limitation of free contract are tremendous. It is interesting that in insuring enforceability of contracts and freedom of contract, the liberty of those who make such agreements is sharply curtailed.

C. PROPERTY AND CONTRACT: NATURAL RIGHT OR SOCIAL PRIVILEGE

The American nation was founded by individuals among whom the idea of natural rights was current. At the time of the American Revolution the theory was generally accepted in political philosophy. In the preamble to

the Declaration of Independence, the political philosophy of the founders is clearly given by the statement that "we hold these truths to be self evident: that all men are created equal; that they are endowed by their Creator with certain inalienable rights: that among these are Life, Liberty and the Pursuit of Happiness." It is probable that among the liberties held to be "inalienable rights" were the rights to hold, use, and dispose of property, and the right to make business contracts which the government would enforce.

To understand the position that property and contract are natural rights, one must turn to the works of the natural-rights philosophers in the early eighteenth century; of these, John Locke is representative.[1] In attempting to explain the rise of the state, Locke, as did other political philosophers of the natural-rights school, maintained that in the original state of nature men were born equal and free of subordination and subjection. The state of nature had a natural law to govern it, which law would be respected because of man's force of reason. This natural law held that individuals, being equal and independent, should not harm each other's lives, health, liberty of action, or possessions. While men might unite in a community, they should be subject to government only by consent, and in no case should their natural rights be taken from them.

Thus, for the natural-rights philosopher, property and contract became "inalienable" in the sense that such rights and liberties naturally belong to men. Because government is created only by consent of the individuals establishing it, government should not impair these rights. If it did so it would be interfering with natural law.

In spite of the theories of natural rights which dominated the philosophy of those who framed the Declaration of Independence and the Constitution, the rights they regarded as so inalienable have undergone change. Modern political and social theory takes an entirely different view of them. Property and contract rights, to say nothing of others, are regarded as social privileges. The private holding of property and the making of a contract are rights enjoyed by individuals because the mores of our social order support them. Property and contract, being social institutions, cannot accurately be regarded as natural in the sense of being absolute or bestowed on man by the Creator. Social institutions change as do the folkways and mores which constitute them.

The fact that rights are really social privileges is illustrated by the development of new "rights." Our American society is apparently beginning to accept as such the right of laborers to a job and of individuals to a material standard of living on a subsistence or better basis. If laborers have a right to a job, then property-owners lose some of their prerogatives of ownership, either through being required to hire labor when they would prefer not to, or being

[1] For Locke's political philosophy see his *Civil Government* (London: Routledge, 1884) or Lamprecht, S. P., *The Moral and Political Philosophy of John Locke* (New York: Columbia University Press, 1918).

subject to taxation so that the government can hire labor. If people have a right to the material necessities of food, clothing, and shelter, then private property must be forced to contribute by way of minimum wages or taxes for relief appropriations. The owner of private property no longer has the freedom to contract for labor at whatever figure he pleases. If society grants that laborers have a right to organize and bargain collectively, then labor contracts can no longer be made upon whatever terms an employer and individual laborer may accept.

So long as property and contract are social in nature, it is difficult to perceive anything natural, inalienable, or absolute about them. Because they are rights, and rights involve obligations on the part of others to do or not to do, one can hardly avoid the conclusion that they are social in nature. Property and contract being social institutions, instead of absolute laws, their metes and bounds are necessarily defined by the desires of society itself. As sociologists are aware, what is "right" or "just" in society is determined, in the long run, by the mores of the group. Social morality is a changeable standard, and it is certainly unsound to claim any fixity or absoluteness for social rights.

D. JUSTIFICATION OF PRIVATE PROPERTY AND CONTRACT

The almost religious respect for private property and contract seen in the social and legal history of business relations, especially since the industrial revolution, must have some justification. While society has seen fit to modify these institutions, legal encroachment upon property and contract rights has been brought about slowly and only in response to exceptional public needs. Any student of constitutional law is aware that the courts and the legal profession have been particularly solicitous of property and contract rights. Legislative action designed to curtail them must still be based on public need if the law is not to be held a taking of property or liberty without due process. While the courts have apparently been taking a more flexible view in the last few years of the inviolability of these rights, the fact remains that they are the bulwarks of the American system of capitalism.

A relatively unrestricted system of private property is said to stimulate individuals to productive activity. The desire to own is a strong motivating force which leads human beings to do in the most efficient way that which is productive of satisfaction to others. This quest for income would hardly be so sharp if it were not possible for a man to gain something which he can call his own and which will return him, directly or indirectly, a measure of satisfaction.

The desire to own and to enjoy the fruits of one's ownership is also largely responsible for saving. It is possible that the state could force saving, or de-

velop a moral standard which would make saving a "good" thing to do, under a thoroughgoing communistic system. But it is extremely doubtful, with human nature what it is, that the spur of ownership in saving could be replaced with a motive as effective. The accumulation of capital, largely the result of some kind of saving, in countries where private property is respected is evidence of the strength of this force. That an increasing fund of capital is requisite to increasing material welfare is hardly to be denied. If private property aids in effecting this, as it certainly does, one can understand the social solicitude for this institution. The protection of private rights to large fortunes has been defended on the ground that society stands to benefit by the fund of productive capital thus made available.

Private property is also justified as being the basis of personal liberty.[1] It cannot be gainsaid that in a capitalistic society real personal liberty is meaningless, if at all possible, unless the individual has property rights of some sort. As a matter of fact, one of the reasons why regulations in behalf of labor's liberty and welfare have to be made is that labor as a group is bargaining to sell its service with an employer who has property. If, as is so often the case, labor has no property to fall back upon in the event that a mutually agreeable wage and working-condition bargain cannot be made, the seller of labor must accept a bargain which is destructive of his personal liberty.

Practically every justification one can think of for private property applies also to the freedom of individuals to make contracts which the state will enforce. Property rights would be empty claims if agreements back of which the authority of the state would stand could not be made. In discussing contract, its importance to practically every aspect of our economic life has been indicated. If a system of private property can be justified, the integrity and freedom of contract must be accepted as a necessary corollary.

E ABUSES OF PRIVATE PROPERTY AND CONTRACTS

Actually, freedom and inviolability of private property and contract can become tyranny. The freedom of a moneylender to make loans to an ignorant or desperate borrower at exceptionally high rates of interest may subject the borrower to servitude which society does not desire. The freedom of a manufacturer to sell adulterated or harmful goods to an unsuspecting customer leads society to curtail his right to his private property and his freedom to make a sales contract. Experience with early freedom of property and contract in the railroad field taught farmers and small-business men that their economic welfare necessitated interference with the rate-making and service-producing activities of railroads.

[1] This idea and other justifications for private property may be found in Ely, R. T., *Property and Contract* (New York: The Macmillan Company, 1914), especially vol. 1, chaps. XII and XIII. Ely mentions among other justifications that private property is the "cement of society; it binds men together" (p. 304), in that, in order to get the greatest benefits from property, men have co-operated by means of such institutions as the corporation.

At one time a state supreme court refused to force a gas company to serve a customer on the ground that the company was, like any other manufacturer or vendor, subject to no obligations to serve.[1] But in a few years the public character of gas manufacture and distribution was so recognized that, in place of the right of a company to refuse to serve, there arose an obligation to serve reasonably and adequately. When the freedom of property and contract resulted in large combinations of businesses approaching a monopolistic character, forcing competitors to sell out at distressful prices, and engaging in other practices regarded as unfair, public opinion caused restraints to be placed on this freedom.

In the labor field, the prerogatives of property and contract were abused (as judged by the prevailing mores) when employers worked children long hours, or failed to look out for laborers' health and safety, or paid sweatshop wages. When popular feeling against these abuses became crystallized, rights to property and contract in this field were restricted.

These few examples show how private property and contract rights may be abused. The whole study of government regulation of business is an analysis of the attempts on the part of people to restrict someone's property or contract rights. In doing so, it is hoped to increase freedom of action by others. The regulation of business tends to be a sort of leavening process, whereby those who are for some reason incapable of defending themselves against free use of property and contract by others are protected. The state, in effect, is aiming to substitute its power for that which certain individuals lack.

So far as regulation goes, there can hardly be any other reason for government intervention. Otherwise competition should be a sufficiently adequate regulatory force. Even when one considers government aid to industry or government ownership, the basis should be that private property cannot fulfill the demands made by society.

What society needs by way of protection or encouragement is difficult to say at any particular time or place. As Justice Cardozo asserted a few years ago: "Needs that were narrow or parochial a century ago may be interwoven in our day with the well-being of the nation. What is critical or urgent changes with the times." [2] The definition of property and contract is not fixed, but depends upon what the predominant public opinion believes the content of these institutions to be. Otherwise, property and contract would have to be regarded as absolute, a view which cannot be supported in the light of their social nature.

As will be clearer when a study is made of the American Constitution as a charter for government control, both property and contract rights have existed subject to certain public powers. No one would deny to the American system of government the power to take property under eminent domain, to

[1] *McCune v. Norwich City Gas Co.*, 30 Conn. 521 (1862).
[2] *Helvering v. Davis*, 301 U.S. 619, 646 (1937).

interfere with property and contract under the police power, and to levy taxes for the support of government. Sovereign governments have the power to take private property for public purposes. This process, called eminent domain, involves fair payment for the property taken, though the property-holder cannot refuse to surrender his property or to accept a price set by a jury of appraisers. The police power is that power inherent in sovereignty to care for the public health, safety, morals, and welfare. Its use necessarily restricts property and contract rights. The power of a government to tax also limits property and contract. Strictly speaking, a tax does more than that, since property actually is taken without regard to fair compensation.

Even ardent protectors of property and contract would not deny these powers to government. Questions arise, however, over their proper use. Should the police power extend to setting wages so that the health, morals, and welfare of laborers will be protected? Should the power of eminent domain be used by the state to force public purchase of a privately owned electric light and power plant? Should taxation of incomes on an ability-to-pay basis be used as a method of equalizing the wide differences in individual income? It is on such matters as these that conflict occurs. The problem is not what power the government has, but within what limits it should be employed.

F. THE CHANGING CHARACTER OF PROPERTY IN MODERN BUSINESS

Lest the reader think that the government is the sole agency effecting a change in the nature of property, consideration might briefly be given to the growth of modern business and the modification of property involved there. The development of large business corporations has resulted in the divorce of ownership and control.[1] The trade union also has obtained ever-increasing concessions from property-owners. In doing so, they have wrought a significant change in the institution of property.

The theory of industrial democracy is that the stockholders, the real owners of a corporation, should exert control through voting their shares. Hence a majority of stockholders would control the policies of a corporation, mainly through their power to elect a board of directors. As a matter of fact, especially in large corporations, the majority of the stockholders do not exercise much control over the corporation. Often a certain group, usually allied with or consisting of the management, is able to maintain control over corporations for a long period of time without owning anything like the majority of voting stock.

Several reasons for the oligarchic nature of the large corporation can be

[1] For a detailed discussion of this point, see Berle, A. A., and Means, G. C., *The Modern Corporation and Private Property* (New York: The Macmillan Company, 1934).

given. In the first place, owing to the fact that many corporations have from 100,000 to 650,000 stockholders,[1] it would be physically impossible for all of them to attend the meetings. Even the attendance of ten per cent of the stockholders would make parliamentary procedure impracticable.

Second, diffusion of ownership of stock in a large corporation means that an individual stockholder has no actual power to do anything anyway. There are thousands of stockholders with less than a hundred shares of stock living in various parts of the world. The practical choice of such a stockholder is either not to vote at all or to assign his voting power by means of the proxy. If he does not vote, fewer shares are represented at a meeting and a small group can more easily assume control. If he assigns his voting power by proxy, the inside group, with ready access to the list of stockholders and with the function of sending out notices to them, will probably receive the proxies.

In the third place, the ordinary stockholder has neither the time, training, nor inclination to vote his stock in a way which would promote intelligent control. He is not primarily a stockholder, but a lawyer, doctor, or merchant who cannot easily become familiar with the problems and operation of the corporation. A further reason for the stockholder's indifference is that he cannot easily afford to attend meetings, even if he thought he could exercise some control.

The result of non-voting by stockholders, plus the proxy system, is often that stockholders' meetings become a formality and existing management is automatically perpetuated. This concentration of control in large corporations and the practical disenfranchisement of stockholders are not consistent with the principles of private property. Ownership implies control, and responsibility for control. While the divorcement of ownership and control does not necessarily result in abuse, the profit-making motive ascribed to private ownership, which is one of the economic justifications of a system of private property, may be lacking. The way is open for "professional" managers of the corporation to adopt policies which are not profitable to the stockholders. At times, insiders have paid themselves huge bonuses and salaries beyond an economically justifiable level, and have made uneconomic purchases of property, materials, and supplies, by which funds have been siphoned from the corporation to those who have the control.

Another example of the changing nature of private property lies in the development of the trade union. Even before the government took an active part in encouraging unionism, the trade union had worked a significant change in the institution of private property. When the time-honored prerogative of ownership whereby an employer rules by command is transformed to rule by

[1] According to the United States Department of Commerce *Survey of Current Business* for 1936, the American Telephone and Telegraph Company had over 657,000 stockholders, the Pennsylvania Railroad had over 227,000, and the United States Steel Corporation had nearly 185,000 stockholders, as of December, 1935 (p. 64). There are, of course, other corporations with more than 100,000 stockholders.

persuasion and by the consent of the governed, private property has surely been changed. The advent of collective bargaining through a central agency and the obtaining of trade agreements are evidence of this change. Unions have exerted control over methods of payment, wages, hours, discharge, and conditions of work. In those plants in which the trade union has gained power, the employer would be foolish indeed to make changes in such matters without consulting the union. The power exerted over the railway industry by the railroad brotherhoods, the strength of the building-trades unions, and the control exercised by the mining and clothing workers' unions are only a few examples of labor control over industry established long before the government took an active interest in labor-employer relationships.

In fact, the interesting thing about divorce of ownership and control in the modern corporation and the capture of partial control by trade unions is that these developments occurred within the framework of private property. Property was not changed by consumers or laborers or investors demanding that the government pass regulations. The modifications came independently of government intervention. Once these influences gave rise to problems which society could hardly overlook, the government intervened for the protection of some social group or groups.

These developments have seemed to some to make it all the more doubtful whether free private enterprise, with its corollaries, property, contract, and competition, can be relied on to protect society. There is no question that society has insisted upon making private property much less private. How far will this trend away from the sanctities of private property go? Will property in the future become really more public than private? What should be the rôle of the government? What underlying principles and problems of government control are presented? These are some of the questions which the intelligent citizen of today must be ready to answer.

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CHAPTER

3

THE CONSTITUTION AND CONTROL OF BUSINESS

AN ANALYSIS of government control of business in the United States can hardly be made without some understanding of the prevailing constitutional system. As many legislators have come to find out, the essence of a program of governmental intervention in business presents a legal problem which cannot be overlooked. The problem which must always be faced is not only whether the electorate desires a particular program of control, but whether the laws and their administration will be within the constitutional framework of the nation and the states.

American constitutions, as contrasted with the English Constitution, are written documents defining governmental power. Because of its paramount importance, the present discussion will be confined, for the most part, to the federal Constitution. It has influenced the wording of the state constitutions, and its grants of power to the federal government and its many restrictions on authority are binding on state and national governments alike. The student should not forget, however, that the whole of constitutional law includes more than the written Constitution itself. Interpretation of it by the courts, the elaborate statutory enactments filling in the framework of the written document, and the element of custom in giving meaning to terminology, form a part of the constitutional law affecting business. No attempt will be made here to analyze constitutional law in its entirety; this chapter will merely point out the legal foundations of governmental control over business.

A few general characteristics of the Constitution can be indicated. Under it, a federal system of government is established. In reality, there are two levels of American governments, the national and the state. Each has certain powers and certain duties. Those of the national government are expressly granted to it, and all powers not so delegated are left to the state governments, unless restricted by the federal Constitution. Through process of amendment, the people have the ultimate power to alter this alignment of powers.

Moreover, the Constitution does give the national Congress authority (art. I, sec. 8, par. 18) "to make all laws which shall be necessary and proper for carrying into execution" all powers vested by the Constitution in the government of the United States. This grant of implied powers has been the basis for the expansion of the scope of the national government beyond any possible conception of the writers of the Constitution.

As students of law are well aware, flexibility in the basic law has come through a steady expansion in the definition of powers granted to the federal government, or a less restrictive interpretation of limitations on powers. The elasticity of meaning of words and phrases has been seized upon by courts desiring to give legal backing to the prevailing mores. Some change in basic law has come through the adoption of amendments to the Constitution, but so far as the extent of powers of the federal government is concerned, this has been relatively unimportant.

A. POWERS OF THE NATIONAL GOVERNMENT UNDER THE CONSTITUTION

1. THE TAXING POWER. The Constitution (art. I, sec. 8) gives Congress "power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States." But all such taxes must be levied uniformly throughout the country, and direct taxes (art. I, sec. 9), except for income taxes (Amendment XVI), must be levied on the basis of population. The Constitution (art. I, sec. 9) prohibits the levying of taxes or duties on articles exported from any state. In addition to these limitations on the power of Congress to levy taxes, another has been implied. In a line of decisions beginning with the Day case in 1871,[1] the Supreme Court had refused to allow the federal government to levy taxes on state instrumentalities or on salaries of employees of state agencies. The basis of these decisions was that, without such exemption, the federal government could destroy the dual system of government which the Constitution had established. Along similar lines of reasoning, state taxation of federal government instrumentalities, including salaries of employees of federal agencies, had previously been prohibited.[2]

The doctrine of mutual tax exemption has recently been restricted sharply. In 1938 the Supreme Court held that federal taxation of admissions to University of Georgia football games was allowable; for football, even as played by a state university, was not a governmental instrumentality.[3] In the same year the Supreme Court upheld federal taxation of salaries of employees of the New

[1] *The Collector v. Day*, 11 Wall. 113, 20 Law. Ed. 122. In this case the federal government was held to be powerless to tax the income of a state officer.

[2] *McCulloch v. Maryland*, 4 Wheat, 421, 4 Law. Ed. 605 (1819); *Dobbins v. Erie County*, 16 Pet 435, 10 Law. Ed. 1022 (1842); *Rogers v. Graves*, 81 Law. Ed. 306 (1937).

[3] *Allen v. Univ. System of Georgia*, 304 U.S. 439 (1938).

York Port Authority.[1] In this case the Court held that non-discriminatory income taxation placed no burden on the Port Authority, which was admitted to be a state-government instrumentality. The Court recalled that the purpose of tax exemption in past cases was to prevent undue interference by one government with another.

Similar reasoning in a case in 1939 led the Supreme Court to uphold state taxation of incomes accruing to employees of a federal government agency, the Home Owners' Loan Corporation.[2] Assuming the loan corporation to be a government instrumentality, the Court found no tangible or certain economic burden imposed on the federal government by virtue of taxing employee incomes. Since the federal government is one of delegated supreme power, while state governments are not, the Court did imply that, should Congress so act, state taxation of employees of federal agencies might be curtailed.[3] In respect to income of employees, consequently, the doctrine of mutual tax exemption has been overruled.

As for the governmental agency itself, the scope both of federal and of state taxation is not clear. In the case of state agencies, there are those who claim that the income-tax power, by which the federal government is authorized to levy taxes on incomes "from whatever source derived," is adequate to give it the right to tax income from state bonds and other state instrumentalities. It is difficult to understand how the Supreme Court can overlook such cases as the National Life Insurance case [4] in which attempts to tax income of state instrumentalities have been thwarted. Yet, as has been pointed out, the seventy-year-old doctrine that the federal government could not tax incomes of state employees was overruled.

For years, there appeared to be no limits to the purpose of taxation except those specifically stated in the Constitution. The federal government was allowed to levy a protective tax on oleomargarine colored to look like butter,[5] and to control dealers of narcotics through taxation.[6] In both these cases, the Supreme Court took the position that so long as the tax was on its face a revenue measure the Court would not look into the motives of the legislature in levying it.

But the taxing power has been markedly restricted in a series of more recent cases. When it seemed to many that this power offered a means for widespread government policing of business, the Supreme Court held that the tax must be for revenue purposes, and for the common defense and general welfare. When Congress attempted to regulate child labor after the first World

[1] *Helvering v. Gerhardt*, 304 U.S. 405 (1938).

[2] *Graves v. New York*, 306 U.S. 466 (1939). [3] *Ibid.*, pp. 478–80.

[4] *National Life Insurance Co. v. U.S.*, 277 U.S. 508 (1928). In this case the federal government tried unsuccessfully to tax interest on state and municipal bonds in an indirect way. Also in the case of *Brushaber v. Union Pacific Railroad*, 240 U.S. 1 (1916), the Supreme Court held that Congress had only the power under the Sixteenth Amendment to levy income taxes without regard to population; that the amendment did not increase the subjects of taxation.

[5] *McCray v. U.S.*, 195 U.S. 27 (1904). [6] *U.S. v. Doremus*, 249 U.S. 87 (1919).

War by levying a tax on profits of businesses which employed children contrary to established regulations, the Supreme Court held that this was an improper use of the taxing power, and that the tax was here employed not for revenue but for coercion.[1]

Several New Deal laws met the same fate. The Guffey Coal Act, under which producers who agreed to certain price and labor provisions of a coal code were entitled to a credit of 90 per cent of a tax levied, was found unconstitutional by the Supreme Court in 1936.[2] In this case the Court held that the taxes and exemption were not intended for revenue purposes but for regulation in a field in which the national government was not empowered to act. In the same year, the Supreme Court upset the processing taxes by which agricultural control was to be effected under the Agricultural Adjustment Act.[3] The Court held that these taxes were not really taxes because they were levied for the benefit of a particular group (the farmers) rather than for the general welfare, and because they were used as a means for regulating a "purely local activity."

Consequently the federal taxing power, strong as it is, may not be used for purposes of regulation if that regulation cannot be undertaken through other powers granted to the government.[4] As the law now stands, the tax must be uniform, must not invade powers granted to the states, and must be for the benefit of the general welfare, not for a particular group. In spite of these limitations, Congress has been able to levy a tax on corporation incomes allowed to accumulate as surplus, which practically forced corporations to pay out earnings as dividends, and to support a system of old-age pensions and unemployment insurance through taxation.[5] Because the decision in the Agricultural Adjustment Act case was a close one, and since the personnel of the Supreme Court has changed, it is not at all unlikely that the Court may take the view that, except in very obvious cases, the question of whether or not the tax is for revenue purposes and the general welfare will be left to Congress.

2. MONEY. Another important grant of power to Congress is that (art. I, sec. 8) to "coin money and regulate the value thereof." The use of this power is of vital concern to business, for the validity and stability of business transactions depend in large measure upon the monetary system. Under this power and in connection with the taxing and spending power, Congress may not only coin money, but also regulate the issuance of bank notes and enter the

[1] *Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922).

[2] *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936). [3] *U.S. v. Butler*, 297 U.S. 1 (1936).

[4] For example, the Supreme Court upheld a prohibitive tax on state bank notes, partly on the ground that, through its power over money, Congress could so regulate, and that the fact that it had chosen taxation as a method was of no moment. See *Veazie Bank v. Fenno*, 8 Wall. 533, 19 Law. Ed. 482 (1869).

[5] Regarding old-age pensions and unemployment insurance, see *Helvering v. Davis*, 301 U.S. 619 (1937), and *Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937). The principle of the surtax on corporate incomes not distributed was upheld in *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).

banking field, or control the banking business to the most minute detail. Congress may adopt what monetary standard it will or establish a managed currency. Through power over credit — for credit is "money" in a broad sense — it may exert control over the price level and the use of credit. When Congress devalued the currency by reducing the gold content of the dollar, this action was upheld as a valid use of the money power, and contracts payable in gold of a certain weight and fineness were rendered invalid in this respect as an interference with the supreme money power of Congress.[1]

3. BORROWING AND SPENDING. In the clause giving Congress power to tax to "provide" for the common welfare, it is easily implied that it has the power to spend for that purpose. Moreover, the Constitution (art. I, sec. 8) gives Congress the power to "borrow money on the credit of the United States." There are few restrictions on spending in the Constitution. An appropriation for armies is not to be made for a period of longer than two years, salaries of federal judges may not be reduced during their continuance in office, and no money may be spent except by appropriation of Congress.

For years the meaning of the spending power was not clearly defined. Could Congress spend money for any purpose so long as it was for the general welfare or common defense, or only in carrying into effect its specifically delegated powers? The Supreme Court had ample opportunity to decide this point in a line of cases from 1892 to 1896, but instead decided them on other points of law.[2] Not until the Butler case, in which the Agricultural Adjustment Act was found unconstitutional, was this question answered. The Court held that the government spending power was not restricted to the other powers, but was as broad as the power to tax, or subject only to the limitation that funds be appropriated properly and that they be for the general welfare.

4. WEIGHTS AND MEASURES. Further control over business has been exercised through the constitutional provision (art. I, sec. 8) giving Congress power to "fix the standard of weights and measures." Under this power Congress could require the adoption of any standards it saw fit. It could, for example, make the metric system of weights and measures obligatory. However, this power has been used largely as a means of aiding business by securing scientific exactness of standards, by making various tests in connection with standards, and by facilitating the adoption of standardized materials, parts, and sizes. In a few cases, such as basket sizes and the use of the term "sterling," definite standards are enforced by law. This power is an important one, however, in that stability of economic exchange is almost as dependent upon a uniform system of weights and measures as upon a uniform monetary system.

[1] See *Norman v. B. & O. R.R.*, 294 U.S. 240 (1935); *Perry v. U.S.*, 294 U.S. 330 (1935); *Holyoke Power Co. v. American Paper Co.*, 300 U.S. 324 (1937).

[2] For a discussion of these cases see Lee, M. G., *The Government's Hand in Business* (New York: Baker, Voorhis and Company, 1937), pp. 254–60.

5. BANKRUPTCIES. The Constitution (art. I, sec. 8) gives Congress the power to establish "uniform laws on the subject of bankruptcies throughout the United States." While Congress made use of this power by passing bankruptcy laws in 1800, 1841, and 1867, none of these laws was very effective and all were repealed, so that until 1898 there was really no stable federal bankruptcy law. At times, no such law being in force, reliance was placed entirely on state laws. Since 1898, and particularly by acts in 1933, 1934, and 1935, the federal bankruptcy law has been growing in importance. To what extent Congress can go in granting relief to bankrupts under this power is uncertain. In a Supreme Court case in 1935 the Court found invalid a bankruptcy law which seemed so unfair to creditors as to take property without due process of law.[1] It appears that Congress may not use the bankruptcy power to interfere with the sovereignty of the states. In spite of the fact that this power carries no limitation of any sort, the Supreme Court in a close decision in 1936 declared unconstitutional a municipal bankruptcy law on the ground that Congress could not extend its bankruptcy power to the political subdivisions of the states.[2] However, this power has shown itself to be a real source of governmental control, particularly in the reorganization of railroads and in justifying laws aimed at regulating credit dealings.

The states are allowed to make bankruptcy laws of their own so long as they do not conflict with federal laws. This is a particularly valuable construction of the federal power in that the states may make many additional bankruptcy provisions with which the federal law does not deal.

6. POST OFFICES AND POST ROADS. The only provision of the Constitution which can be construed as an outright grant to the national government to enter business is that (art. I, sec. 8) "to establish post offices and post roads." This power has been widely used to exert control over business, and there are those who see in it possibilities for further expansion of governmental intervention. The postal power has been used as the basis for construction of post-office facilities and roads and for the establishment of postal savings and money-order systems. Interference with the mails has been made a federal offense, whether it takes the form of robbery or only a labor dispute. Regulation of the mails has been used for punishment of fraud conducted through them, and for the exclusion of lotteries, libelous or defamatory matter, obscene literature, and other objectionable matter.

To what extent the postal power can be adopted to regulate matters not clearly within the other powers of the federal government is not clear. Congress may disallow the use of the mails for securities which are fraudulent or "unfair to investors." [3] But it is doubtful if it can exclude businesses from

[1] The first Frazier-Lemke Act, by which farmers were granted mortgage extensions under excessively liberal terms, was held unconstitutional in *Louisville Land Bank v. Radford*, 295 U.S. 555 (1935). A later act safeguarding creditors more amply was upheld in 1937.

[2] *Ashton v. Cameron County Water Imp. Dist.*, 298 U.S. 513 (1936).

[3] I.e., under the Securities Act of 1933. This is clear from the decision in *Electric Bond & Share Co. v. S.E.C.*, 303 U.S. 419 (1938).

using the mails if they cannot be regulated under any other power. In one case in 1913 the Supreme Court specifically held that the postal power must be "construed in the light of definite prohibitions in the Constitution." [1] The power is apparently limited to control over the matter mailed, including prevention of injury to the recipient. However, Congress has been able to exert control over companies doing business with the post office. Contracts with air, water, and railway carriers ordinarily contain provisions involving far-reaching control over these agencies. Through contracts with builders and companies furnishing supplies, the government has also been able to impose restrictions.

7. PATENTS AND COPYRIGHTS. The Constitution (art. I, sec. 8) entrusts to Congress the promotion of "progress of science and useful arts" by authorizing grants of patents and copyrights "for limited times." Notice that the Constitution gives Congress no power to register trade-marks, this being undertaken as a regulation of interstate and foreign commerce.

This power vests in Congress the authority to establish patent and copyright laws which will secure an exclusive right to inventors and authors. The length of time that the patent or copyright may run is for Congress to determine. The definition of what constitutes "exclusiveness" is of course also subject to the discretion of Congress. The courts here have held that these rights are exclusive only as are any property rights, and that without permission of Congress they cannot be used for purposes which would be unlawful.[2] However, as a property-holder the patentee may refuse to allow the use of his patent.

Because this power is vested in Congress by the Constitution, the states may not interfere with the granting of patents or copyrights.[3] Whether the states have a concurrent power to grant such rights so long as they do not interfere with federal laws is a question which has not been adjudicated.

8. TREATIES. Power to make treaties with foreign governments is given (art. II, sec. 2) to the President "by and with the advice and consent of the Senate . . . provided two thirds of the senators present concur." The treaties made and ratified are a part of the "supreme law of the land" (art. VI, sec. 2), and as such are enforceable by the courts. Some students of government have claimed that the treaty power would make possible the passing of regulations in fields outside the specifically delegated powers of Congress. Many lawyers claim that the federal government can be given no power to do through treaties anything which the Constitution as a whole seems to forbid. Indeed, in 1855 the Supreme Court suggested that a treaty which would encroach upon powers reserved to the states would be unconstitutional.[4] Actually, the Court

[1] *Lewis Pub. Co. v. Morgan*, 229 U.S. 288, 313 (1913).

[2] For example, a patent right does not entitle holders of several patents to join together to restrain trade in opposition to the anti-trust laws. See *National Harrow Co. v. Hench*, 83 Fed. 36 (1897).

[3] The states may register trade-marks, and many have done so.

[4] *Prevost v. Greneaux*, 19 Howard 1, 15 Law. Ed. 572 (1855).

has upheld treaties which involved intrastate regulations. Regulation of migratory birds within a state was upheld as a valid control under a treaty between the United States and Canada.[1]

If through treaties with other countries on economic matters the national government exerts control where it otherwise could not, the treaty power would become tremendously important for domestic business as well as for business with foreign countries. This is not probable, however, for two reasons. First, the use of the treaty power to do indirectly what cannot be done directly is still of doubtful legality. Second, the expansion of other powers, notably the interstate commerce power, by Supreme Court interpretation has probably made the use of the treaty power unnecessary.

9. PROPERTIES OF THE UNITED STATES. The Constitution empowers Congress (art. I, sec. 8) to "exercise exclusive legislation" over the District of Columbia and (art. IV, sec. 3) to "dispose of and make all needful rules and regulations respecting territory or other properties belonging to the United States." Thus, in the District of Columbia and in the incorporated territories of Hawaii and Alaska Congress is not limited to those powers expressly delegated by the Constitution. In these fields it has a general police power. The power to "dispose" and make "needful rules" likewise applies to such projects as the Tennessee Valley Authority properties and the Boulder Dam property, which are owned by the United States. Through this ownership, Congress can do pretty much as it pleases. Once the authority to acquire ownership can be upheld as constitutional, it appears that the power of Congress in matters which are purely intrastate is also constitutional. Thus it has been able to effect control over private companies by the sale of electric power from government-owned plants, and has brought about regulation of wages, hours, and other labor conditions through provisions attached to the granting of government building and supply contracts.

10. INTERSTATE AND FOREIGN COMMERCE. In the regulation of business by the national government, perhaps no power of Congress is more important and has more possibilities for expansion than the control of interstate and foreign commerce. Of the many regulations of business in recent years, few can be found which do not rest in part upon this grant of power.

a. The clause. The part of the Constitution (art. I, sec. 8) in which this power is delegated to Congress tersely states that Congress may "regulate commerce with foreign nations, and among the several states, and with the Indian tribes." Of particular significance is the phrase referring to interstate commerce. Passed by the framers of the Constitution without debate, this section was probably designed by them to give the national government authority to prevent the states from placing burdens on the free flow of commerce between states and with foreign countries. Except for some control over navigable waters, largely negative in that it merely forbade certain interferences with

[1] *Missouri v. Holland*, 252 U.S. 416 (1920).

free commerce, the commerce power was little used for nearly a century after the ratification of the Constitution. The beginning of its use for positive regulation of business in reality dates from the Interstate Commerce Act of 1887, under which railroads were subjected to national control.

As one writer has pointed out:

> Following the Interstate Commerce Act came a veritable deluge of legislation under the commerce power. In the exercise of that power Congress has not only regulated the railroads, but has prohibited contracts and combinations in restraint of trade and certain "unfair" business practices, and extended federal jurisdiction over stockyards, boards of trade, aviation, communication, warehouses, and securities exchanges. It has regulated the quality of foods and drugs and the standards for articles shipped in interstate commerce, such as meats, cotton, grain, etc. It has regulated the shipment of liquor into "dry" states and prohibited the movement in interstate commerce of prison-made goods, kidnapped persons, white slaves, and stolen automobiles. It has chartered railroads and determined who shall construct dams and power plants on navigable waters. Indeed, the commerce power has come to be the principal means which the national government has at its disposal for the regulation of private business, the chief fount of federal power, "perhaps the most benign gift of the Constitution." [1]

b. What is interstate commerce? The interstate commerce clause, while concise, is a direct and complete grant of power to the federal government. But the questions of what is "commerce" and what is "interstate" have proved exceedingly difficult to answer. Because of the possible varieties of meaning attaching to these two words, particularly in specific cases, the real import of the interstate commerce clause has depended singularly upon interpretation by the courts. This interpretation has at times appeared restrictive, although generally it has been expansive. Nevertheless a few principles are now generally accepted. These principles are still not comprehensive, for future interpretation may bring new principles, or change those now regarded as established.

(1) *Interstate exchange.* In the first case in which the Supreme Court attempted interpretation of the interstate commerce power, Chief Justice Marshall held that "commerce, undoubtedly, is traffic, but it is something more; it is intercourse. It describes the commercial intercourse between nations and parts of nations, *in all its branches*, and is regulated by prescribing rules for carrying on that intercourse." [2] What the Chief Justice was endeavoring to emphasize was that the concept of commerce includes more than mere buying and selling over state boundaries; it includes the whole process by which the exchange is carried on. In the case cited, the Supreme Court found that interstate navigation was an essential part of this broader view of exchange, to which Chief Justice Marshall referred as "commercial intercourse." In other cases, the Supreme Court has emphasized that all interstate transportation by

[1] Lee, M. G., *The Government's Hand in Business* (New York: Baker, Voorhis and Company, 1937), pp. 6–8.

[2] *Gibbons v. Ogden*, 9 Wheat. 1, 6 Law. Ed. 23, at p. 68 (1824) (italics mine).

any means is included in the legal concept of commerce, if not indeed being "commerce itself." [1] Thus, transportation by railroad, telegraph, telephone, radio, truck and bus, pipe line, power line, and airplane, when interstate, have all been held to be within the purview of the power.

The commerce must, of course, be over state boundaries. But the jurisdiction of Congress does not begin and end at these boundaries. While the limits of interstate commerce are subject to somewhat varied interpretation in the light of the peculiar facts of each case, it is fairly well settled that it does not begin until the property being exchanged starts on its interstate journey, and ends only when that journey is completed and the goods become mingled with the other goods of the state. On this basis the Supreme Court has held that mining, manufacturing, and farming, as productive processes, are distinct from the selling, buying, or contracting to sell and buy for movement in interstate commerce, and are local matters outside the federal commerce power.[2] Nevertheless, recent decisions on the "flow of commerce" have greatly modified this thesis.[3]

(2) *Instrumentalities or agencies.* Although a particular agency or instrumentality may be inside the boundaries of a state, it still may be engaged in interstate commerce and thus subject to the power of Congress. In a famous case in 1871 the Supreme Court held that a steamship which carried goods within the boundaries of a state was an instrumentality of interstate commerce because it handled goods traveling in interstate commerce.[4] This recognition of participation in the flow of commerce has been followed by an enlargement of the commerce power to include certain intrastate agencies. Local grain elevators which purchased grain and reshipped to an out-of-state market were found to be in the "flow" of interstate commerce.[5] The "same practical conception of interstate commerce" was given to federal regulation of stockyards.[6] Here the Supreme Court found that the stockyards of the country, being an agency through which interstate commerce flowed, were but an "incident" in the current of commerce from state to state, and were subject to the power of Congress to regulate interstate commerce.

(3) *Removing obstructions to interstate commerce.* Having established the concept

[1] *Railway v. Van Husen*, 95 U.S. 465 (1872).

[2] Note such cases as *Kidd v. Pearson*, 128 U.S. 1 (1887), regarding manufacture; *Utah Power & Light Co. v. Pfost*, 286 U.S. 165 (1931), in which generation of electricity was held to be essentially manufacture; *Oliver Iron Mining Co. v. Lord*, 262 U.S. 172 (1923), in which mining was held not to be interstate commerce but a "local business"; *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936), regarding mining; *McCready v. Virginia*, 94 U.S. 391 (1877), in respect to oyster culture.

[3] See *infra*, pp. 43–44.

[4] *The Daniel Ball*, 10 Wall. 557, 19 Law. Ed. 999. Here the Court held that the steamship "was employed as an instrument of that [interstate] commerce; for whenever a commodity has begun to issue as an article of trade from one state to another, commerce in that commodity between the states has commenced"; and that "to the extent in which each agency acts in that transportation, it is subject to the regulation of Congress."

[5] *Lemke v. Farmers' Grain Co.*, 258 U.S. 50 (1922).

[6] *Stafford v. Wallace*, 258 U.S. 495 (1922).

that commerce between states is a "flow" or "current" of business over state boundaries, Congress has derived much of its power for regulation from the correlative authority to preserve the freedom of this commerce. In upholding the regulation of stockyards, the Supreme Court held that such regulation was made "imperative for the protection" of the free flow of commerce. Even before the stockyards case, the Court had held that attempts to monopolize business interfered with this freedom.[1] Also, when states have attempted to force railroads to charge, on the intrastate portion of interstate traffic, rates lower than the interstate rates, the Supreme Court has upheld the power of Congress to regulate these rates to the extent necessary to remove burdens on the movement of commodities in interstate commerce.[2] This principle has even been extended to require a state-owned and operated railroad, operating entirely within a state, to use safety appliances prescribed through an act of Congress, because the railroad equipment was used "on the highways of interstate commerce."[3]

Perhaps the most far-reaching Supreme Court case affecting interstate commerce which has been decided in recent years is that finding the National Labor Relations Act constitutional.[4] Without attempting to describe the act in detail, it is enough to note that under the law a board has power to deal with unfair labor practices which affect interstate commerce. In administering the act, the board found that a large steel manufacturer was guilty of engaging in unfair labor practices. Having declared for years that manufacturing and mining were not interstate but local in nature, the Supreme Court now held that the steel corporation was "organized on a national scale," that its "relation to interstate commerce" was "the dominant factor" in its business activities, and that interstate commerce could be protected "from the paralyzing consequences of industrial war." Consequently, not only could Congress remove obstructions in the form of labor strife from the flow of interstate commerce, but labor practices of the steel producer, in view of its "far-flung activities," had an effect on interstate commerce which was not "indirect or remote."

Following the Jones and Laughlin Steel case, the Supreme Court has found that the labor practices of a clothing manufacturer,[5] a trailer-building company,[6] and a California fruit-packing company with only 37 per cent of its output shipped in interstate commerce [7] affect interstate commerce enough to admit of control by Congress. This apparently represents a reversal of the

[1] *Northern Securities Co. v. U.S.*, 193 U.S. 197 (1904). See also *Swift and Co. v. U.S.*, 196 U.S. 375 (1905).

[2] See especially *R.R. Commission v. Chicago, B. & O. Rwy. Co.*, 257 U.S. 563 (1922), and *Shreveport Rate Cases*, 234 U.S. 342 (1913).

[3] *U.S. v. California*, 297 U.S. 175 (1936).

[4] *National Labor Relations Board v. Jones and Laughlin Steel Corp.*, 301 U.S. 1 (1937).

[5] *N.L.R.B. v. Friedman-Harry Marks Clothing Co.*, 301 U.S. 58 (1937).

[6] *N.L.R.B. v. Fruehauf Trailer Co.*, 301 U.S. 49 (1937).

[7] *Santa Cruz Fruit Packing Co. v. N.L.R.B.*, 303 U.S. 197 (1938).

legal position that agriculture, mining, and manufacture are beyond the scope of the interstate commerce power.

Note, however, that the legal *principle* has not been changed. In the steel case, Chief Justice Hughes pointed out that:

> Undoubtedly the scope of this power must be considered in the light of our dual system of government and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government.[1]

In essence, this principle is not different from that enunciated time and again by the Supreme Court in refusing to extend congressional authority to cases where the effect on interstate commerce is "indirect." The change has come partly in point of view and partly in the greater centralization of business and economic activity. If increasing regulation under the commerce power seems to the Supreme Court to involve direct effects on the flow of commerce, the regulation will be upheld. The way is apparently open for an expansion of congressional power. But so long as the principle remains unchanged, one can never be sure how the Court will split hairs between "direct" and "indirect" effects.

(4) *Policing interstate commerce.* Under its power to regulate commerce, Congress can keep the channels of interstate commerce free of traffic which is injurious to public health, morals, and safety. Thus, it has constitutionally excluded from interstate commerce lottery tickets,[2] impure foods and drugs,[3] stolen automobiles,[4] below-standard grain,[5] and the transport of women for immoral purposes.[6] But, until 1941, the United States Supreme Court had held that goods made under substandard labor conditions could not be excluded from interstate commerce. In a case in 1918 involving the prohibition of goods produced by child labor from interstate commerce, the Supreme Court decided that, since these goods were harmless in and of themselves and since the prohibition really involved regulation of local business, the goods could not be excluded from interstate commerce.[7] However, in a case concerned with the validity of regulation of minimum wages and maximum hours, the Supreme Court held in 1941 that goods produced under low labor standards might be excluded from interstate commerce by Congress.[8]

The decision of the Supreme Court in 1941, by which the earlier case was overruled, opens wide the power of Congress to regulate business through excluding goods from interstate commerce. The Court admitted that the new

[1] *N.L.R.B. v. Jones and Laughlin Steel Corp., supra,* p. 37.
[2] *Champion v. Ames,* 188 U.S. 321 (1902).
[3] *Hipolite Egg Co. v. U.S.,* 220 U.S. 45 (1910).
[4] *Brooks v. U.S.,* 267 U.S. 432 (1924).
[5] *Lemke v. Farmers' Grain Co.,* 258 U.S. 50 (1922).
[6] *Hoke v. U.S.,* 227 U.S. 308 (1912).
[7] *Hammer v. Dagenhart,* 247 U.S. 251 (1918).
[8] *U.S. v. Darby Lumber Co.,* 85 Law. Ed. (Adv. Sheets) 3.95 (1941).

construction practically gives Congress a general police power because of the pervading nature of interstate commerce. Although the Court still agreed that manufacture is not commerce, it did hold that the power of Congress over interstate commerce is plenary and that the authority extends to regulation of intrastate activities where they may have a substantial effect on interstate commerce. If Congress has reason to believe that good public policy demands the exclusion of articles from interstate commerce, the Court held that the motives behind such prohibition are matters of legislative judgment over which the courts have no control.

c. State control over interstate commerce. Although the power of the federal government over interstate commerce is superior to that of the states, the courts have held that states, under their police and taxing powers, may enact laws which incidentally affect that commerce. This power is subject to several limitations: the laws can be made only in the absence of federal legislation on the subject; they must be concerned with matters which are primarily local in character; and the states may not unduly burden interstate commerce by passing such laws.

A few examples will serve to illustrate what this power is. Since Congress has not legislated on the subject of a minimum railroad crew for safe train operation, states, under their police power, may pass full-crew laws.[1] The hours of labor of employees of interstate railroads were subject to state regulation until superseded by federal regulation.[2] State regulation of the retail rates for gas and electricity was upheld even though the gas and electricity were transmitted into the state by a utility company in another state, on the ground that this regulation concerned a local matter and Congress had not acted on the subject.[3] But where a state attempts to regulate the price of milk within its boundaries, and in doing so prohibits out-of-state milk producers from selling at less than a certain price, the state law ceases to be local in nature and becomes a burden on interstate commerce.[4]

In exercising its police power the state may require proper labeling,[5] set up quarantine laws against diseased plants or animals,[6] or forbid commerce in adulterated foods.[7] On the other hand, a state law aimed at curtailing the interstate transmission of gas to other states, on the ground that such gas was needed in the producing state, was held to be an obstruction to interstate commerce and hence unconstitutional.[8] A tax may be levied by a state on the property of a railroad even though it be in interstate commerce.[9] But a tax on

[1] *St. Louis I.M. and S. R.R. Co. v. Arkansas*, 240 U.S. 518 (1916).
[2] *Nor. Pacific Rwy. Co. v. Washington*, 222 U.S. 370 (1912).
[3] *Pennsylvania Gas and Elec. Co. v. Public Service Commission*, 252 U.S. 23 (1919).
[4] *Baldwin v. Seelig*, 294 U.S. 511 (1935).
[5] *Patapasio Guano Co. v. N.C. Board of Ag.*, 171 U.S. 345 (1898).
[6] *Mintz v. Baldwin*, 289 U.S. 346 (1933).
[7] *Crossman v. Lurman*, 192 U.S. 189 (1903).
[8] *Pennsylvania v. West Virginia*, 262 U.S. 553 (1923).
[9] *New York v. Miller*, 202 U.S. 584 (1906).

the doing of business, such as one on railroad tonnage passing through the state, has been held to be an unconstitutional burden on interstate commerce.[1]

11. Due Process of Law. All the enumerated powers of the national government are subject to the restrictions on Congress which are found in the Constitution. The provision most frequently violated is that included in the Fifth Amendment, which provides that no person shall "be deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use without compensation." The last part of this restriction presents little difficulty, meaning only that the government under its inherent power of eminent domain shall pay a reasonable price for any private property it takes for public use. Thus, when private property was needed for the building of the Tennessee Valley dams the property could be taken, but a reasonable compensation, as determined by agreement of the government and the owner, or by a jury of appraisers, had to be paid.

The amendment prohibiting the taking of life, liberty, or property without due process of law has been of tremendous significance in American legal history. The same restriction was applied to state actions by the Fourteenth Amendment to the Constitution, and so far as due process is concerned most of what is discussed here will apply to the powers of states.

The amendment declares, not that private property or liberty cannot be taken, but that the federal government cannot take it without due process of law. This restriction has been construed to be applicable to all the enumerated powers, regardless of how complete they seem to be. The nature of business liberty and property has been analyzed in the previous chapter. The problem now is to find out what is meant by due process of law.

a. Procedural due process. This phrase was borrowed by the framers of the Constitution from the English common law. Under the latter it meant that a person's property or liberty could not be taken by government unless it was done according to "the law of the land."[2] This was merely another way of stating that a person had the right to a fair hearing before a fair court. Thus "due process" under the common law was procedural due process in that all it implied was that an accused should have "his day in court."[3] So long as impartial and fair hearing is given before the taking of life, liberty, or property, and so long as this hearing is held before a court or commission legally qualified as to jurisdiction, the requirements of due process, as procedure, would apparently be met. It is worth noting that procedural due process extends to acts of judges, legislators, and executive officers, and is designed to safeguard against

[1] *Case of the State Freight Tax*, 15 Wall. 232, 21 Law. Ed. 146 (1873).

[2] For discussion see Commons, J. R., *Legal Foundations of Capitalism* (New York: The Macmillan Company, 1924), pp. 331 ff.

[3] There are those who claim that the English common law actually did embrace within due process more than mere procedure, that due process really meant that the taking of liberty or property must be inherently fair. See Mott, R. L., *Due Process of Law* (Indianapolis: Bobbs-Merrill, 1926), chap. V.

tyrannical or arbitrary practices which are substituted for legal customs of fairness and impartiality.

b. Substantive due process. In the development of American constitutional law the procedural aspect of due process has been pushed into a minor place. Following the Civil War, it is claimed that the courts broadened their construction of this phrase to include not only restrictions as to the *form* of procedure, but also the principle that laws and their administration should not violate the *substance* of individual rights, liberty, and property.[1] In other words, some students imply that judges have read into due process the proposition that laws must conform to a standard of substantive fairness consonant with the importance of public purpose involved. Even though a law is passed by Congress, even though an individual is convicted under the law after a fair and impartial trial, the law may fail to be constitutional if it seems to the courts that it deprives an individual of his property or his liberty by legislation which is arbitrary or unreasonable in substance.

The interpretation that due process involves substantive fairness has forced the courts to become arbiters of what line can be drawn between reasonable use of enumerated powers of Congress and cases where exercise of these powers takes property or other rights unreasonably. For example, when Congress, under its power to legislate for the District of Columbia, set a minimum wage for women and children employed in the District, the Supreme Court found this law invalid because it seemed to the Court to be an unreasonable and arbitrary interference with the right to contract freely for labor services.[2] There was no question here of procedural due process, the invalidation being based entirely upon the belief that the law was in substance a deprivation of property without due process of law.

Interpretation of due process as substantive due process has been far more important (in the sense that there have been more cases) with respect to the Fourteenth Amendment (restraining states) than under the Fifth Amendment (restraining the federal government). Nevertheless, because almost any business legislation is likely to impair some property or contract rights, the extension of due process to substance has put much responsibility on the courts in determining the lengths to which social legislation can legally go in interfering with these business rights.

B. POWERS OF STATES UNDER THE CONSTITUTION

Under the federal Constitution the powers of states are affected in three ways. First, powers delegated to the federal government are supreme and represent

[1] See Commons, J. R., *op. cit.*, pp. 333 ff. Also see McGovney, D. O., *Cases on Constitutional Law* (Indianapolis: Bobbs-Merrill, 1935), p. 612, note. While this construction was first adopted with respect to the Fourteenth Amendment, it has been applied to the Fifth Amendment.

[2] *Adkins v. Children's Hospital*, 261 U.S. 525 (1923). The construction of what is reasonable deprivation of property or contract rights has since been overruled in *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

those which the states have surrendered. Second, the Constitution declares that all other powers are reserved to the states. Third, the Constitution places certain restrictions on state powers. Enough attention has been given to enumerated national powers to show the student how their supremacy curtails the sovereign position of the state. But some analysis of the reserved powers of the states and of restrictions under the federal Constitution should be undertaken.

1. RESERVED POWERS. The residuum of power inhering to the states after recognition of the supremacy of powers delegated to the national government and the limitations of restrictions imposed by the federal Constitution is called the reserved powers of the states. In a broad sense all these may be referred to as police powers in that they include power to legislate in the interest of the health, safety, morals, and public welfare of the people of the state.[1] However, a clearer definition of the reserved powers of the states, especially as they affect business, may be had by discussing them as police power in a regulatory sense, proprietary powers, and the power of eminent domain.

a. Police power. It is almost impossible to give meaning to the power of a state to regulate for health, morals, safety, and welfare without discussing the limitations of due process of law under the Fourteenth Amendment, and other limitations of the federal Constitution, which are dealt with below. What is really regulation in the interests of public need is a matter of judgment by legislature and courts, based upon the facts which give rise to the need.

As the law has developed in the United States, one can say that this police power affects a business differently according to whether it is regarded as private in nature, or as peculiarly subject to the public interest. In respect to private businesses, a state may inspect foods and meats, impose restrictions to prevent frauds, adopt building codes, license pharmacists and physicians, require factories and mines to adopt safety devices, and pass a host of other regulations designed to protect health, morals, safety, and welfare.

These regulations must be reasonable and also likely to achieve the desired ends. When the state of New York attempted to limit the hours of bakers to eight per day the Supreme Court held that the interference with contract rights was not necessary or appropriate to safeguard the public health, or the health of the individuals who follow the trade of a baker.[2] Likewise, when the state of Pennsylvania required, among other things, that all stockholders of corporations owning drugstores be licensed pharmacists, the Supreme Court declared that there was no substantial relationship between ownership of drugstore stock and public health.[3]

[1] Note in *Chicago, B. and Q. R.R. Co. v. Drainage Commission*, 200 U.S. 561 (1906), where the United States Supreme Court says (p. 609), "We hold that the police power of a state embraces regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals or the public safety."

[2] *Lochner v. New York*, 198 U.S. 45 (1905).

[3] *Liggett Company v. Baldridge*, 278 U.S. 105 (1928).

With private businesses, the police power does not usually extend to regulation of price charged or to a requirement to serve reasonably and adequately. But in the case of quasi-public businesses affected with a public interest, such as electric, gas, telephone, street railway, and other companies, the state police power, in addition to general regulations to which private businesses are subject, extends to regulation of rates and reasonable and adequate service.[1]

b. Proprietary power. Every sovereign government has the power to engage in undertakings which it regards as necessary to the functioning of government. This may be limited to the construction and operation of public buildings or the granting of contracts for public supplies, or it may extend to the building and operation of a barge canal or the construction of a system of state-operated elevators.[2] The state may also incorporate private businesses, or it may grant to its subdivisions such as counties and municipalities the authority to enter into practically any kind of business. The extent to which a given state may become proprietors of businesses seems to be limited mainly by its constitution and the sanction of its people and legislature. To the extent that due process requires that taxation be for a public purpose, and because states may hardly enter business without resorting to taxation, the idea that the business must be for the general welfare would seem to follow as a further limitation.

As a proprietor the state can impose such conditions, limitations, and regulations as it desires. While a state might not be able to regulate the price of gasoline sold by private dealers,[3] it could embark in the retail gasoline business and hence indirectly regulate the price of gasoline sold by others.[4] Regulation by other yardstick methods which would otherwise be invalid has been upheld. By regulating the hours and wages of state employees, and by making certain labor standards a condition for private business accepting state contracts, the states, as proprietors, have been able to exert control which would not be upheld if they policed private businesses directly.

c. Eminent domain. The power of a state to take private property for public purpose, upon payment of just compensation, is "an attribute of sovereignty," "inheres in every sovereign state," and is "so often necessary for the proper performance of governmental functions that the power is deemed to be essential to the life of the states." [5] The only real limitations on this power are that the property taken must be for a public use and that a fair compensation must

[1] This division of the applicability of the police power is somewhat confused by the case of *Nebbia v. New York*, 291 U.S. 502 (1934). Here the Supreme Court upheld price regulation in retail milk sales on the grounds that this method was an appropriate means of meeting the problem of policing milk production. Yet, in the accepted sense of the term, the milk business is not affected with the public interest. For discussion of businesses affected with a public interest, see below, Chapter 13.

[2] That this is perfectly consistent with the federal Constitution was shown in *Green v. Frazier*, 253 U.S. 233 (1920), by which state ownership of grain elevators and mills was upheld.

[3] The Supreme Court so held in *Williams v. Standard Oil Co.*, 278 U.S. 235 (1929).

[4] *Standard Oil Co. v. Lincoln*, 275 U.S. 504 (1927), upholding the right of a city, properly authorized by the state, to sell gasoline.

[5] *State of Georgia v. Chattanooga*, 264 U.S. 472 (1924).

be paid for it. The power is different from the regulatory or taxing power of a state in that the exercise of the latter does not require such compensation.

The state may take property by eminent domain, or it may allow any of its subdivisions or any privately owned business to do so; no matter which of these methods is adopted, the main limitation is that the taking be for public use. The states and their subdivisions have had little difficulty in showing public use in seizing property for state buildings, roads, canals, or sewers. All public utilities, granted the right of eminent domain by the states, are held to be using this power for a public use. Even in businesses which cannot be held to be public utilities in the sense of being affected with a public interest, the use of eminent domain has been upheld. States have granted this power to mining and timber companies needing a right of way from their property. In doing so they have been upheld by the United States Supreme Court.[1] Apparently, so far as the federal Constitution is concerned, the determination of what is public use is left largely to the states under their constitutions and the interpretation of their courts.

2. Restrictions on State Taxes. The federal Constitution places some restrictions on the taxing powers of states. Except where absolutely necessary for inspection purposes, the Constitution (art. I, sec. 9) forbids states "without the consent of Congress" to "lay any imposts or duties on imports or exports." The purpose of this limitation is to restrain the states from interfering with a free flow of commerce, and in deciding whether a state tax falls under this clause the courts have looked for undue interference with interstate commerce.

Far more restriction on state taxation has resulted from the doctrine that all taxes, both federal and state, must be for a public purpose. With regard to state taxation, this doctrine is not found in the Constitution but has been firmly established by a line of judicial decisions.[2] If taxation is used to advance private interests or class interests, it is a taking of property without due process of law, in opposition to the Fifth and Fourteenth Amendments.[3]

3. Restrictions on State Money Powers. Besides granting money powers to the national government, the Constitution (art. I, sec. 10) forbids the states to coin money, issue bills of credit, or make anything but gold and silver coin tender for payment of debts. This in itself does not prohibit the states from chartering banks with the privilege of issuing notes, but the federal government has practically done so through levying a high tax on such notes. Nor does the Constitution restrict state-chartered banks in their use of deposits subject to check as a medium of exchange. It seems reasonable to assume, how-

[1] As to gold mining, see *Strickley v. Highland Bay Mining Co.*, 200 U.S. 527 (1906).

[2] See particularly *Loan Association v. Topeka*, 20 Wall. 655 (1874). The due process clause in the Fourteenth Amendment implies such a restriction on state taxation in that, under it, property may not be taken except by due process of law and a tax not for a public purpose would violate due process.

[3] See *Fallbrook Irrigation District v. Bradley*, 164 U.S. 112 (1896).

ever, that, if the national government wished to do so, the power over money could be extended to regulation of the use of checks by depositors of state banks.

This restriction upon states, plus the money powers of the national government, is important to the stability of business. Without a uniform national monetary system, business on a country-wide basis would be difficult.

4. Obligation of Contracts. One of the most important restrictions on the states imposed by the federal Constitution is that (art. I, sec. 10) forbidding the states to pass a law impairing the obligation of contracts. The term "contract" has been interpreted broadly. It includes contracts between a state and private parties. Thus a franchise, charter, or other privilege obtained by private corporations from the legislature is construed to be a contract within the meaning of this clause. This interpretation has economic and social significance, because many such privileges have been held to be inviolable rights which the state may not later impair. For example, a street railway in New York City was granted a perpetual franchise for use of the city streets. By its terms there was no practicable way, except by condemnation proceedings under eminent domain, that the state legislature could divest the company of its rights without impairing the obligation of contracts.[1] On the other hand, charters granted by the state to its subdivisions are not held to be contracts, nor is the appointment of an individual to public office at a fixed salary for a certain term held to be one.[2]

The obligation of a contract is impaired when its value has been diminished as the result of legislation.[3] But a legislature may change the procedure of enforcing a contractual claim, so long as the value of the contract is not changed, without impairing the obligation of contracts.[4]

In interpreting the contract clause, the courts have held that all contracts are made under laws existing at that time, and that only laws passed subsequent to the date of the contract can impair the obligation. To avoid later impairment, especially in contracts to which the state is a party, nearly all the states now provide by law that all future contracts made by them may be repealed or amended. In this way, they have protected themselves to a great extent from being held to irrevocable grants which later appear unwise. However, this protection is not absolute. States may repeal corporation charters where the right has been reserved, but they may not deprive third parties, such as stockholders, of their vested property rights without due process of law.[5] The states may, then, amend or repeal contracts if they have reserved such power at the time the contract is made, but the arbitrary power

[1] Although the state was allowed to dissolve the corporation, the franchise was held to be irrevocable. *People v. O'Brien*, 111 N.Y. 1 (1888).

[2] See *Trenton v. New Jersey*, 262 U.S. 182 (1923), and *Butler v. Pennsylvania*, 10 Howard 402, 13 Law. Ed. 472 (1850).

[3] *Planters' Bank v. Sharp*, 6 Howard 327, 12 Law. Ed. 447 (1848).

[4] *Oshkosh Water Works v. Oshkosh*, 187 U.S. 437 (1903).

[5] See *Greenwood v. Freight Co.*, 105 U.S. 13 (1882), and *Coombes v. Getz*, 285 U.S. 434 (1932).

which this reservation would seem to grant is greatly restricted by the interpretation of the due process clause in the Fourteenth Amendment. Even where due process hinders a state in repealing its charter or franchise grants, there is nothing to stop the state from taking the property involved, including the franchise, for a public purpose with fair compensation under its power of eminent domain.

As a general proposition the states may not contract away their police power. All contracts are held to be made in accordance with both present and future regulations which may be found necessary for the protection of public health, morals, safety, and welfare. A brewing company's right to manufacture and sell beer under its charter was held to be subject to the morals or health of the people as protected by a prohibition law passed subsequent to the company's incorporation.[1] A lottery charter granted to a company has been held to be subject to later laws prohibiting lotteries.[2]

An exclusive grant to a railroad company to submerged lands on a lake frontage was held to be repealable on the grounds that the state could not abdicate the "public trust" to preserve waters for public use.[3] And temporary postponement of foreclosure of mortgages in an emergency has been upheld when vital public interests might otherwise suffer.[4]

While the restrictions on impairment of contract obligations apply specifically to the states alone, the federal government is limited in practically the same way. Contract rights are regarded as property. Consequently, under the substantive interpretation given to the due process clause of the Fifth Amendment, the courts have held that the property represented by contracts cannot be taken by the federal government without due process of law.[5]

5. INTERSTATE COMPACTS. The Constitution (art. I, sec. 10) prohibits states from entering into an agreement or compact with another state or with a foreign power without the consent of Congress. The interesting thing about this prohibition is that it has suggested a means for state co-operation with the consent of Congress. While no one knows the full meaning of this provision, it does make clear that if Congress consents states can contract with each other to accomplish ends that could not otherwise be attained. As for the consent, the Supreme Court has upheld interstate compacts made prior to as well as after consent, and has even held that consent may be implied where other acts of Congress show an approval of the compact.[6]

Interstate compacts have been used mostly for agreements concerning water rights on rivers and lakes in which several states are interested. Bridges across

[1] *Beer Co. v. Massachusetts*, 97 U.S. 25 (1877).

[2] *Stone v. Mississippi*, 101 U.S. 814 (1879).

[3] *Illinois Central R.R. Co. v. Illinois*, 146 U.S. 387 (1892).

[4] *Home Bldg. and Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934).

[5] See *Sinking Fund Cases*, 99 U.S. 700, 718, 719 (1879).

[6] In *Virginia v. Tennessee*, 148 U.S. 503 (1893), a compact made ninety years previously was held to be assented to by Congress by implication in other legislative acts.

interstate boundaries have usually been provided for by an interstate agreement. For example, the Port of New York Authority was set up after a compact between New York and New Jersey and was empowered to build and operate certain bridge and tunnel facilities between the two states.

In recent years there has been a tendency to extend the interstate compact to other fields. Joint state control of oil production has been obtained through an interstate oil conservation agreement between Oklahoma, Texas, Kansas, New Mexico, and Colorado. The interstate compact has been used as a means of control of labor conditions, where one state was placed at an economic disadvantage if it undertook reforms alone.[1]

In fields where effectiveness of state laws depends upon other state action, and where the national government has inadequate power to legislate, interstate compacts may become of increasing importance. On the other hand, should the federal interstate commerce power be expanded along the lines indicated in the last few years, increased use of interstate agreements may be found to be both unduly cumbersome and unnecessary.

6. Interstate Privileges and Immunities of Citizens. The Constitution grants (art. IV, sec. 2) to citizens of each state "all privileges and immunities of citizens in the several states." These privileges and immunities include, among other things, "the right of a citizen of one state to pass through or to reside in any other state, for purposes of trade, agriculture, professional pursuits, or otherwise; . . . to institute and maintain actions of any kind in the courts of a state; to take, hold and dispose of property, either real or personal; and an exemption from higher taxes or impositions than are paid by other citizens of the state." [2]

The restriction upon state discrimination against citizens of other states is important to business. But the courts have allowed some prejudicial laws which they found to be a reasonable exercise of the state police power. Thus, a state law refusing a liquor dealer's license to citizens of another state was upheld,[3] and one requiring an individual or at least one firm member conducting a bank to be a state resident has also been upheld.[4] These exceptions were allowed because effective regulation in certain fields depended in part on having citizens of the state concerned in the business.

Furthermore, a corporation of one state, being "a mere creature of local law," is not regarded as a citizen within the scope of this clause, and a state may refuse to allow corporations from other states to do business within it, or

[1] Note that in 1934 seven northeastern states formed an interstate compact on minimum-wage regulation. By 1937, Massachusetts, Rhode Island, and New Hampshire had ratified the compact. For a general discussion of the interstate compact, see Clark, J. P., "Interstate Compacts and Legislation," 50 *Political Science Quarterly*, pp. 502–24 (1935), and vol. 51, pp. 36–60 (1936).

[2] *Corfield v. Caryell*, 4 Wash. C.C. 371 (1825).

[3] *DeGrazier v. Stephens*, 101 Tex. 194 (1907). Also in *Mette v. McGuckin*, 18 Nebr. 323 (1885), affirmed by a divided United States Supreme Court in 149 U.S. 781 (1892).

[4] *State v. Richcreek*, 167 Ind. 217 (1906).

it may regulate foreign corporations differently from domestic ones.[1] But where the foreign corporation is engaging in interstate or foreign commerce from outside a state, that state may not exclude its commerce, for to do so would be an interference with interstate commerce. A mail-order business incorporated in Illinois, for instance, could not be excluded from Indiana if its business were done entirely by mail.

7. Due Process of Law. Following the Civil War, the Fourteenth Amendment to the Constitution was ratified. Among other things it provided (sec. 1) that no state shall "deprive any person of life, liberty or property without due process of law." This restriction upon states, practically identical with that placed on the federal government by the Fifth Amendment, need not be discussed at length here. It means for the most part that the police power of the states must be used reasonably and not arbitrarily. Since exercise of this power almost invariably involves taking life, liberty, or property, the requirement of due process limits that power. As indicated above, this becomes a matter for judicial determination and the courts have the authority to declare how far regulations of states may go before property is taken without due process.

Because of the indefinite character of the state police power as compared to the more definite nature of delegated federal powers, the due process clause of the Fourteenth Amendment has been subject to more litigation than any other part of the Constitution. Corporations have been held to be "persons" within the meaning of this amendment and the Fifth Amendment.[2] As a result, businesses of all forms of organization have used this clause as a legal refuge from state regulation.

8. Equal Protection of the Laws. In contrast to the Fifth Amendment, the Fourteenth Amendment (sec. 1) forbids the states to "deny to any person within its jurisdiction the equal protection of the laws." Here also the word "person" includes both natural and corporate persons. The equal protection of the laws so guaranteed means that any person within a state "is entitled to stand before the law upon equal terms, to enjoy the same rights as belong to, and to bear the same burdens as are imposed upon, other persons in a like situation." [3] This clause was inserted in the Constitution primarily to protect Negroes from discriminatory legislation. But it has been resorted to time and again for the protection of businesses from laws which discriminate against one business in favor of another.

Equal protection of the law does not mean that legislation may not classify subjects for regulation. An act of the Kansas legislature making railroads liable both for fire losses and for attorneys' fees of the injured party was upheld as reasonable classification designed to protect the public along a railroad

[1] *Paul v. Virginia*, 8 Wall. 168, 19 Law. Ed. 357 (1868).

[2] First recognized by the Supreme Court in *Santa Clara County v. Southern Pac. Rwy. Co.*, 118 U.S. 394 (1886).

[3] *Southern R.R. Co. v. Greene*, 216 U.S. 400, 412 (1910).

right-of-way against an unusual fire hazard.[1] A state law which permitted railroads operating less than fifty miles of road to employ smaller crews than longer railroads was held not to be an unreasonable classification.[2] State laws imposing higher taxes on chain stores than on other stores have been upheld on the ground that owing to the difference between chain stores and other stores equal protection of the laws was not denied.[3]

But where the classification appears to the courts to be arbitrary or capricious, regulation has been found unconstitutional. A tax applying more heavily to corporations doing business both within and outside a state than on those doing business entirely inside it was held to make for unequal protection of the laws.[4] An Arizona statute which forbade the granting of an injunction to stop all picketing, legal or illegal, in a labor dispute, but which permitted injunctions against other threatened injuries to property, was held by the Supreme Court to deny equal protection of the laws, as well as to take property without due process of law.[5] However, in view of the broad interpretation of due process by the courts and the element of reasonableness which inheres in both due process and equal protection, it is doubtful if the phrase "equal protection of the law" really adds anything to the phrase "due process of law."

C. STATE CONSTITUTIONS

A complete understanding of the legal basis for government control of business would necessitate an examination of the constitutions of every state of the United States and the charter of every city. So far as state regulation is concerned, laws controlling business are subject to the provisions of the state constitutions as well as of the federal Constitution. It is obviously impossible to deal even in general with all the state constitutions. However, a few general characteristics may be selected which will suffice for the present study of government control of business.

In contrast to the federal Constitution, state constitutions are primarily restrictive. Because of the plenary nature of the powers reserved to the states, a legislature does not really need to have power delegated to it. Consequently most of the provisions are designed to limit the legislature in its use of sovereign (subject to the federal Constitution) power. Moreover, state constitutions are much more detailed than the federal Constitution. They cover more subjects, have more exceptions, and are less succinctly worded.

1. BILL OF RIGHTS. Like the federal Constitution, state constitutions usually include a bill of those rights with which the state is not to interfere by arbitrary legislation. Fair compensation for private property taken for public use is

[1] *Atchison, Topeka and Santa Fe R.R. Co. v. Matthews*, 174 U.S. 96 (1899).
[2] *Chicago, Rock Island and Pac. Rwy. Co. v. Arkansas*, 219 U.S. 453 (1911).
[3] *Indiana v. Jackson*, 283 U.S. 527 (1931).
[4] *Royster Guano Co. v. Virginia*, 253 U.S. 412 (1920).
[5] *Truax v. Corrigan*, 257 U.S. 312 (1921).

ordinarily included. Taking of life, liberty, and property without due process of law is usually prohibited. Impairment of obligation of contracts is often prohibited. Along with these measures protecting property are often found provisions granting the state power to go into business and to authorize its municipal corporations to do likewise. Often, also, corporations are excluded from privileges and immunities of citizens and the terms of recognition of foreign corporations are placed in state constitutions.[1]

2. Financial Power of Legislature. State constitutions typically limit the power of the legislature to put the state into debt. Not only does this limitation affect the financial program of the state, but it also acts as a curb upon state expenditures for aids to, or ownership of, business. In addition, many state constitutions provide in detail for the taxing system, and many require certain types of taxes on business, such as franchise, incorporation, or stock-transfer taxes.

3. Regulation of Corporations. While most states leave the details of private and public-utility corporation regulation to statutory law, some constitutions include rather complete regulatory provisions for these corporations. Thus, the procedure of incorporation, the method of rate regulation of public utilities, prohibition of discriminatory practices by common carriers, the condition of granting public-utility franchises, chartering and regulation of banks, and regulation of monopolies and trusts have been provided for in varying ways.

4. Labor Regulation. A variety of labor provisions is found in state constitutions. A few states provide for arbitration and conciliation laws, for workmen's compensation and liability of employers in industrial accidents, and for safety and health regulation. Some constitutions forbid child labor. A few set eight hours as the working day in public employment or in certain industries, and some empower legislatures to pass minimum-wage laws.

5. Miscellaneous Provisions. A few miscellaneous constitutional provisions affecting business are interesting. The Arkansas constitution directs the legislature to pass laws which will foster and aid agriculture, manufacturing, and mining. That of Idaho commands the legislature to pass laws protecting the health of livestock. The Wyoming legislature is directed to provide for "the proper development, ventilation, drainage, and operation" of mines. Oklahoma even includes in its constitution regulation of railroad passenger fares (based on a rate of two cents a mile), the requirement that railroads furnish clean and warm depots, and the detailed provision that the flash test for illuminating kerosene "be 115 degrees Fahrenheit" and the specific gravity test "40 degrees Baumé."

[1] Of course, various political and religious rights are also included.

D. JUDICIAL REVIEW AND CONTROL

In studying the legal basis for government control of business, great emphasis must be placed on the function of the judiciary in giving meaning to laws. Both federal and state constitutions are susceptible of various interpretations. Almost any clause or phrase can be construed in widely different ways. In the case of states, those powers inherent in sovereignty, such as the police power, may be exercised in spite of silence on the particular subject by the state constitution. When one considers the elasticity of construction possible under written constitutions, and adds the uncertainty which must exist as to the boundaries between the legitimate exercise of powers and the deprivation of property without due process, he cannot remain unaware of the tremendous power of American courts.

The courts, both federal and state, have declared in principle that the laws passed by a legislature are entitled to the greatest respect, and that their regulations should not be held invalid unless they appear to be unconstitutional beyond a reasonable doubt. This does not mean that all reasonable men, or even all legal experts, agree as to the constitutionality. Five-to-four decisions are not uncommon in the United States Supreme Court. There would seem to be in such a decision a basis for saying that four reasonable men believe the law to be valid, therefore the remaining five should rule likewise. However, judicial decisions are not based upon collective opinion, but on the opinion of individual judges. Furthermore, it may well be that the four who uphold the law do so because they have a reasonable doubt, not because they believe it to be clearly constitutional. On the other hand, the five who hold it void may feel that it is clearly unconstitutional. Under such conditions the doubts of a minority can hardly be said to prove that there is a reasonable doubt as to the invalidity of the law.

Study of judicial decisions does indicate that the courts are likely to construe written constitutions in the light of strongly prevailing mores. This construction may lag somewhat, but the meaning of such powers as the commerce and money powers and the due process restrictions has changed along the line of public opinion. For example, a closely divided United States Supreme Court held minimum-wage laws unconstitutional in 1923 and 1936, but in 1937 found that the change in economic conditions had been so great as to make such laws now constitute a valid use of the police power.[1]

Nevertheless, one of the significant problems in a study of government control of business is the legal basis of that control, not only as found in constitutions but also as represented in court decisions. The field of regulation, the administrative difficulties incurred, and the economic problems to be solved are usually colored by, if not caused by, the underlying legal problem.

[1] *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

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CHAPTER

4

THE MACHINERY OF CONTROL

ONCE the government has embarked upon a program of control of business, a wide choice of machinery for exerting that control is presented. This machinery varies with the businesses regulated, and certain kinds of control are used more completely in one field of business than in another. Some of these have developed to such a point that the more important ones may be regarded as standardized. The methods and types depend largely upon the extent of control intended and the problems encountered in any particular field of governmental intervention. Moreover, they represent devices which have been developed out of experience and furnish patterns for the possible extension of government control into new fields.

The student should bear in mind that a more complete appreciation of this machinery must wait for the analysis of government control in the fields to be undertaken later. It is to be hoped, however, that this chapter will aid him to recognize when and where these methods and types are being used and to comprehend better the administrative problem involved.

In the following discussion, the study of methods is concerned with those instrumentalities through which control is exercised; under types of control are analyzed the more common kinds of objects of control. For example, the commission as treated here is a *method* of administering control over public utilities, and one of the *types* of control it usually employs is the securing of a reasonable price for utility services.

A. METHODS OF CONTROL

1. JUDICIAL DECISION. The English common law is a body of legal doctrine developed from the accepted decisions of the courts. Since judges are likely to decide in line with prevailing customs, especially in the absence of a written constitution, the English common law has been as much as anything a body of

principles of fairness in accordance with these customs. Under this system of law there were many legal principles which in effect regulated business. Some of these have already been mentioned.[1] Contracts intended to monopolize were generally regarded as unenforceable. The laws of partnerships and negotiable instruments were brought into the common law from the early law merchant. The concept of a common carrier and his obligation to serve adequately, safely, and at a reasonable charge was also embodied in the common law. Common-law principles were developed for liability and the prosecution of damage suits; these were in reality laws regulating business. For example, while the common law recognized that the employer should use reasonable care in protecting his employees and was liable for injuries in the absence of such care, an employee could not receive damages where the injury was due to inherent occupational hazards or where he had contributed to it by his own negligence.

Regulation of business according to common-law principles means that the method of control is through judicial decision; an aggrieved party must sue the aggressor. Some regulation of business could be effected in this way. As a matter of fact, such regulation was common prior to the middle of the nineteenth century and is not at all uncommon today. Even though a constitution or the legislature should lay down general principles to be applied in regulating business, interpretation of these principles would be ultimately, if not immediately, a matter of judicial decision.

For really effective regulation of business, judicial decision is grossly inadequate. Legal proceedings are expensive, slow, and likely to be inexpert. The ordinary user of a railroad, for example, could hardly afford to institute a lawsuit if he felt that the rates were too high or the service poor. Moreover, months and sometimes years elapse before a final decision can be reached in legal proceedings. Furthermore, courts lack administrative machinery for handling the variety of problems arising in business regulation; they do not ordinarily have a staff of trained engineers, accountants, and financial experts at their disposal. When one considers the intricacies of the law itself, one can hardly expect a judge to be trained in law and also in public-utility problems, competitive practices of business, holding-company matters, or other many difficult aspects of business control.

Limited as they are by judicial precedents, judges are seldom free to make decisions which look to the future and to the growth of a constructive regulatory program. The principles which they apply usually limit them to passing upon the question in a general way. Thus, under laws of common carriage they may find a carrier to have discriminated unreasonably against a particular customer, but they cannot lay down a detailed procedure of reasonable discrimination. In finding a rate unreasonable, the courts are customarily limited to this finding alone and may not declare what a reasonable rate would be.

[1] See *supra*, pp. 5–6.

Obviously, as an exclusive method for government control of business, judicial decision is unsatisfactory. Regulation is something which should be continuous, not sporadic. For if regulatory control is to follow any line of public policy, it must involve constant supervision. This is a legislative and administrative function, and not one for the courts.

2. LEGISLATION. Businesses may be regulated by direct legislative action. It is not beyond possibility for federal and state legislatures and municipal councils to enact a governmental-regulation program by passing detailed statutes and ordinances involving the myriad of details necessary. State legislatures have made such attempts in many cases. Before general incorporation laws were enacted, new corporations were chartered by direct legislative action. In the latter part of the nineteenth century it was also common for such matters as railway rates to be regulated by statutes. Municipal ordinances even today often include many detailed regulations of local businesses.

Just as in the case of judicial decision, control through detailed legislation is likely to be unsatisfactory. Legislators have enough to do to pass wise general laws and the numerous private bills which call for direct action. Furthermore, control by statutes is likely to be sporadic and subject to delay. State legislatures seldom meet in continuous session throughout the year, and continuing supervision can hardly be had. Again, the control of business, especially as its scope has broadened in recent years, calls for specialized and expert attention. Legislators do not usually have adequate staffs of experts available, and there is certainly little chance that any one legislator could be adequately trained in the variety of fields over which the government exerts control.

Regulation of business calls for an administrative type of organization, with a personnel able to apply general principles to particular cases. This is indeed a different function from that of legislatures, whose job it is to lay down fair laws of general application in an even wider field than government control of business.

3. FRANCHISES. The franchise, as the term is used here, denotes the grant by a sovereign government of a special privilege to an individual or corporation, which could not otherwise be exercised legally and which ordinarily rests exclusively with the state. As such, power to establish corporations is a franchise given to incorporators. If a corporation or an individual wishes to lay gas, water, electricity, or telephone lines under or over public streets, the privilege of so doing is likewise a franchise. Closely akin to the franchise is the license or permit by which permission is given to individuals by some competent authority, conferring the right to do some act which would otherwise be illegal.

By requiring franchises, licenses, or permits for engaging in business, any government can exercise regulatory powers through laying down conditions

for granting or revocation of these permissions.[1] As a method of control, the franchise has been particularly important in the public-utility field, but the conditions upon which franchises to corporations have been granted make the corporate charter type of franchise also of significance. In recent years, too, the tendency to require licensing of various types of businesses, and to revoke those licenses when certain conditions are not met, has made this method of control of increasing moment.

As a way of control, however, the franchise, the license, and the permit are inflexible, in that they do not and cannot make complete provision for the varying conditions which government control is certain to encounter. While still widely used, they are now generally accompanied by an administrator or an administrative commission to interpret and apply phraseology purposely made elastic.

The public-utility franchise has been largely superseded as an instrument of regulatory control by the development of commissions. The experience with such franchises amply indicates their weaknesses. To be at all effective in a field where fairly complete control is necessary, the franchise must include so many provisions and must be so carefully drawn to take care of future exigencies that, unless it is accompanied by commission regulation, it is likely to be a hindrance to protection of the public interest. It must be remembered that a franchise is a contract between a governmental authority and an individual or a corporation. As such, unless enough safeguards are placed in it to make future change in the public interest legal, its provisions may be held enforceable in spite of their defects or outmoded nature. If a franchise is made elastic enough to allow for future conditions not envisaged at the time, administrative treatment of its provisions by some body, such as a commission, is necessitated. If a franchise is drawn up in detail to care for needed regulation, but its term made short to safeguard the public, the prospect of losing franchise privileges is not conducive to the economic embarkation of capital in such enterprises as railroads and gas and electric companies.

Furthermore, legislators who grant franchise rights are not usually trained to care well for the legal or business details necessarily included in a well-drawn contract. Too often companies, with their superior knowledge of the business and ability to hire good lawyers, have outwitted unsuspecting state legislators or city councilmen into making concessions which do not safeguard the public. In addition, the granting of franchises in the past has often been accompanied by bribery to legislators for favorable votes. A franchise granted in 1884 to operate street railways on New York's Broadway was admittedly obtained by means of large-scale bribery, but its perpetual and irrevocable character has been upheld by New York's highest court.[2]

[1] A license can be differentiated from a franchise: the former is an imposed device of regulation; the latter is a grant of privilege.

[2] *People v. O'Brien*, 111 New York 1 (1888).

4. COMMISSIONS.

a. Nature. Viewed as a method of control, a commission is a governmental body consisting of a certain number of members charged with administering a regulatory statute. While the term "commission" implies a board of several members, it is not at all unusual for the functions of the body to be exercised by one individual or commissioner. The purpose of a commission is, then, to enforce regulatory laws through the administrative method, as contrasted with the strict judicial or legislative method. Certain regulatory principles are set up by law, usually in the form of statutes passed by a legislature. The commission is charged with the duty of seeing that these principles are put into effect. Often it is given rather detailed guides as to how this is to be done. But one of the most important features of commission regulation is that a large field of discretion remains to the commission as to how the will of the legislature is to be enforced.

For example, the federal legislature has made unlawful interstate railroad rates which are unjust or unreasonable, and has entrusted the administration of this law to the Interstate Commerce Commission. But the statutes do more than this. They empower the Commission not only to condemn existing rates but to establish rates for the future. They lay down a sort of rule by which it is to determine reasonableness. They state the procedure which it is to follow in exercising this power and in putting its orders into effect. Moreover, through legal prohibitions on certain kinds of rate discrimination, through policies to be followed where competing forms of transport are involved, and through many other provisions touching upon rates, the statutes chart the course for the Interstate Commerce Commission. Nevertheless, in spite of the detail to which they have gone, the Commission in applying these laws is left a high degree of discretion. The application of the law to the facts of each case involves discretion, as does the interpretation of such elastic phrases as "unreasonable," "unjust," and "adequate."

The commission is in reality a mixture of the legislative, administrative, and judicial functions of government. The typical regulatory commission is always given discretion in applying certain legislative rules, and this usually means that it has to devise rules of its own. The power of the Interstate Commerce Commission to regulate railroad accounts, for instance, grows out of a statutory provision which is exceedingly general. The Commission, however, has laid down numerous rules for the keeping of these accounts; in doing so it is acting as a lawmaking body.

Obviously, in enforcing the laws set down by the legislature, the commission is acting in an administrative capacity. The statutory basis of many regulatory commissions often goes much farther. They may be charged to act as representatives of the public in controversial matters and to be the guardians of its interest. Thus, the commission has sometimes been likened to a public prosecutor when it brings suit to enforce an order against a violator of that which the commission believes to be the law.

Commissions indubitably have judicial characteristics. Hearings are held and evidence is introduced, although commissions are not usually limited by rules of evidence as strictly as are the courts. In so far as these boards undertake to interpret legal rules by giving meaning to them in particular cases, they are exercising a judicial function.

The mixed character of the commission has been opposed in this country as being inconsistent with the separation of powers and hence unconstitutional. The commission's validity has also been challenged as an unconstitutional delegation of legislative power. This opposition has not been sustained, for the courts have realized that if certain powers are to be exercised at all, a commission or board is necessary. Constitutional quibbling has given way to "common sense" before the courts, for, so far as general rules are laid down by the legislature, "purely legislative power" has seemed not to be delegated to a commission.[1] As for the judicial character of these commissions, their "quasi-judicial" nature has been held to be no more than incidental to legislative or administrative power, and not to destroy the fundamental separation of powers.

b. Development in the United States. The development of the commission as a method of regulatory control has been interesting. Commissioners (or "superintendents") of banking and insurance have long been granted administrative powers over banks and insurance companies by many states. Railroad commissions were set up before 1850 to watch out for the public interest (at first as an organ of publicity or "advice") as these new transport agencies grew in importance.

One of the earliest federal administrative commissions, and one which has become a pattern for many others, is the Interstate Commerce Commission, mentioned above, which was originally established in 1887 to administer railroad regulation. Its scope, in terms both of forms of transport and of objects of regulation, has been increased, until today there is hardly any other commission with larger experience or greater importance in the field of control. The commission movement was given impetus by the adoption of commissions for state public-utility regulation in the decade prior to the first World War. In the same period many federal commissions were created. The Federal Reserve Board, with powers over central-banking policy and national-bank practices, was established in 1914, the same year in which the Federal Trade Commission, with powers over competitive practices of business in or affecting interstate commerce, was set up. In recent years, commission regulation has been further extended, as can easily be noted from the creation of the Securities and Exchange Commission in 1934, and the National Labor Relations Board and the Social Security Board in 1935. These are only a few examples of the ever-widening use of quasi-judicial, quasi-legislative administrative boards as agencies of control.

Besides regulation by boards, the administrative principle of the commission

[1] *Interstate Commerce Commission v. Goodrich Transit Co.*, 224 U.S. 194, 214 (1912).

is being increasingly applied to single commissioners or administrators. In addition to such important regulatory administrators as the Comptroller of Currency, the Patent Commissioner, and departmental administrators such as the chief of the Food and Drug Administration in the Federal Security Agency, entrusting of enforcement of the new federal Wages and Hours Law to a single administrator is exceedingly interesting.

c. Advantages of commissions. The commission is particularly suited to most fields of government control. As contrasted to judicial decision, it makes possible prescription of action to safeguard the public interest, *before* injury to that interest. It is better to set public-utility rates on a reasonable level than to rely on customers' suing for a return of money expended on extortionate rates. It is better to insure competence in advance by licensing physicians than to wait for patients harmed by a quack doctor to sue for damages.

In the second place, commission regulation makes possible continuing supervision. Usually where government control is found necessary, continual contact with the industry is important. With the furnishing of public-utility service, or with the application of labor regulations, problems are seldom *finally* solved, and changing conditions call for an almost ceaseless regulatory treatment. The commission may keep in close contact with these problems. The informal nature of the commission method, whereby commissioners or commission representatives can work out in advance solutions to these problems, without recourse to courtroom technicalities or legislative politics, helps to explain how this kind of supervision can remain so uninterrupted.

A third advantage of the commission method is that administration of general regulatory principles *can* be handled by a group of experts. If those entrusted with railroad regulation in a state are experts in this field, the advantage for efficient public regulation is obvious. Because the commission is usually limited to a narrow field, its membership can include men who are experts in this line.[1] Moreover, the commission may, for the same reason, as well as because of the constant nature of its activities, make efficient use of a staff of expert assistants. It would obviously be excessively costly for the courts or legislatures to hire experts to advise them in all the fields with which they might deal. But a public-utility commission or a securities commission has its jurisdiction limited to a certain type of regulation, and its staff of experts will likewise be limited to this narrower field.

d. Dangers in the commission method. One of the dangers in the commission method is that it can become the basis for a complicated bureaucracy. Not only can the field of government regulation be extended, but the jurisdictions of commissions may be so broken down and the number of commissions increased, for the purpose of obtaining expert control, that the business man or customer has to deal with altogether too many of them. This may become so

[1] Or who become expert as the result of long familiarity with certain problems. Practically, this experience in the commission may be the most important source of expertness.

confusing to persons subject to commissions, and so much red tape may result, that much of the efficiency of the commission may be lost.

The commission has often been criticized as being legislator, prosecutor, judge, and jury. In a sense this may be true. On certain matters the commission must make rules to aid in the administration of a law. Most commissions are empowered to make investigations into the activities of persons under their jurisdictions. On the basis of these investigations, commissions often decide what they believe to be the law and whether they find a violation of it. Having made this decision, an order is usually issued. If it is not obeyed, the commission may then bring suit against the violator in a court. There do seem to be possibilities for abuse in an administrative device of this sort.

Actually, however, most commissions take care to divide these functions. A member of the commission staff, ordinarily an examiner, gathers the facts for the investigation. The commission itself sits as a sort of jury and judge to decide whether these facts justify a finding of violation of the law. If, on issuance of an order, compliance is not forthcoming, the legal staff of the commission brings proper suit. Hence, to the extent that these different functions are divided within the organization of the commission and its staff, it is not correct to say that the membership of the commission itself combines them all.

If the commission does not separate these functions within its organization, or if in making its finding it places undue emphasis upon evidence presented by examiners, unfairness can easily result. While abuse of commission power may be curtailed by resorting to the courts or to the legislature which created the commission, this is likely to be little solace to the small-business man or customer who feels that he has been treated arbitrarily and unfairly. He may not be able to afford an appeal to the courts, or he may find it difficult to convince a court, in the absence of a clear legal mistake by the commission, that the latter's conclusions from the facts were unjustly reached. After all, the commission must have some discretion in applying the law to the facts, but this discretion may be open to abuse.

One of the best methods of insuring fairness and effectiveness of commission regulation is to be sure that its members are competent in the field and not subject to undue political control. In many states public-utility commissioners are still elected by popular vote; in cases where commissioners are appointed, the appointment is often looked upon as a way to repay political debts. When political factors cause incompetent or partial men to be placed on commissions, effective regulation is threatened. The unfair baiter of business is as dangerous as the influenced conniver with business. Since commissions are generally regarded as protectors of the "public," particularly the consuming public, there is likely to be a bias in its favor at the expense of big business. But this bias can be kept at a minimum by some non-political method of selection of qualified members.

e. Judicial review of commission action. In the United States, any decision on

a point of law of an administrative commission is open to review by the courts. In some cases the legislature defines the procedure of appeal, but no legislature, state or federal, could refuse to grant the right of appeal. To do so would be to take liberty or property without due process of law.

The main problem in respect to judicial review of commission action is the extent of this review. If the court reviews both the law upon which the commission's action was based and the facts upon which it arrived at the action, it is in effect duplicating the commission's functions and much of the advantage of commission regulation is lost. From a strictly legal point of view, a court entertaining an appeal from a commission decision usually limits itself to the legal question. Even if it did not, it is clear that the legislature may limit the court to the legal question.[1]

Where the legal question is whether or not the commission had statutory authority to act as it did, the court may need to pay little attention to the facts. But where, as is most usually the case, the order of the commission is appealed as being opposed to due process, there is little that can keep the court from reviewing the facts. Due process, as already noted, is not only a matter of fair hearing; a commission must have acted upon the evidence and not arbitrarily.

According to legal principle, the courts will not substitute their judgment of the facts for that of the commission, and due process does not require that the decisions of the latter be accurate in view of the evidence. But due process does require that the decision of the commission be supported by evidence on which the commissioners, as reasonable men, might have reached a judgment. The record must also show that an opportunity to present all the pertinent facts was given and that the commission weighed them. This means that in many cases a question of fact shades into a question of law.

Although a court may declare that it is interested in legal questions only, or that it does not sit "as a board of revision to substitute its judgment for that of the legislature or its agents as to matters within the province of either," so long as commission orders must meet the test of due process in substance, there is apparently no way of dividing up the regulatory task so that commissions determine facts and courts determine only the law. However, the courts may restrain themselves in overruling commissions and interfere only where the legal fault is clear. Also, by the legal procedure of remanding to the commission cases in which facts are questionable, the courts usually avoid duplicating too much the quasi-judicial work of the commission.

If property and liberty are to be safeguarded from possible abuse by administrative commissions, there is apparently no way to avoid the delay and expense of appeal to the courts. The legal skirmishes which follow or accompany commission action are costly in terms of effective regulation. When a telephone-rate case can be kept in the judicial air for more than a

[1] See *Interstate Commerce Commission v. Louisville & Nashville R.R. Co.*, 227 U.S. 88, 91 (1913); *St. Joseph Stock Yards Co. v. U.S.*, 298 U.S. 38 (1936).

decade before any decision is reached, as was disclosed in Chicago a few years ago,[1] the effect of court action on efficient regulatory control is apparent.

Inefficiency introduced by the delay and expense of court appeal can be reduced by the courts' limiting themselves to the legal question as much as possible, allowing commissions to work out administrative methods as they will, and interfering only where the action of a commission is clearly arbitrary, incompetent, or dishonest.

5. CODES. Under this method of control, business is given the opportunity to regulate itself, subject to supervision by the government. The code of fair competition, a set of ethical practices approved by a trade, is an outgrowth of the attempt by trade associations to stabilize practices in a particular field of business. Even before 1933, many of these codes were accepted by the Federal Trade Commission as embodying a standard of fair competition in a field. With the passage of the National Industrial Recovery Act in 1933, the code became a dominant form of business self-regulation under governmental supervision. Although the Recovery Act was short-lived, the code as a method of control has not succumbed.

Codes are an advantageous method of control in that they represent, to some degree, self-regulation by the businesses concerned. Such regulation should consequently include provisions of importance and interest to the group. Because the regulation comes from the trade, compliance should be made easier. On the other hand, for a code to be effective the government must have an agency empowered to enforce it. Also, because the members of the group which formulate the code are likely to consider their own interests to the exclusion of other business men and consumers, protection of the latter groups may greatly complicate the machinery of arriving at a code truly cognizant of the public interest. Furthermore, the multiplicity of codes and code provisions is likely to result in an all too burdensome mass of regulations, the interpretation, administration, and harmonizing of which might be extremely difficult.

6. INVESTIGATION AND PUBLICITY. As a method of exercising control, public investigation and the force of publicity arising therefrom should not be overlooked. Investigations of business by federal and state legislatures are commonplace, and it is not unusual for administrative commissions and administrative officers to make public investigations of business practices and conditions. To be sure, most investigations are undertaken to gain expert data on conditions so that regulatory laws can be passed to meet the needs so exposed. But often the most important effect of investigations is to force business, under the spur of public opinion, to make changes in practices and policies in advance of, or without recourse to, statutory measures.

While many of the investigations of the Federal Trade Commission have been used as the basis of new legislation, one of their most significant results has been to cause discontinuance of certain practices. For example, investi-

[1] See *Lindheimer v. Ill. Bell Telephone Co.*, 292 U.S. 151 (1933).

gation of public-utility holding companies disclosed practices inimical to effective regulation of local public-utility operating companies.[1] Even before the national government passed a law regulating these holding companies in 1935, many of the companies had discontinued the practices involved.

The Federal Power Commission's investigation of electric rates also did much to cause reduction of rates which appeared to be relatively high.[2] The investigation of civil liberties undertaken by a Senate subcommittee, in which employers' methods of spying upon and interfering with labor unions were exposed, has definitely affected labor policies of most of the companies concerned.[3]

Effective as this method of control may be in certain cases, the inquisitorial nature of some investigations, plus the fact that practices of all the businesses in a field can seldom be publicized, make it one to be used sparingly. Too often large businesses are forced by public opinion to give up certain practices, while smaller businesses escaping investigation can continue without restraint. Moreover, in some matters where regulation may be needed, the force of public opinion may not be an adequate goad.

7. PUBLIC AID. Grants of public aid, whether in terms of cash, special privilege, government services, or advantageous enabling laws, very often carry with them certain conditions upon which the gift will be made. With the government extending aid on a wider front to businesses of all sorts, it is only natural that control through such aid should increase.

A perhaps insidious feature of control by this method is that the recipient of government aid may be so happy to receive the help that the strings attached to it may not seem to be important. Furthermore, a question exists as to whether the emergency character of much government aid will ever pass over. There are those who believe that such emergency grants, especially in the field of credit facilities, will become permanent, and that this method of control will take an important place along with those methods which are admittedly more direct.

8. TAXATION. While taxation in order to be valid must be for revenue purposes, or be one of many devices to carry into effect some power a government has, its method of application, especially in regard to exemptions, is one of the most important means of exerting regulation. Customs duties on selected imports are certainly used to regulate the flow of foreign trade and aid the development of domestic industry. Taxes on certain commodities, such as colored oleomargarine, opium, and white phosphorus matches, are probably more valuable as regulatory devices than for revenue. Taxes on chain stores are also imposed in the interests of restricting the effectiveness of this method of merchandising as compared to that of the independent retailer.

[1] *Utility Corporations*, U.S. Sen. Doc. 92, 70th Cong., 1st Sess. (1928–1937).

[2] Federal Power Commission, *Electrical Rate Survey* (1937).

[3] *Rights of Labor*, U.S. Senate, Subcommittee of Committee on Education and Labor, 74th Cong., 1st Sess. (1937).

Taxes must also conform to certain standards in order to be valid. They must apply uniformly. Within reason, as stated above, they must be for revenue purposes. But reasonable exemptions from the operation of the tax can be laid down, so that its regulatory force can be applied on certain subjects, as desired.

9. Government Ownership. Some may object to the inclusion of government-ownership methods as a means of government control of business. But the fact that the government directly or indirectly goes into business is sure to have a controlling effect upon certain aspects of business. The government in business is no ordinary competitor or monopolist. The way it does business, the conditions it makes for others to do business with it, the political power behind it, and its practically unlimited financial backing make it a formidable agent of control.

Government ownership is often frankly used for yardstick purposes whereby private business is either brought into line by the danger of government competition, or the supposed inefficiency or imprudence of private management is "exposed" by the government plant. Yardstick regulation has been recommended particularly in the public-utility field.

Government ownership is carried out usually in one of two ways, by direct ownership through administrative departments or by the government corporation.

a. Direct ownership through administrative departments. State, local, and national governments own many businesses directly and operate them under some administrative department. Thus, the federal government's largest single enterprise is the post office. The property of the post office is owned directly by the government, and a Post Office Department is set up to administer this business, with the Postmaster General as executive head. Most municipally owned water businesses are administered directly by the municipality, with the water system and its organization as a department of the municipal government.

So long as the economic functions of government remain fairly simple, direct ownership through an administrative department is an adequate method. But as government ownership has gone more into the business field, rather than the furnishing of routine governmental services, the disadvantages of such a method of ownership have become very apparent. Being a part of the governmental administration and hence subject to political changes, ownership by this method has made difficult the formulation of a long-time business policy. Periodic change in executive heads has made continuity of policy practically impossible, and the policy followed has usually been subject to the political demands of the time. In the United States, particularly, the finances of such enterprises have to be handled through a central treasury, and in federal business the expenditures have often been subject to the vicissitudes of annual appropriation bills. In addition such businesses have to conform to general governmental practices respecting the appointment of personnel, the making

of contracts, and the keeping of accounts. Adherence to such mechanisms does not make for the flexibility necessary in carrying out a business enterprise. To meet these difficulties the government corporation has been developed as a method for effective public ownership.

b. The government corporation. By incorporating a business owned by the public, the government creates an entity separate from the government itself but subservient to the government. Proponents of this device say that it is possible to obtain the advantages of continuous business organization under a personnel not limited by the red tape of the ordinary government departments. By appointing directors or trustees with staggered terms it is possible for the corporation to weather political changes and still maintain some continuity of policy. The directors may also operate the corporation like any other business enterprise and sue, entertain suits, hold property, borrow money, and make expenditures in the corporate name rather than in the name of the government.

Government corporations are of several kinds. The government may own all the capital stock and consequently select all the directors. This is most typical of government corporations in the United States. Examples are the War Finance Corporation, the Panama Railroad Company, the Inland Waterways Corporation, the Reconstruction Finance Corporation, and the Home Owners' Loan Corporation.

In a few cases in the United States, and in many cases abroad, government corporations have been "mixed" in that the government owns part, and individuals or private corporations own the rest, of the stock. Although the government may own only a part of the stock, it may exercise exclusive control, or major control, or little control at all. While the federal government owns only 51.8 per cent of the stock in the Federal Deposit Insurance Corporation, the remainder being owned by the federal reserve banks, all directors are appointed by the United States. In the case of federal land banks, the federal government appoints four of seven directors, regardless of its stock ownership. But with the early-nineteenth-century United States Banks, the federal government was a minor stockholder and had a minority representation on the board of directors. Variety in "mixed" corporations is also shown by the British Anglo-Iranian Oil Company, in which the English government is a majority stockholder but appoints only a minor part of the board of directors.

A third type of government corporation is the non-stock corporation. No stock is issued, the government merely granting funds and powers to act to the corporation, and placing a board of directors or trustees in charge. This type of corporation is quite similar in nature to the Russian "trusts" whereby business is organized into "trusts" and administered by a board of trustees acting for the state. This is a logical kind of government-ownership device, for the "trust" may be incorporated and a small group of directors made responsible administrators, without the detail of stock issuance, holding, and voting. The

Port of New York Authority, organized in 1921 to operate and construct toll bridges and tunnels in the New York City area, is such a non-stock corporation, with directors appointed by both New York and New Jersey. The Tennessee Valley Authority is also such an organization, as is the British Port of London Authority and the British Broadcasting Corporation.[1]

B. TYPES OF CONTROL

1. ENTRY INTO SERVICE. Perhaps no type of business control is more common than that exercised by the government over entry into service. Physicians, dentists, beauty experts, and barbers must usually obtain permits before setting up in business. Taxicab operators, bus companies, telephone companies, railroads, electric light and power companies, and others also receive some kind of permit before they can begin business. Persons who would open a bank, an insurance company, or a brokerage agency usually must get permission to do so. A moment's reflection may bring to mind even more examples where entry into business is not a right to be freely exercised without getting some permission from the state.

Sometimes the purpose of requiring permits or licenses before entry into business is largely for the revenue that can be obtained. More often, however, regulation of entry is designed to protect the public interest in some way and is a use of a state's police power or of the federal government's power to police those matters within its jurisdiction. Thus, obtaining competent physicians, dentists, or even barbers is a matter of public concern. Because telephone, bus, and other public-utility companies use public streets and highways, the public has an interest in keeping these facilities from being crowded with competing companies. Moreover, in the public-utility field it has been found that the most efficient service to the public can ordinarily be obtained by encouraging monopoly. For this purpose, permission to enter the business has been required. In this and other fields, the necessity of protecting public property, or of obtaining efficient production of important public services, or of insuring that the business will be responsibly operated, has been held to justify the regulation and restriction of entry into service.

2. QUALITY OF PRODUCT. In many cases, regulation of the quality of product has been found necessary in the public interest. Pure-food and drug laws have been passed with the hope of safeguarding the innocent consumer, who may be duped into accepting not only adulterated substitutes but goods positively injurious to his health. Wherever a monopoly is granted to a private company, such as to an electric light and power company, the quality of the product is ordinarily subject to regulation; this may be in terms of minimum

[1] For an excellent discussion of government corporations both in the United States and abroad, see Thurston, John, *Government Proprietary Corporations* (Cambridge, Massachusetts: Harvard University Press, 1937).

and maximum voltages, interruptions of service, or accuracy of meters. Specified standards of quality of service are also customarily required of other public utilities. Blue-sky laws, whereby the honesty of security issuance is regulated, are also an example of an attempt to regulate quality of product.

3. Quantity of Product. In the public-utility field particularly, service regulation includes the requirement that the service be adequate. For example, a telephone company which has held itself out to serve a certain locality cannot decide that it will not expand its business in that locality if more customers want service. While the requirement that enough of a product of an industry must be forthcoming to serve customers adequately is rather peculiar to the public utilities, this type of control can be found elsewhere. For example, through government-owned lending agencies, the government has been known to put pressure on banks to lend to businesses on freer terms and in larger amounts.

Another variation of this type of control can be found in the regulation of the extractive industries. Many states and the federal government have attempted to curtail the output of oil producers and farmers, as well as coal-mine operators. While this control has been largely for the purpose of raising prices in these fields, it has also been justified as a measure for the conservation of natural resources.

4. Abandonment of Service. A type of control applicable to public-service companies and to common carriers is the restriction on free abandonment of service. In these fields a company may not withdraw from service whenever or to whatever extent it wishes. Because these companies have embarked upon a business which the public regards as necessary, and because they are often given monopoly privileges, their right to abandon service is limited. In order to quit such service, they must receive permission from the administrative agency in charge of their regulation. This type of control is not found in other business fields, although liquidation of such businesses as banking or insurance is accompanied by many legal technicalities.

5. Reasonable Price. One of the most important types of control is regulation to obtain a reasonable price. Because price has been regarded as the heart of a contract, and freedom of contract indispensable for a system of free private enterprise, extension of regulation of price to new fields has been strongly resisted. At first applied in this country only to common carriers and public utilities, enforcement of reasonable price has been introduced to new subjects of regulation. Regulation of wages and bargaining conditions of laborers have incorporated the idea of reasonable price. Production control in agriculture and other industries has been dominated in part by the desire to obtain a reasonable price. Regulation of bank interest charges and insurance company rates are further examples of the application of this type of control.

It might be noted here that of all types of control perhaps none has caused

more difficulty than the attempt to set reasonable prices. Because of its close connection with the very essence of property, and because reasonableness of prices is not a matter of formula, lawmakers and administrative officers and commissions, as well as judges, have found the concept of reasonable price not easily understood or defined.

6. Discrimination in Price and Service. Strict business privacy would imply that the business man may deal with whomever he pleases and upon what terms he pleases. In other words, the right to discriminate between customers as to either price or service is one of the traditional elements of privacy. In certain fields, however, government control has taken the form of forbidding unreasonable discrimination in price or service between customers. Note that discrimination is modified to include only that which is unreasonable. For example, it is unreasonable for a telephone company to take toll calls from one resident user but refuse to take them from another, or to charge two users in exactly the same position different rates. But it is not unreasonable to charge a different rate to resident and business users, since the type of service required, or other factors, makes this discrimination reasonable in the opinion of the public.

Unreasonable discrimination in price or service has ordinarily been limited to common carriers and public-service companies. Because their service has been regarded as so necessary to the public and because they often operate under certain public grants of privilege, such requirement is deemed to be in the public interest. This type of control has been extended to general business through various fair-trade laws, so that the manufacturer or wholesaler who would charge or serve two customers differently may find himself faced with this type of control.

7. Honest and Prudent Financing. Because of increased public interest in the ways in which certain businesses are operated, control for purposes of securing honesty or prudence in financing has been growing in importance. Where price has been regulated, such control has been found necessary for its more accurate determination. In some cases, notably the public-utility holding company, the public has found that financing methods have thwarted the purpose of administration of government regulation. In other cases, even where the businesses were dominantly private, some control over financial practices has been necessary for protection from fraudulent security issuance.

8. Restraint of Trade. Because relative freedom of trade has been regarded as desirable in most fields, many aspects of government control have been devoted to removing restraints from the freedom of doing business. These restraints are usually those of monopoly or monopolistic practices which interfere with the effectiveness of competition. This type of control does not envisage the removal of all restraints upon the freedom of trade. The advantage to the public of patents and copyrights is an exception. Monopoly has also

been allowed in business where the growth has appeared to courts and commissions as being natural rather than artificially stimulated.

Moreover, in some fields restraint of trade has actually been encouraged. Extension of the monopoly principle in the public-service industry (electric, gas, water, telephone, etc.) has been encouraged because it has seemed that the public interest in adequate service and reasonable rates lies in this direction. Although the transport field is still dominated by competition, recent developments indicate that the public favors encouragement of monopoly there also. It is important to remember, however, that, where restraint of trade is actually promoted, increased regulation to prevent injury to the public from monopolistic practices is a necessary concomitant.

9. UNFAIR PRACTICES. Introduced in this country as a type of control to aid in gaining ethical freedom of trade, prohibition of unfair practices has become an increasingly important regulatory device. Not only is it used to limit business men in taking such advantage of rivals as "unfairly" to reduce the freedom of doing business, but the concept has been extended to other fields. Most important is the unfair labor practice where an employer is forbidden to interfere with the privilege of self-organization and collective bargaining by employees through freely selected unions.

What is an unfair practice is a matter of the prevailing mores, as these come to be recognized by legislatures and administrative commissions and as they are supported by the courts. It is interesting to note how this type of control in the field of competition was at first limited to practices which were unfair in that they artificially stimulated monopolies. But under the National Industrial Recovery Act, an unfair practice became an act of nonconformity with a monopolistic business code. And under recent "fair-trade laws," an unfair practice has become refusal to sell a trade-marked good at a fixed price set by a manufacturer, a procedure which smacks of monopoly.

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Part Two

REGULATION OF TRANSPORT AGENCIES

CHAPTER

5

RAILROAD REGULATION: *Evolution*

WITH the possible exception of money and banking regulation, the earliest government control over business of a continuing and supervisory nature was exercised in the transportation field. While canal and turnpike regulation antedated control of railroads, it was sporadic and limited largely to the enforcement of charter provisions. The real beginnings of regulation and the development of many regulatory principles are therefore found in the railroad field.

In railroad regulation both the states and the federal government have exerted control. But because control by the former has been rendered largely ineffective by the interstate aspect of railroad carriage, particularly since the growth of railroad systems in the latter half of the nineteenth century, the control exercised by the federal government has been far more important. For this reason, most of the discussion of railroad regulation will be limited to it. However, in discussing other transport agencies, notably motor carriers, more attention will be given to state legislation, since the federal government has not gained as complete control there as it has with the railroads. Furthermore, because the regulation of public-service companies has been so much a matter of state control, the later analysis in that field will suffice to indicate the principles and problems of state regulation in the sphere of businesses affected with the public interest.

A. DEVELOPMENT OF RAILROAD REGULATION

The difficulties of bringing a large industry under government control can hardly be realized without sketching the development of such regulation. Space forbids tracing the growth of all the types of regulation treated in this book. Even for the railroad industry, in which the regulatory basis may now be said to be fairly complete, only the very briefest outline will be made.

A few landmarks may be given as an aid to understanding this complex development. In the first place, regulation prior to 1887 was in the hands of state governments. Some states had strong commissions; others regulated by weak commissions which had power to do little more than to investigate and to publicize abuses; still others relied upon charter provisions, and some states had little more regulation than could be found in the common law respecting carriers. Passage of the Interstate Commerce Act of 1887 represents a second landmark. This act denotes the entrance of the federal government into the field. Weaknesses of the law caused a series of amendments, largely of a patchwork nature, to be passed in the next two decades. The third landmark was the Hepburn Act of 1906. This act, by which teeth were put into the law, represents the beginning of effective and strong railroad regulation.

While a number of important laws were passed in the decade or so following the Hepburn Act, the Transportation Act of 1920 is selected as a fourth landmark. As the result of weaknesses discovered in the railway system during the first World War, and owing to the realization that the railroad system needed constructive legislation, this act represents a new approach to railroad regulation. Legislation prior to 1920 was largely punitive. The law of 1920, while not relaxing railroad regulation, did include provisions which were designed to help the railroads and to build an adequate and efficient railroad system.

Although many important laws have been passed since 1920, particularly by the New Deal in 1933 and after, these represent merely a further development of the new approach in 1920. Because of the critical condition into which the railroads were thrust by the depression following 1929, these relief measures may be regarded as a fifth landmark in railroad regulation.

The following brief analysis is not meant to give a complete picture of the many regulatory provisions applicable to railroads under federal control. Some of the more important phases of the subject will be taken up in succeeding chapters, with special emphasis on the problems and results of regulation, using as a point of departure the law in effect at the present.

1. Regulation Prior to 1887. Effective regulation, even by the states, did not come before the 1870's, although some regulation was found in charter limitations and early "advisory" railroad commissions. Many railroad charters included limitations on maximum charges and rate of profits, but these maxima were usually so high as to be of no significance as regulatory measures. Moreover, such regulation as resulted did not touch the problem of rate discrimination, or adequacy or equality of service. The charters were also a weak form of regulation in that even in the same state charters differed in their provisions and no uniformity in policy was possible.

Railroad commissions were first created in Rhode Island in 1839, New Hampshire in 1844, Connecticut in 1853, Vermont in 1855, and Maine in 1858. These commissions have been called advisory in that their main purpose was not to regulate but to advise legislators, administrators, and railway

officials on certain matters. They usually had the duty of seeing that railroads lived up to charter provisions; they appraised land taken by railroads through eminent domain; they reported accidents, adopted measures to reduce accidents, and gathered what financial and operating statistics they could. Some also attempted to help the railroads in apportioning receipts and expenditures in interstate traffic.

Positive control over railroads did not come until the so-called Granger legislation of the seventies. This was brought on by an agrarian revolt against certain railroad practices, a revolt which has come to be known as the Granger Movement. While the "Grange," an organization of farmers especially popular in the Midwest, did not sponsor railroad legislation, discussion of railroad problems by its members had much to do with solidifying opinion in favor of regulation of the railroads.

Actually, the Granger Movement was brought about by the agricultural depression of the late sixties and seventies caused by a decline in agricultural prices. While the railroads were not to blame for this depression, the farmers, angered by railroad practices, felt that relief lay in the direction of railroad regulation. They believed that unreasonably high rail rates contributed to low farm prices, that the railroads discriminated against them by charging lower rates to competitive points and to certain favored shippers, and that control of the railroads by Eastern capitalists had robbed them of the beneficial effects of railroads, many of which roads they had helped to build through taxes and direct investment.

As a result, strong regulatory measures were passed by legislatures in most Midwestern States. These included strict regulation of maximum charges, usually by direct legislative action, pro-rata clauses by which rates lower for a long haul than for a short haul were prohibited, provisions prohibiting granting of free passes to public officials, and clauses forbidding combination of competing railroads.

Although upheld in 1877 as a constitutional regulation of businesses "affected with a public interest" by the United States Supreme Court,[1] the Granger laws were repealed in the late seventies by most of the states. The depression of 1873, together with effective propaganda efforts by the railroads, as well as the difficulty of effectively administering the crudely drawn laws, caused the public to wonder whether it had actually been helped or hindered by this legislation. State regulation was revived in the eighties. However, by that time the federal government had entered the field, and it has since overshadowed, though not entirely displaced, state regulation of the railroads.

2. The Interstate Commerce Act of 1887. For some years before 1887, Congress had investigated the feasibility of providing for federal regulation of railroads. In 1874 a congressional committee had reported that the abuses in the railroad system could best be met by government competition and

[1] *Munn v. Illinois*, 94 U.S. 113 (1877).

recommended the improvement of natural waterways, the construction of canals, and the building of a railroad from the Mississippi River to the Atlantic seaboard.[1] Since no action was taken following this report and the demand for regulation became imperative, a second committee was selected to study the question; it reported its findings in 1886.[2]

The report of this committee, as well as the decision of the Supreme Court in the Wabash case,[3] led to the adoption of the Act of 1887. The committee described widespread abuses, and emphasized that the extension of railway facilities made the problem of regulation an interstate rather than an intrastate one. Overbuilding of railroads, industrialization of the Middle West, and the depression of 1873 had led to cut-throat competition between railroads. This competitive struggle had given rise to rate discrimination and to the organization of pooling arrangements which impressed the popular mind as placing the small shipper and the consumer in danger of monopolistic exploitation. Competitive construction had been accompanied by fraudulent financial practices and excessive promotion profits, with a resultant threat to the solvency of railroad investment.

The decision in the Wabash case also hastened the enactment of federal legislation. In this case the Supreme Court held that a state could not regulate rates on interstate traffic. Since much of the traffic was interstate, a large part of the railroad business was left unregulated. This situation, in the face of popular demand for regulation of the railroads, made federal legislation necessary.

The Act of 1887 created a commission of five members to administer the new law. The legislation was made applicable to all common carriage by railroads operating in interstate and foreign commerce, as well as over interstate and foreign common carriage by water and rail where through traffic was involved. Since few railroads engaged exclusively in intrastate commerce, most of them carrying some interstate traffic, the act really applied to all railroads.

On the subject of rates, the act prohibited "unjust and unreasonable" charges; forbade discrimination between persons; prohibited unjust discrimination between places or kinds of traffic; and outlawed higher charges made "under substantially similar circumstances and conditions, for a shorter than for a longer distance over the same line, in the same direction, the shorter being included within the longer distance." [4] In addition, the act required publication of rates and fares and ten days' public notice of rate increases. Pooling of traffic or of revenue of competing carriers was forbidden.

[1] This interesting report may be found in *Transportation Routes to the Seaboard*, 43d Cong., 1st Sess., Sen. Rep. 307.

[2] *Report of the Senate Select Committee on Interstate Commerce*, 49th Cong., 1st Sess., Sen. Rep. 46.

[3] *Wabash Rwy. Co. v. Illinois*, 118 U.S. 557 (1886).

[4] The Commission was empowered to grant relief from the operation of this section when in its discretion such exemption seemed in the public interest.

The Interstate Commerce Commission was also to function as a board of investigation and was authorized to inquire into railroad management. For this purpose it might require the presence and testimony of witnesses, and the production of books and documents relating to the subject under investigation. The Commission was in addition empowered to require annual reports and to prescribe a uniform system of accounting. Enforcement of any Commission order necessitated application to a federal circuit court.

3. Weakening and Repair of the Act of 1887. While the Act of 1887 showed promise of being an effective regulatory law, a series of court decisions soon brought out its feeble character. In the first place, the Supreme Court in 1892 upheld refusals of witnesses to testify on the grounds that their testimony might incriminate them and that the law gave them no immunity from criminal prosecution upon this testimony.[1] This deficiency was removed by legislation passed in 1893, but the amendment was not upheld by the Supreme Court until 1896.[2] A second handicap for the Commission, in addition to the necessity of carrying its orders through the courts before they could be enforced, was the refusal by the latter to accept its findings of fact as final. Until a Supreme Court decision in 1896,[3] the lower federal courts treated every case as being original, and allowed the railroads to introduce new evidence which they had advantageously withheld in earlier hearings before the Commission. This hindrance to effective regulation was also partly removed by the passage of the Expediting Act of 1903, under which appeals to the Supreme Court were hastened.

A serious blow was dealt to the Commission's authority under the Act of 1887 when the Supreme Court held in 1897 that it had no power to fix rates, whether maximum or minimum, and that it could only find certain rates unreasonable or unjust.[4] This meant that effective rate regulation was impossible, for once the Commission had obtained court sanction to its order that a rate was unreasonable, nothing could stop a carrier from setting the rate slightly lower. If the rate were still unreasonable, the same process would have to be repeated. This disability was not removed until 1906, when power to set maximum rates was specifically given to the Commission.

The Act of 1887 was further emasculated by a Supreme Court decision in 1897 concerned with the long- and short-haul clause.[5] In this case the Interstate Commerce Commission had attempted to forbid a carrier to charge a lower rate for a long haul than for a shorter haul over the same line. The carrier claimed that competition with another railroad forced the discrimination. Obviously, most of these low long-haul rates were due to competitive influences and no effective prohibition of them could permit such influences.

[1] *Counselman v. Hitchcock*, 142 U.S. 547 (1892).
[2] *Brown v. Walker*, 161 U.S. 591 (1896).
[3] *Cincinnati, New Orleans and Texas Pac. Rwy. Co. v. I.C.C.*, 162 U.S. 184 (1896).
[4] *I.C.C. v. Cincinnati, New Orleans and Texas Pac. Rwy. Co.*, 167 U.S. 479 (1897).
[5] *I.C.C. v. Alabama Midland Rwy. Co.*, 168 U.S. 144 (1897).

But the Supreme Court held that the phrase "under substantially similar circumstances and conditions" signified that dissimilarity could result from competition between railroads. This decision meant that the Commission could do little about long- and short-haul discriminations, a lack of power which was not remedied until 1910.

The two decades after passage of the Act of 1887 brought little of any permanent importance in the way of regulation. Some of the weaknesses of the act were removed, but the major obstacles to effective control remained. Even the Elkins Act of 1903 did little to increase this effectiveness; under it, fines were provided for the granting of rebates and the non-publishing of tariffs, published tariffs were made binding, and the recipient of a rebate was made equally liable for punishment with the giver.

4. The Hepburn Act of 1906. Regulatory revision was provided by the Hepburn Act of 1906. The jurisdiction of the Interstate Commerce Commission was extended to express companies, sleeping-car companies, pipe lines other than water and gas, and accessorial services such as private car companies. The Commission was enlarged from five to seven members and the salary of commissioners was increased. Power to establish maximum rates, to regulate through routes and joint rates, and to require annual reports and uniform accounts was granted in unequivocal terms. In order to give the Commission more time for investigation and to insure publicity of rates, thirty days' notice of all rate changes was required. Subject to specified exceptions, issuance of free passes was prohibited. Stricter penalties in the form of imprisonment and higher fines were included. Moreover, in order to remove one of the main causes for personal discrimination the law contained the so-called "commodities clause," designed to keep railroads from carrying products of businesses in which they had an ownership interest.

The changes in procedure included in the Hepburn Act are also important. Orders of the Interstate Commerce Commission, except those involving the payment of money, were to become effective in thirty days, unless the carrier obtained a court order staying execution. Disobedience of the Commission's order brought a high fine. Such procedure meant that the burden was placed upon the carrier to obey the order or to institute court proceedings.

5. The Mann-Elkins Act of 1910. Intended to stop some of the gaps left by the Hepburn Act, the Mann-Elkins Act of 1910 was in effect a part of the movement for strong regulation represented by the Hepburn Act. The long- and short-haul clause, made meaningless by court decisions, was revitalized by the elimination of the phrase "under substantially similar circumstances and conditions," thus making the prohibition practically absolute. To keep the railroads from killing water-borne competition, the law provided that if low long-haul rates were allowed to meet such competition, the carriers could not later ask to increase these rates unless for some other reason than the elimination of water competition. To aid the Interstate Commerce Commission in

making a rate investigation and to protect the shipper who might be overcharged in the event a rate was later found unreasonable, the law included provisions for suspension of proposed changes in rates for an initial period not exceeding one hundred and twenty days, and for a second period of like length if the first period was insufficient. Another measure included was the establishment of a special court to enforce or enjoin orders of the Commission. Since this court was abolished in 1913, no further attention need be paid to it.

6. LEGISLATION, 1910–1920. The decade 1910–1920 witnessed the passage of a few isolated pieces of railroad legislation. The Panama Canal Act of 1912 is especially notable because it forbade any railroad or other common carrier under the jurisdiction of the Commission to control by ownership or otherwise any passenger or freight vessel operating through the Panama Canal or elsewhere in competition with such carrier. This measure was obviously designed to protect water carriers from extinction or limitation by competing railroads.

Another interesting piece of legislation was the Valuation Act of 1913. In order to settle the question of the value of railroad properties in the rate-making controversy of the time, Congress directed the Interstate Commerce Commission to make a valuation of the railroads of the United States. It is an interesting commentary on legislative judgment that Congress estimated this colossal task to cost about $5,000,000, but that its actual cost as of 1936 was over $200,000,000.[1]

Of interest, too, are the Adamson Act of 1917, by which labor was granted the basic eight-hour day; the Esch Car Service Act of 1917, under which the Interstate Commerce Commission was given more extensive control over the movement of railroad cars; and the Commission Division Act of 1917, in which the enlargement of the Commission to nine members and its reorganization into divisions for expedition of cases were provided.[2]

7. THE TRANSPORTATION ACT OF 1920. The wartime experience of the federal government in its operation of the railroads had brought to the fore their financial difficulties. The war administration had also left labor and rate problems unsolved. But more than anything else, the war experience led the public to question past regulatory policies by which competition had been enforced and rates kept down. The people came to realize that an adequate and financially sound railroad system was a need of national importance. Furthermore, there had been a long-felt need for new regulatory measures over issuance of railroad securities, minimum rates, new construction and abandonment, and fair return.

[1] See Taylor, H. G., "Simplification of Railroad Regulation," 187 *Annals of American Academy*, pp. 49–56, at p. 52 (September, 1936).

[2] Several other acts were passed in this decade, the most important by far being that by which the operation of railroads was taken over by the government. This experience is analyzed in Chapter 30, on government ownership.

As has been noted, the Transportation Act of 1920 represented a new approach to regulation. As Chief Justice Taft said in 1924:

> ... The new act seeks affirmatively to build up a system of railways prepared to handle promptly all the interstate traffic of the country. It aims to give the owners of the railways an opportunity to earn enough to maintain their properties and equipment in such a state of efficiency that they can carry well this burden. To achieve this great purpose, it puts the railroad systems of the country more completely under the fostering guardianship and control of the Commission...[1]

In addition to the long-range provisions, the law included arrangements for the return of the railroads to their owners after the period of federal control. Besides doing this, the act provided for certain transitional safeguards by which the railroads could be helped, mostly through loans, until they could get back on their feet.

One of the most important provisions of the act was that respecting rate-making. For the first time, Congress set up a guiding rule for the Interstate Commerce Commission to follow in setting rates so that adequate revenues might be obtained for the carriers. In order to meet the problem of strong and weak railroads, partial recapture of excess earnings of the more prosperous railroads was authorized, these recaptured earnings to be used for loans to needy railroads. The rate-making power of the Commission was extended to the fixing of minimum rates, so that with the previously granted authority over maximum rates it could set the absolute charge. Its power to grant relief from the prohibition against long- and short-haul rates was curtailed somewhat, and the time limit on rate suspensions was reduced.

A new legislative policy regarding combinations was included in the act. Pooling agreements found by the Interstate Commerce Commission to be in the public interest and not unduly restricting competition were to be allowed. Elaborate provisions were made for the encouragement of consolidation under Commission control and according to a plan which would preserve competition "as fully as possible." Authority over acquisitions of control by methods other than consolidation was given to the Commission. Further power over financial practices was granted by bringing the issuance of securities under its supervision.

In the field of railroad service, control over abandonments and new construction was placed in the Interstate Commerce Commission's jurisdiction, including power to require, under certain conditions, extension of railroad facilities. The Commission was also empowered to require joint use by several railroads of terminal facilities. Other service regulations included increased authority over railroad car-service rules and practices, and authority to order railroad carriers to install certain safety devices.

Several miscellaneous provisions may also be mentioned. Elaborate machinery was established for the settlement of labor disputes, although nothing,

[1] *Dayton-Goose Creek Rwy. Co. v. U.S.*, 263 U.S. 456, 478 (1924).

except the force of public opinion, was included to force compliance with wage decisions of the Railroad Labor Board created under the act. Interlocking directorates were forbidden except upon permission by the Commission. Accounting regulation was reinforced to the extent of requiring the Commission to broaden mandatory depreciation accounting. The body was again enlarged, from nine to eleven members, and power to initiate rate actions as well as to wait for complaints was given to it.

8. Legislation Since 1920. It is worth noting that, except for legislation affecting industrial relations, most of the railroad laws enacted since the revision in 1920 have been of an emergency nature, designed to help the railroads, or, as in one instance, the farmers. Here and there regulatory revision of a permanent nature has taken place, but on the whole, outside of labor matters, railroad legislation has not changed much since 1920.

a. The Hoch-Smith Resolution, 1925. The Hoch-Smith Resolution, passed in 1925, is especially interesting in that it represents an attempt at direct legislative control of railroad rates. While this resolution is not a part of the Interstate Commerce Act itself, such congressional statement of "true policy in rate making" did affect the work of the Commission for several years. The resolution directed it to make such rate changes as would promote the movement of products of agriculture affected by the depression in that industry. In addition, this resolution directed the Commission to overhaul the whole railroad rate structure of the country so as to bring commodity prices and freight rates into better balance.

b. The Railroad Labor Act of 1926. The failure of the Railroad Labor Board created by the Act of 1920 to keep the confidence of contesting groups, notably the employees, caused its abolition in 1926 and the creation of new machinery for the settlement of labor disputes. Without describing this machinery in detail, it can be said that the Railroad Labor Act of 1926 separated mediation and arbitration boards, eliminated public representation on some of the boards, created a permanent mediation board but left arbitration boards to be specially selected, and maintained reliance upon delay and publicity to force disputing parties into agreement.

c. The Reconstruction Finance Corporation Act of 1932. One of the general relief measures of the Hoover Administration was the establishment of the Reconstruction Finance Corporation in 1932. This corporation was created to lend funds to various business and government borrowers, among which were the railroads. In the early days of the depression, and to some extent much later, it was instrumental in keeping many railroads out of bankruptcy.

d. The Emergency Transportation Act of 1933. This act was in two main parts, one dealing with temporary aid to the railroads, the other containing permanent amendments to the Interstate Commerce Act. The temporary provisions authorized the creation of the office of Co-ordinator of Transportation for a limited period. The act directed the co-ordinator to investigate the possibili-

ties of economy in rail operation through the elimination of unnecessary duplication of services and facilities, and through the curtailment of other charges or expenses. Subject to certain limitations which will be discussed more fully below,[1] the co-ordinator was empowered to order carriers to undertake measures which his office found would eliminate waste. As we shall see, this power was never used.

The permanent parts of the Emergency Transportation Act included legislation respecting railroad combination, the rule of rate-making, and the recapture clause. Control of combination by the Interstate Commerce Commission was enlarged so that railroad holding companies could not gain control of railroads without consent of the Commission. Non-carrier companies controlling railroads were also placed under the accounting and securities regulations imposed on railroads.

The rule of rate-making was changed by dropping all reference to definite standards such as "fair return" or "fair value," and gave the Commission wide discretion to set rates which it should find to be in the interest of both carrier and public. Because of the impracticable and disputed nature of the clause covering the recapture of excess earnings, it was repealed. Moreover, certain minor amendments were made with regard to revising the valuation records of carriers when and if necessary.

e. The Bankruptcy Acts of 1933 and 1935. To aid the reorganization of bankrupt railroads a special bankruptcy act was passed in 1933 and some amendments were added in 1935. A special bankruptcy procedure was provided to expedite sound railroad reorganization. It enabled all interested parties to be heard in order to arrive at a plan fair to all classes of creditors and stockholders; it made it less possible for minority groups to block desirable reorganization; and it gave the Interstate Commerce Commission authority to participate in the formulation of the plan in the hope of gaining a sounder financial structure than had theretofore existed.

f. The Railroad Labor Act of 1934. Certain defects in the 1926 labor law were supposedly remedied by amendments made in 1934. Most of the changes introduced no new principles and affected procedure only. However, new provisions were made for the prevention of interference with independent organization of railroad employees.

g. Railroad retirement acts. Railroad retirement acts were passed in 1934, 1935, and 1937. These were designed to set up a system of retirement allowances for railroad employees. The 1934 law was found unconstitutional, and the 1935 law was quickly replaced by the 1937 act, which incorporated a plan agreed upon by management and labor. Interesting features of this law are that the retirement system for railroad employees is separate from the general Social Security Act applying to other businesses, and that the railroad retirement taxes and allowances are higher than those applicable to workers in other industries.

[1] See *infra*, pp. 167–69.

h. The Transportation Act of 1940. After considerable study of the transportation problem, Congress passed a new transportation law in 1940. The law is most significant for its treatment of the transportation situation in general, especially in respect to widening control over water carriers, although a few provisions of the statute apply to railroads directly. Of rather indirect interest to railroads is the broad statement of policy placed by the law at the head of the Interstate Commerce Act. By this policy, all forms of transport are to be regulated fairly and impartially so as to recognize the inherent advantages of each, to foster economic conditions in each, to develop reasonable and non-discriminatory rates, and to encourage fair wages and equitable working conditions. With certain exceptions, to be noted in Chapter 11, regulation of water carriers is extended to interstate inland carriers, and somewhat more thorough regulation under the Interstate Commerce Commission is applied to intercoastal and coastwise water carriers.

The Interstate Commerce Commission is given authority over the combination and consolidation of all common carriers covered by the Interstate Commerce Act. The requirement of railroad consolidation according to the plan introduced by the Transportation Act of 1920 is relaxed to allow the Commission discretion in permitting combinations of railroads. The new law places certain impediments to railroad combination, however, by requiring that the Commission in allowing it shall consider whether the public interest in better service will be promoted, whether the fixed charges resulting may be too high, and whether the combination adversely affects the interest of the carrier employees concerned. In addition, the new law specifically states that the Commission shall include, as a condition for approval of unification, terms and conditions providing that, for four years following the approval of a plan, no railroad worker may be placed in a worse position with respect to employment.

The Transportation Act of 1940 institutes new controls over the management of railroads, water carriers, and motor carriers. By giving the Interstate Commerce Commission power to investigate the manner of conducting business and to recommend to Congress any needed regulation of managerial affairs, the law opens the way for a broader supervision of transportation management.

The new law makes some slight modification in the rate discrimination provisions applicable to railroads, particularly with respect to the long- and short-haul clause. The law also repeals the land-grant rates, except for transportation of military and naval property or persons, thereby removing much of the necessity of railroads which once received land grants from the government to grant it half-rates. The power of the Reconstruction Finance Corporation to make new loans is also extended so that loans to railroads might be increased by a half-billion dollars.

A new special board of investigation is also set up by the law. This board of three members appointed by the President is directed to investigate and

report upon the relative economy and fitness of each kind of carrier, the use of public funds for transportation facilities, the extent of taxes, and other matters. The creation of such a board, and many other features of the Transportation Act of 1940, are interesting as representing the first important single transportation law in which regulations have been applied to railroad, water, and motor carriers. Although it does not rewrite the transportation law of the land into a single co-ordinated piece of legislation, and still leaves certain kinds of carriers regulated differently from others, it may signify the arrival of the time when transportation will be regulated as a whole industry, rather than as segments of an industry.

B. CONFLICT OF FEDERAL AND STATE AUTHORITY

In the discussion in Chapter 3 of the interstate commerce power, some attention was paid to the relative spheres of control of business by federal and by state governments. The conflict between the two has been of significance in the railroad field. Regulation of railroads is still carried out through forty-seven state commissions (all states except Delaware), as well as the federal government. It has been an occasion for the development of three recognized spheres of jurisdiction: that in which the federal power is exclusive, that in which the state power is exclusive, and that in which these are concurrent. By concurrent powers is meant, not that both state and federal governments have equal jurisdiction, but that the states may act until the federal government comes into the field.

1. GROWTH OF FEDERAL POWER. As the result of a series of Supreme Court decisions, the jurisdiction of the federal government has been extended until today few railroad matters are outside its power. To be sure, some such regulation rests exclusively with the states, and in some fields state regulation has been upheld, at least until Congress acts.

Early state regulation of railroads was at first upheld even though it did affect interstate commerce, the Supreme Court claiming in 1876 that "... until Congress undertakes to legislate for those who are without the state, Wisconsin may provide for those within, even though it may indirectly affect those without."[1] While this decision was taken to mean that interstate aspects of state regulation did not affect its validity so long as Congress did not act, the decision of the Supreme Court in the Wabash case ten years later decided to the contrary.[2] In this case the Court declared that even before Congress had acted, a state could not interfere with the freedom of interstate commerce by imposing rate regulation or "other restrictive regulations interfering with and seriously embarrassing this commerce."

Federal control over intrastate rates where they interfered with control of

[1] *Peik v. Chicago and Northwestern Rwy. Co.*, 94 U.S. 64.

[2] *Wabash, St. Louis and Pac. Rwy. Co. v. Illinois*, 118 U.S. 557 (1886).

interstate rates was upheld in the Shreveport rate case in 1914.[1] The Interstate Commerce Commission had ordered an increase of rates between two points within Texas, which charges were fixed by the Texas commission so low as to result in discrimination against an interstate rate. Although the rates complained of were purely intrastate, the Supreme Court upheld the Interstate Commerce Commission's order on the ground that the state rates interfered with the effective use of a rate power delegated by Congress to the Commission.

The same reasoning as that of the Shreveport case was used to extend the power of the federal government further over intrastate railroad rates. In 1920, the Interstate Commerce Commission ordered an increase in all interstate railroad rates. Wisconsin refused to raise intrastate passenger rates. In order to prevent discrimination against the interstate passenger, as well as to make possible increased revenues for interstate railroads operating in Wisconsin, the Interstate Commerce Commission ordered the entire level of passenger rates in Wisconsin to be raised to that set for interstate rates. The case went to the Supreme Court, where the Commission was upheld.[2] The Court declared that the situation which resulted from the lower Wisconsin fares was an "undue, unreasonable and unjust discrimination against interstate and foreign commerce."

2. Exclusive State Power. So far as the railroads are concerned, their relation to interstate commerce, even where operation is wholly intrastate, makes it difficult to say with certainty when the power of the states is exclusive. The analysis of the interstate commerce power made above amply indicates the extension of this power. But the field for exclusive state control has been outlined by the Supreme Court as those matters which "concern the strictly internal commerce of the state, and while the regulations of the state may affect interstate commerce indirectly, their bearing upon it is so remote that it cannot be termed in any just sense an interference."[3] In other words, so long as a railroad is operating between two points within a state, where its business only incidentally affects interstate commerce, a state may regulate it if the regulation does not interfere with interstate commerce. But it is difficult to think of any modern railroad the control of which is *exclusively* a matter for the state. The extension of federal control has been too great for this to be the case. Even the Long Island Railroad, which operates entirely within the state of New York, and which is under the jurisdiction of the Public Service Commission of that state, is not exclusively under the control of state authorities.

[1] 234 U.S. 342. Earlier, in 1913, the Supreme Court had intimated that state regulation hostile to federal control would not be valid. See *Minnesota Rate Cases*, 230 U.S. 352.

[2] *R.R. Commission v. Chicago, Burlington and Quincy R.R. Co.*, 257 U.S. 561 (1922).

[3] *Covington and Cincinnati Bridge Co. v. Kentucky*, 154 U.S. 204, 223 (1893). Like principles have been applied in allowing limited state regulation of railroad rates. See *Minnesota Rate Cases*, 230 U.S. 352 (1913).

3. "CONCURRENT" STATE-FEDERAL POWER. The states still exercise much control over railroads under their police power. In the absence of congressional action, reasonable police regulations not interfering "unduly" with interstate commerce are permissible. The states have been upheld in passing many safety and health laws applicable to the railroads. Thus, both interstate and intrastate rail carriers have been forced to comply with laws specifying minimum train crews, certain safety devices, and health regulations on trains and in stations, as well as the shipping of certain commodities regarded as injurious to the people of the state. But such state regulations, it must be emphasized, would be superseded if Congress should act.

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CHAPTER

6

RAILROAD REGULATION: *Rates*

THE most important part of the work of the Interstate Commerce Commission in its regulation of railroads for the federal government is the control of rates. From the point of view of difficulties, public interest, carrier concern, and sheer bulk, the proceedings regarding some aspects of rate regulation have held the central place. Even some of the other work of the Commission, such as valuation, security-issuance control, and accounting control, has been undertaken largely as an aid to rate regulation.

Moreover, the economic and legal nature of the railroad industry has made rate regulation necessary. Railroads are businesses in which the elements of overhead and joint costs predominate. Operation under such conditions normally leads to price and service discrimination and to generally unstable competitive conditions. The desire to increase volume of traffic at any rate in excess of out-of-pocket costs, as well as to grant other concessions to gain business, is particularly strong where overhead costs are high. This feature is of special meaning to the public served by the transportation industry, because the economic welfare of individuals and groups may be largely dependent upon the terms by which they can reach their markets. The abuses of the railroads in rate matters before the era of rigid regulation, and the present continual round of cases before the Commission involving alleged rate discriminations, are ample evidence of public interest in the economic effects of transportation. Even when the railroads are considered alone, increasing competition from other forms of transport is not an adequate safeguard against these inequities.

Regulation of railroad rates is also grounded upon legal factors. Railroads have been granted the power of eminent domain in order to get facilities which they might not be able otherwise to obtain except at exorbitant prices. Public aid, in terms of land grants, credit extension, and investment of public funds, has been given to them. These legal privileges give the public a

more than ordinary interest in the rates that are charged for railroad service.

Even without these many legal favors, the railroads would still be recognized in law as common carriers. This term implies a class of transport business which serves all who may come. For centuries the English common law has recognized that these carriers, by professing to serve, have been subject to obligations to serve adequately, continuously, at reasonable rates, and without discrimination.

A. THE RATE LEVEL AND THE RATE STRUCTURE

Railroad rate regulation, as is the case of all regulation of price in the public-service field, falls into two main divisions, the rate level and the rate structure. The former of these has to do with the financial adequacy of rates in general. The problem of reasonableness here is whether the rates taken as a whole are high enough to support on a sound financial basis the cost of an adequate railroad system. Yet the rate level should not be excessive in the sense of exacting more than this from rate-payers.

Regulation of the rate structure, on the other hand, is concerned with particular rates. Because these apply as between places, commodities, persons, or kinds of traffic, they may discriminate in some way so as to give an unearned or unreasonable economic advantage. The central problem here is to adjust individual rates or groups of rates so that discrimination does not result, or if inevitable, will be reasonable. This is a complex task. While passenger rates are fairly simple, freight rates are based upon five thousand different types of freight to which distance rates, as modified by many competitive influences, are applied for every possible haul. In addition to the problem of discriminatory rates within the rate structure, individual rates must also be reasonable *per se*. But as will be shown, the standard of reasonableness applied to individual rates differs from that applied to the level of rates.

Rate regulation is not separated completely into that of levels and that of structures. As a matter of fact, these two aspects are closely related. Very seldom can a shift in the rate level be undertaken without upsetting many of the individual rate adjustments. For example, when the Interstate Commerce Commission allowed a general increase in the level of railroad rates in 1938 it recognized that competition with other forms of transport, as well as possible discrimination against localities, made a blanket increase of a certain percentage applied to all rates impracticable.[1]

B. THE RATE LEVEL

1. Economic Basis of Reasonable Rate Level. If the rates of any privately owned business are to be regulated and private ownership preserved, the

[1] *Fifteen Per Cent Case*, 226 I.C.C. 41 (1938).

rate level must be adequate enough to support the transportation service desired by the public, and to cover all expenses necessary to insure efficient operation. Imprudent expenses should not be added to the rate-payer's bill. But all prudent operating expenses, including an adequate allowance for depreciation and taxes and for experimental work, should be allowed. In addition, the rates should be sufficient to make possible a return on capital invested, whether by bondholder or stockholder, adequate to keep capital flowing into the industry. If private capital is to be relied on in the railroad field, any level of rates which does not induce private capital to be invested there is not a reasonable one. On the other hand, a higher rate level would require the public to pay in excess of reasonable total cost, and the object of regulation is to avoid higher charges.

The economic basis is simply that a reasonable rate is one which covers the *cost* of furnishing a service demanded by the public. If the public demands expensive service, then a rate level in order to be reasonable must cover the cost of that service. Not only will the adequacy and stability of that return determine to a great extent the cost of the capital, but the public must pay enough to keep capital flowing into the industry if improvements involving new investment are wanted by it.

2. Legal Basis of Reasonable Rate Level. Interpretation of the due process clauses of the Constitution by the Supreme Court gives the legal basis for a reasonable rate level in a publicly regulated, though privately owned, business. While some property right is clearly taken away from the railroad-owner, who may not charge what he pleases for service, the courts early discerned regulation which destroyed property without due process of law.[1] In other words, due process of law permitted the taking of property in so far as it was necessary to protect the public against unreasonable charges. But property was taken *without* due process if the rate level did not cover the reasonable cost of the service to the public. As the Supreme Court said in 1898, "the corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it."[2] The question as to when rates are so low as to amount to the taking of property has been difficult to answer. Of all the perplexing problems resulting from this question, none has been more confusing than that of valuation, to be discussed presently.

3. Commission Authority over the Rate Level. Until the Transportation Act of 1920, the Interstate Commerce Commission had no very definite guide to follow in settling the level of railroad rates. The Act of 1887 had required that all rates be just and reasonable. Later laws gave the Commission

[1] See *Stone v. Farmers' Loan and Trust Co.*, 116 U.S. 307 (1886). At page 331 the Court said: "... it is not to be inferred that this power of limitation or regulation is itself without limit. This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation."

[2] *Smyth v. Ames*, 169 U.S. 466, at p. 546.

power to fix maximum rates and to suspend rates pending investigation. But the standard of reasonable rates gives the Commission no criteria as to how this reasonableness is to be measured.

As a matter of fact, until 1910 the Commission had little occasion to pass upon the general level of rates. Most rate regulation had to do with reasonable particular rates and with adjustment of rate discrimination. However, in cases in the decade after 1910,[1] the Commission was called upon to adjudicate requests for a general increase of rates. In these cases a few principles developed.

Some criteria for the Commission's determination of the reasonableness of the rate level were given by the Supreme Court in Smyth *v.* Ames in 1898.[2] This case set forth the principle that rates established by a government agency might not be fixed at a point so low as to deprive a carrier of a fair return on the fair value of the property used for the public service. This return was construed to be that over and above the amount necessary to meet operating expenses, since the right of a railroad to recover operating expenses from rates was not questioned.

It must be remembered that prior to 1920 the Commission had no positive duty to see that a reasonable level of rates was fixed. Its duty was mainly to protect shippers and passengers from an exorbitant rate level. Moreover, in 1910 Congress declared that the burden of proof for an increase in rates "shall be on the common carrier." With these considerations in mind, the Commission refused to be placed *in loco parentis* for the railroads, and insisted upon deciding rate-level cases on the basis of evidence presented.

One principle the Commission followed in setting a level of reasonable rates was the test of adequacy of revenues to support the credit of the railroads, to the end that reasonable demands for service could be met. While this principle was the guiding criterion of the Commission before 1920, the rate-advance cases in 1915 and 1917 indicate a lack of appreciation by it of the need of the railroads for adequate revenues in the face of rising costs and increasing traffic demands. The Commission did pay some attention to the fair-value test outlined by the Supreme Court; but in the absence of data to support the determination of value, this rule was hardly an effective part of the Commission's basic rate-level principles before 1920.

a. Rule of rate-making in the Act of 1920. In the Transportation Act of 1920, Congress realized that railroad credit and facilities needed positive rate action by the Commission, and established definite criteria to be followed in setting the rate level. This rule provided that

> In the exercise of its power to prescribe just and reasonable rates the Commission shall initiate, modify, establish or adjust such rates so that carriers as a whole (or as

[1] *Advances in Rates — Eastern Case*, 20 I.C.C. 243 (1911); *Advances in Rates — Western Case*, 20 I.C.C. 307 (1911); *Five Per Cent Case*, 31 I.C.C. 351 (1914), 32 I.C.C. 325 (1914); *Western Rate Advance Case*, 35 I.C.C. 497 (1915), 37 I.C.C. 144 (1915); *Western Passenger Fares*, 37 I.C.C. 1 (1915); *Fifteen Per Cent Case*, 45 I.C.C. 303 (1917).

[2] 169 U.S. 466.

> a whole in each of such rate groups or territories as the Commission may from time to time designate) will, under honest, efficient and economical management and reasonable expenditures for maintenance of way, structures and equipment, earn an aggregate net railway operating income equal, as nearly as may be, to a fair return upon the aggregate value of the railway property of such carriers held for and used in the service of transportation: *Provided*, That the Commission shall have reasonable latitude to modify or adjust any particular rate which it may find to be unjust or unreasonable and to prescribe different rates for different sections of the country.

In determining the fair value the Commission was to have the aid of data compiled under the Valuation Act of 1913, so far as these data were available. In addition, it was directed by the statute to give due consideration "to all the elements of value recognized by the law of the land for rate-making purposes." As for the fair rate of return, the Commission was to take into account "the transportation needs of the country and the necessity (under honest, efficient, and economical management of existing transportation facilities) of enlarging such facilities in order to provide the people of the United States with adequate transportation."

Passage of this rule did not in any way guarantee to the carrier a fair return. The Commission was merely directed to exercise its rate-making power so that resultant rates would bring a fair return, if that be possible. This rule, of course, made no allowance for mistakes in judgment by the Commission nor for situations in which high rates could be collected. Furthermore, the rule applied to carriers as a whole, or to groups of carriers in certain rate areas. Since railroads seldom operate in exclusive territories, any other application of the rule would have been impracticable.

b. Rule of rate-making in the Act of 1933. Because the Interstate Commerce Commission found the definite terms of the 1920 rule of rate-making unworkable, a new rule was provided in 1933. Increasing elasticity of demand for railroad service, as the result of more effective competition of other transportation agencies and the successful operation of new ones, made it impracticable to augment the return to the railroads merely by the expedient of raising the rate level. Moreover, the prospect of raising railroad rates in a depression seemed clearly to be no solution for obtaining a higher return. The Commission also found that an average "fair return" for all or a group of railroads had no practical meaning; all railroads could have a fair return which was on the average adequate, while many individual ones might be faced with bankruptcy.

In the face of practical difficulties regarding the rule of rate-making, the Commission, even before 1933, began to exercise its administrative discretion over the rate level in such ways as to make the 1920 rule an empty clause. In recognition of this situation, Congress passed the following rule in 1933: [1]

> In the exercise of its power to prescribe just and reasonable rates the Commission shall give due consideration, among other factors, to the effect of rates on the

[1] The rule as quoted includes a slight change in phraseology introduced by the Transportation Act of 1940.

> movement of traffic by the carrier or carriers for which the rates are prescribed; to the need, in the public interest, of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service; and to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management, to provide such service.

This new rule eliminates references to fair return on fair value and adds, as a factor for consideration, the effect of rates on traffic. Thus it removes much of the definiteness of the earlier rule and leaves practically the whole job to the discretion of the Commission. Instead of being commanded to do its best to set rates which will result in a fair return, the Commission is in essence directed to do what it can to obtain a level of rates which will support the transportation service demanded by passengers and shippers.

In spite of the omission of fair return and fair value, it is not clear that these factors will be entirely missing from the deliberations of the Commission. The encouragement of capital flow into the railroad field is necessary for maintenance of a high caliber of service. This question can hardly be divorced from consideration of fair return. The determination of the economic cost of performing transportation service practically necessitates paying some attention to fair value and fair return.

What is perhaps more important, constitutional guarantees against the taking of property by setting a rate level too low make consideration of fair value and fair return imperative. Even since the passage of the new rule of rate-making, the Commission has recognized that fair value and fair return cannot be overlooked in a rate-level proceeding.[1]

4. Factors Considered in Fixing Rate Level. Certain legislative standards have been set up to guide the Commission in fixing a reasonable level of rates for the railroads; in addition, it has developed a few principles itself. Under the different rules of rate-making, and indeed before any rule was promulgated by Congress, the Commission has based its decisions on the rate level upon certain factors. These will be considered briefly at this point.

a. Other means of increasing revenues. In considering a fair level of rates, the Commission has studied how the level of rates can be made reasonable by increasing revenues through other means than raising the level of rates. While these other means might be just as important to consider in the event that the Commission is faced with the problem of lowering the rate level, as a matter of fact cases respecting it have usually arisen from requests by railroads for an increase in rates.

In several cases, the Commission has suggested ways by which the railroads could increase revenues.[2] Readjustment of unremunerative freight rates, curtailment of free transportation, reduction of allowances to shippers for special services, increase of charges for special lighterage, storage, and other

[1] *Fifteen Per Cent Case, 1937–1938*, 226 I.C.C. 41, 60 (1938).

[2] See, for example, *Five Per Cent Case*, 31 I.C.C. 351, 407; 32 I.C.C. 325, 334 (1914).

services not adequately paid for by shippers, and increase of rates made too low by railroad competition through pooling and other traffic agreements are some of the methods suggested whereby revenues might be increased without raising the general level of rates.

Suggestions for increasing railroad revenues were also made by the Federal Co-ordinator of Transportation during the three-year existence of his office, from 1933 to 1936. Methods of promoting traffic and modernizing rate structures and facilities, as well as means for charging more adequately for accessorial services, were recommended.

Both the Commission and the Federal Co-ordinator have done little to force upon the railroads these means of raising revenues. In many of the rate-level cases the Commission has indicated that its decision has been tempered by the belief that the railroads have not done all they could to increase revenues. But definite orders to do so have been very rare. In investigating certain practices of the carriers which affected revenues, the Commission did order in 1933 that excessive payments for rental of private cars of shippers and the furnishing of storage services at less than prevailing rates should cease.[1]

b. Operating expenses. One factor always considered in arriving at a decision respecting the rate level is the quantity and validity of operating expenses. While some control over them has come about indirectly through accounting regulation (such as the requirement that depreciation allowances be made), the Commission has actually done little to interfere with charges made for these expenses. On the whole, its examination of operating expenses has disclosed that those incurred have been valid.

The Commission has called attention of the carriers to differences in operating costs between different carriers for the same service, and has questioned whether this may not indicate that greater efficiency or economy could be practiced.[2] Pooling of traffic and reduction of wasteful competitive practices have also been encouraged.[3]

The suggestions of the Federal Co-ordinator of Transportation were the most far-reaching of any attempts by a governmental agency to influence railroad operating expenses. It is impractical to summarize all of them, but a few may be mentioned. Consolidation of less-than-carload freight and express services and the pooling of rail and highway transportation were recommended. Elimination of competitive passenger-traffic departments, unification of stations and terminals, and elimination of duplicating passenger-train services were advised. To make more efficient use of rolling stock, and hence reduce investment and maintenance costs thereof, the co-ordinator recommended pooling of freight cars. While none of these moves were ordered to be put

[1] *Use of Privately Owned Refrigerator Cars*, 201 I.C.C. 323 (1934), and *Practices of Carriers Affecting Operating Revenues or Expenses* (Part VI), 198 I.C.C. 134 (1933).

[2] *Advances in Rates — Eastern Case*, 20 I.C.C. 243, 279 (1911).

[3] See, for example, *Fifteen Per Cent Case, 1931*, 178 I.C.C. 539, 585–86 (1931).

into effect by the co-ordinator, and the Commission made no such orders, the suggestions made have resulted in pressure being placed on the railroads to attempt such economies.

In a few cases actual control of operating expenses has resulted, though in no case involving the level of rates has the Commission definitely refused to accept the carriers' operating-expense data. Beginning in 1914, the Commission required carriers to charge off depreciation on equipment.[1] As for the rates at which depreciation should be charged, little control has been exerted. In 1926 and 1931 the Commission ordered the railroads to charge it on road and structures;[2] however, the effective date of this order has been postponed from time to time.

Expenses involved in the construction and repair of railroad equipment have been subject to control.[3] The Commission has also attempted to reduce inefficiency resulting from the practice of favoring large shippers in making purchases of materials and supplies.[4] In two notable instances, too, the Co-ordinator of Transportation intervened to effect reduction of expenses.[5] As the result of informal pressure in 1933, supplemented by action of the Reconstruction Finance Corporation and courts administering receivership and trusteeship, the salaries of high railroad officials were reduced to a maximum of $60,000 per year. In the same year the co-ordinator, with the co-operation of President Roosevelt, forced the steel companies to lower the price of steel rails from $40 to $36.375 per ton.

The validity of operating expenses in setting a reasonable level of rates is exceedingly important. With an average of 80 per cent of railway revenues going for operating expenses (including depreciation and taxes) in 1929 and 86 per cent in 1937,[6] the part played by the expenditure of proceeds from rates is quite clear. But operating expenses are largely determined by economic conditions, notably changes in prices, by the pressure of union labor for higher wages, and by formal or informal industrial price-fixing. The size of tax expenses is also largely beyond the control of the railroads and the Interstate Commerce Commission. Moreover, even though the latter had power to control more completely than it does the expenditure of proceeds from rates, it is questionable whether such regulation would be desirable. The existence of private ownership and management implies that some discretion in operating expenses must be left to railroad managers. Were the Commission to assume the detailed regulation of operating expenses, the traditional function of management would be taken away from private hands. Even the specifi-

[1] I.C.C., *Classification of Operating Revenues and Expenses* (Issue of 1914).

[2] *Depreciation Charges of Telephone and Steam Railroad Companies*, 118 I.C.C. 295 (1926); 177 I.C.C. 351 (1931).

[3] *Construction and Repair of Railroad Equipment*, 66 I.C.C. 694 (1922), 66 I.C.C. 727 (1922).

[4] *In the Matter of Reciprocity in Purchasing and Routing*, 188 I.C.C. 417 (1932).

[5] See *Regulation of Railroads*, Sen. Doc. No. 119, 73d Cong., 2d Sess., pp. 68–70 (1934).

[6] *Fifteen Per Cent Case, 1937–1938*, 226 I.C.C. 41, 59 (1938).

cation by law of the maintenance of honest, economical, and efficient management, now found in the rule for rate-making, can hardly be taken to mean complete regulation of operating expenses by the Commission. This provision still implies that managerial discretion should prevail, and only establishes general standards by which the Commission is to judge the quality of exercise of this discretion.

c. Fair value. As has already been noted, in spite of exclusion from the rule of rate-making of 1933, the Interstate Commerce Commission must still take into account fair value in fixing a reasonable level of rates. This has been due to the decision of the Supreme Court that a privately owned company whose rates are regulated is entitled to receive a fair return on the fair value of its property. In the railroad field, valuation controversies arose mainly from interpretation of the law providing for recapture of excess earnings, to be treated presently. Because valuation has been more important and subject to more disagreement in the local public-utility field, a more extensive treatment of the law of valuation and of merits of particular kinds of valuation bases is reserved for a later chapter (Chapter 15).

Introduction of valuation into rate-level regulation dates from Smyth *v.* Ames in 1898. There Mr. Justice Harlan declared for the United States Supreme Court that

> ... the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property.[1]

This listing of possible bases for value can be summarized in terms of capitalized earnings, original cost, and present cost. Since the regulation of rates cannot be undertaken on the basis of an earning-capacity value, the other two bases, with variations of each, have been used in determining fair value for rate-making purposes. Capitalization of expected earnings may be sound in the industrial or commercial field in which price is set by the free play of competition. But use of earning value would involve circular reasoning where regulation of price is attempted. For regardless of the rates fixed, so long as operating expenses are covered, the return, capitalized at a fair rate of interest, would give a value which would be "fair" as a base for computing that rate.

The valuation reached by a commission is ordinarily a judgment figure based upon consideration of original cost and present cost, less accrued depre-

[1] 169 U.S. 466, 546–47.

ciation. Many rate cases have been fought, particularly in the electric, gas, and telephone fields, over the degree of consideration to be given these two bases and their variations. At this point, it is sufficient to say that apparently the courts have favored the inclusion of present costs as the most important factor in determining this fair value. This does not mean that commissions are bound to make their valuations by computing present costs of the plant, but their resultant valuation basis must withstand a present-cost test. While this principle cannot be said to be absolute, valuing property below a figure which is equal to its present value may cause the rate level fixed on that basis to be held to produce confiscation of property.

(1) *The valuation project.* In several rate cases, especially after the Supreme Court's decision in Smyth *v.* Ames, the Interstate Commerce Commission held that it could not base its findings on the formula of fair return upon fair value because of lack of valuation data.[1] In 1903 the Commission urged Congress to authorize making a valuation of railroad property,[2] a request which was repeated from year to year. As a result of these requests and the desire of politicians who believed that such a valuation would show much "water" in railroad financial structures, the Valuation Act was passed in 1913.

This law directed the Commission to compute (1) the original cost, cost of reproduction new, and cost of reproduction less depreciation in detail as to each piece of property, other than land; (2) other values, particularly intangible assets; (3) land values; and (4) original cost and present value of property not held for carrier purposes. Little must Congress have realized the tremendous job that was being imposed. Had the Commission only been asked to examine the books of the railroads to ascertain historical book cost, the task would have been large. But this was only one part of a valuation project which was carried on for decades, cost $200,000,000 to execute, and can hardly be regarded as complete yet.

From time to time in the 1920's the Interstate Commerce Commission published preliminary and revised valuation figures. In 1933 the completed valuation figures to that date were announced. These figures showed that (1) original cost of railroad-carrier property, other than land, plus land fixed at present value, and plus working capital allowances, was over $26,000,000,000; and (2) cost of reproduction new, plus working capital and plus land at present value less depreciation, was about $21,000,000,000.[3] These figures apparently represent very conservative estimates and do not include anything for intangible assets. On the other hand, the depreciation calculation was per-

[1] See *Re Proposed Advances in Freight Rates*, 9 I.C.C. 382, 404 (1903); *Advances in Rates — Eastern Case*, 20 I.C.C. 243, 256–64, 305 (1911); *Five Per Cent Case*, 31 I.C.C. 351, 361–62 (1914).

[2] 17th *Ann. Rep. I.C.C.* (1903), p. 26.

[3] *Regulation of Railroads*, Sen. Doc. 119, 73d Cong., 2d Sess., p. 3 (1934). As of January 1, 1937, the original cost figure was $26,000,000,000 and the present cost less depreciation figure was about $22,000,000,000. Original cost less depreciation, plus land and working capital, was equal to about $20,000,000,000. Total railway securities outstanding in the hands of the public equaled about $19,000,000,000. See *Fifteen Per Cent Case*, 226 I.C.C. 41, 61 (1938).

haps not high enough in view of impending obsolescence of much railroad property, although the computation made some allowance for obsolescence.

(2) *Commission use of fair value.* In cases involving the rate level there is evidence that, since valuation data have been available, the Interstate Commerce Commission has considered them in arriving at a decision. But railroad rates have been so influenced by competitive and other factors that it has seemed impractical to attempt to set a rate level adequate to allow a fair return on the fair value of railroad property in general, as that value is indicated by either original or present-cost figures. These other factors have influenced the Commission more than fair value. Moreover, the railroads have not appealed to the courts to force it to raise the rate level, with a hope of obtaining the return to which the Supreme Court in Smyth *v.* Ames held that the carriers were entitled.

A policy giving effect to fair return on fair value would have to be applied to large groups of carriers, owing to the interrelationship of rates between carriers. If the policy were applied widely, there would be no guarantee that all carriers in a group would get anything like the same rate of return. Within an interrelated group of railroads there would be some which would receive much more than the average and others much less. Thus, the Pennsylvania Railroad and the Chesapeake and Ohio both carry much bituminous coal, but in 1937 the former railroad earned less than three per cent on its investment in road and equipment, while the latter earned over eight per cent.

The place actually given to fair value by the Commission is indicated by the Fifteen Per Cent case of 1937–1938. In this case, the Commission made a calculation of fair value of $21,000,000,000. Taking net operating income [1] as representing the amount earned on the railway property used for public service, the Commission did this by groups of carriers in geographical districts. The results in this case showed that the average return in the eastern district was 3.028 per cent, in the southern district 4.681 per cent (due mostly to the higher earnings of three coal-carrying railroads), and in the western district 2.354 per cent. These rates of return were obviously too low. It is difficult to estimate what influence the application of fair rate of return had on the Commission's decision in the case, but where the rates were so low, the finding seemed to remove any doubts it might have had about considering raising the rate level.

d. Fair rate of return. From a legal point of view, a rate of return is "fair" when it permits a company, the rates of which are governmentally regulated, to earn a return "reasonably sufficient to assure confidence in the financial soundness of the utility" and "adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." [2]

[1] Net operating income equals railway operating revenues less railway operating expenses (including depreciation), less taxes and plus or minus rents of equipment and joint facilities.

[2] *Bluefield Water Works and Improv. Co. v. Public Service Commission*, 262 U.S. 679, 693 (1923).

From an economic point of view, the same may be said. If a company cannot make such a return, not only may it not be able to pay compensation to its investors in line with what they have a reasonable right to demand, but, what is perhaps more important, the public cannot expect a free flow of capital into the industry for the purpose of maintaining or improving service.

The Interstate Commerce Commission has considered this fair return, particularly in the rate-level cases since 1920. Some evidence exists that the Commission, aided by Congressional opinion, allowed too low a rate of return in the twenties, since the railroads as a whole probably did not make more than six per cent on their fair value during any of these years. In the thirties the rate of return has been notably low, and there are those who believe that raising the rate level will not bring a higher return, because of the elasticity of demand for railroad service.

The low rate of return received by the railroads in recent years has been reflected in their impaired credit standing and the large number of them in bankruptcy or trusteeship. That this situation has affected the position of the Interstate Commerce Commission respecting rate-level advances is clear from the rate increases allowed in recent years. But here again, other factors have affected the Commission's determination of how great an increase to allow. In the railroad industry, the formula for increasing rate levels is not so simple as determining whether the rate of return is too low, and automatically ordering rate increases where it is clearly so.

e. Effect of rates on traffic. This factor has been increasingly important in decisions by the Interstate Commerce Commission as to railroad rate levels. It should be noted that the rule of rate-making incorporated in the Act of 1920 envisaged the simplification of rate-level determination to a mathematical formula. If the railroads as a whole, under efficient and economical management, were not earning a fair return, the rate level was to be raised to yield such return. In the rate-level increases of 1920, the Commission showed the effect of this formula by ordering blanket rate increases of 25 to 40 per cent, depending upon geographical area.[1] In 1921, when an industry suggested that business depression be accepted as a reason for lowering rates, the Commission repudiated this consideration as placing reasonableness on a foundation of "shifting sands." [2]

No sooner had the fair-return formula been adopted than the Commission modified the rule by considering the effect of rates in general on traffic. The depression of 1921, following the increases of rates in 1920, caused these rail rates to be a burden on business, and railroad traffic fell off considerably. In response to complaints respecting the railroad rate level, the Commission lowered the general level in spite of the fact that carriers were not earning a fair return. Declaring that "high rates do not necessarily mean high rev-

[1] *Increased Rates, 1920*, 58 I.C.C. 220, 246–47 (1920).

[2] *National Live Stock Shippers League v. A.T. & S.F. Ruy. Co.*, 63 I.C.C. 107, 116 (1921).

enues," the Commission lowered the railroad rate level in 1922.[1] Its position was that it was charged by the Transportation Act of 1920 to do what it could to fix rates so that railroads could earn a fair return, and that, owing to business conditions, a lower rate level would stimulate traffic and give "consequent fuller assurance to the carriers of realizing the fair return contemplated by the law." [2]

Thus, long before specific recognition by Congress in the rule of rate-making of 1933, the Interstate Commerce Commission noted the effect of rates upon traffic in its treatment of the general level of rates. This principle is only slightly different from that under which rates would be reduced because of depression in certain industries. The volume of traffic a railroad may obtain from a depressed industry may depend upon railroad rates. Hence, it is difficult to distinguish between rate reductions (or refusals of increases) based upon stimulating volume of traffic and those based upon favorable treatment to depressed industry.

The rate-level case of 1931, in which the railroads asked for a horizontal rate increase of 15 per cent, shows an interesting application of this factor by the Interstate Commerce Commission. In this case, the Commission allowed a few increases, but denied the general rate advance.[3] Pointing out that a rate increase would do great harm, it held that the dangers of increasing freight rates were (1) "that at a time when transportation costs are of vital consequence to every industry it will stimulate new competitive forces already rapidly developing"; (2) "that it will alienate or impair the friendly feeling toward the railroads on the part of the people," a feeling necessary for proper and "adequate" regulation; (3) "that it will disturb business conditions and an already shell-shocked industry"; and (4) that it will "accelerate the tendency toward a localization of production," with consequent reduction of length of rail hauls.[4]

Consideration of the effect of traffic on the level of rates was dramatically portrayed in the passenger-fare case of 1936.[5] After investigation of the problem of passenger fares, the Commission ordered their reduction in 1936, in spite of the objections of many railway managements, particularly in the eastern district. The basis for this decision was that drastic action had to be taken if railroad passenger traffic was to be increased and was to pay its part of the cost. It seemed to the Commission that the way to increase net income from passenger operation was materially to reduce rates.

The question has been raised as to how far the Commission should go in giving effect to traffic in setting rates. It is often declared that the Commission is invading managerial discretion by insisting upon deciding when a lower rate, or a moderate increase, in the face of uncontested financial need, will bring an increased return. It is said that the central function of manage-

[1] *Reduced Rates, 1922*, 68 I.C.C. 676, 732 (1922).
[2] *Ibid.*, p. 734.
[3] *Fifteen Per Cent Case, 1931*, 178 I.C.C. 539 (1931).
[4] *Ibid.*, pp. 575–76.
[5] *Passenger Fares and Surcharges*, 214 I.C.C. 174 (1936).

ment is to determine how an increased return can be had, so long as existing return is too low, and so far as a rate structure does not result which would be discriminatory.

There are two schools of thought on this question. One position is presented by those who claim that, if private property is to endure, some faith must be placed in private management to set rates which will be most profitable for it. According to law, regulated private enterprises are "entitled" to rates which will give such fair return. Unless the rates suggested by private management are excessive (in terms of operating expenses plus fair return) or unduly discriminatory, the Commission, while perhaps warning the carriers that it believes the change to be unwise, should grant the rate pleas. In other words, more responsibility should be placed on railroad management to work out compensatory rates.

The other school of thought maintains that the Commission has a responsibility to fix rates so that the carriers will be able to furnish adequate transportation service, without at the same time putting shippers under a burden of transportation charges which would impede economic readjustment. In other words, the job of this regulatory agency is to harmonize what it conceives to be the long-run interests of carriers and shippers. If it seems to the Commission that lower rates than those asked for by carriers will stimulate railroad business and aid shippers to make readjustments necessary to restore economic equilibrium, it should use the rule of rate-making as a "flexible instrument of public policy" to attain this end.[1]

However, one should recognize that adoption of this policy places the Commission in the position of judging when lower rates will make for more adequate revenues. The basic difference between the two schools of thought lies in this point. Is this exercise of judgment proper regulatory policy, or should the responsibility rest with private management?

C. THE PROBLEM OF STRONG AND WEAK RAILROADS

In setting any general level of rates, even for groups of railroads, it is impractical so to fix them that all carriers will earn a reasonable return. Some may earn much less and others much more. This problem has been referred to above in discussing the level of rates. Moreover, it is also impractical to establish rates for each carrier so that he may make reasonably adequate earnings. The interrelationship of railroad rates and service for small geographical groups, as well as for large sections of the country, is too close to allow for anything but general treatment.

Several devices have been used to bolster up revenues of weak lines without giving too liberal returns to the strong ones. The Interstate Commerce Com-

[1] For an elaboration of this position, see Sharfman, I. L., *The Interstate Commerce Commission*, vol. III B, pp. 290–308 (New York: Commonwealth Fund, 1936).

mission has allowed, where feasible, higher rates on lines or in areas where operating costs are high or traffic density low. In dividing joint rates between connecting strong and weak carriers, the Commission has tended to favor the latter. Its power to take into account revenue needs of carriers has been supported by the Supreme Court.[1] Often weak lines are favored by being allowed to charge lower long-haul rates than short-haul rates in order effectively to compete with stronger roads. They have also been aided by the Commission's encouragement to strong lines to include them in consolidation and pooling plans.

One of the most striking attempts to solve the strong and weak railroad problem was the recapture clause incorporated in the Act of 1920. Although repealed retroactively in 1933, it represented an interesting experiment in government regulation and involved an unprecedented invasion into traditional property rights.

1. THE RECAPTURE CLAUSE. This section of the Transportation Act of 1920 provided that one half of the net railway operating income of an individual carrier in excess of six per cent of the value of its property should be paid to the United States Treasury. These payments were used to establish a "general railroad contingent fund." The law required that the other half of the excess income be kept by the railroad and placed in a reserve fund, to be used for interest, rental, and other payments only when the return in any particular year was less than the recapture rate. But when this reserve reached five per cent of the value of the property, the carrier was empowered to use its share of further excess earnings for any lawful purpose.

The recapture clause was held to be constitutional by the Supreme Court in 1924.[2] The Court pointed out that the commerce clause of the Constitution included regulation intended to "foster, protect, and control" commerce as well as to promote its growth. Recapture of excess earnings was seen to be the "key provision of the whole plan" of the law to maintain an adequate transportation system. The existence of an excessive profit by certain lines in a group of carriers was held not to make the rates of that line unreasonable to the shipper, because he must share with all other shippers the burden of having adequate transportation service. Moreover, the Court held that recapture of the excess earnings of an individual carrier was not a deprivation of property as forbidden by the Fifth Amendment. It declared that the carrier was made a trustee of excess earnings by statute, and never had lawful title to this excess "as to render the recapture of it by the government a taking without due process." [3]

2. RESULTS OF THE RECAPTURE EXPERIMENT. The operation of the recapture clause was so unsatisfactory that its repeal in 1933 occasioned no opposition. Too difficult and expensive to administer, the plan involved such

[1] *New England Divisions Case*, 261 U.S. 184 (1923).
[2] *Dayton-Goose Creek Rwy. Co. v. U.S.*, 263 U.S. 456. [3] *Ibid.*, p. 484.

problems that its disadvantages in the opinion of the Interstate Commerce Commission far outweighed any advantages. As set up, it was unsound in that it based recapture on a single year's earnings rather than on earnings over a period of time long enough to reflect "normal" operations. Those railroads which did a fluctuating business often found themselves owing sums for recapture which were sorely needed to maintain interest and rental payments in poor years. During good years, the recapture clause encouraged railroads to make liberal and sometimes wasteful expenditures rather than to accumulate reserves for poor years.

Important, too, is the fact that even had the Commission been able to collect recapturable incomes, the plan would not necessarily have helped the weak railroads. The law provided for an adequately secured loan bearing six per cent interest before help would be extended. Weak railroads in need of funds could hardly meet these requirements. If they could, such railroads were usually able to borrow from other sources on at least as favorable terms. Thus a well-meant experiment, embodying a novel principle, was written off in 1933 as a failure.

D. RATE STRUCTURES

Regulation of railroad rate structures is an extremely complicated phase of government control. The prescription of rates for particular commodities and between particular points would be difficult enough if the Interstate Commerce Commission had only to decide whether the rates *per se* were just and reasonable. But when it must decide in addition that the particular rates do not cause "undue" discrimination between persons, localities, ports, markets, or gateways, the problem becomes almost impossible to comprehend. It is true, however, that the regulation of rate structures is usually attempted piece by piece in response to complaints, so that the present structure is the result of years of rate development as tempered by thousands of decisions by the Commission.

1. Commission Authority over Rate Structures. The legislative basis for Commission regulation of the relationships of railroad rates within a general structure is found in several parts of the Interstate Commerce Act. The Commission has power to set just and reasonable rates. Because what is "just" or "reasonable" is not defined by law, the determination of the meaning of these concepts is within the administrative discretion of the Commission. This power has been extended not only to authority to condemn existing rates as being unjust or unreasonable, either upon complaint or investigation, but also to setting reasonable maximum or minimum rates for the future.

Undue or unjust discrimination against persons or places is also held to be unlawful by statute. Lower rates for a long haul than for a shorter one over the same line or route are declared by statute to be unlawful unless special

permission to file such rates is granted by the Commission. Subject to a like condition, the law forbids setting rates for a long haul in excess of the aggregate of intermediate rates over the same line. In addition, the Commission's discretion in granting relief is limited by certain restrictions, to be mentioned below.

As a part of the Interstate Commerce Commission's power over rate structures, provisions of the Hoch-Smith Resolution of 1925 should be mentioned. This resolution, technically not a part of the Interstate Commerce Act, directed the Commission to make a complete investigation of existing rate structures and to adjust rates in accordance with its findings. What the resolution did was to call the Commission's attention to the problem of rates in relation to market prices of certain products and in certain parts of the country. Although couched in rather general terms, the resolution did direct the Commission to pay particular attention to the depressed condition of agriculture. While held by the Supreme Court not to place agriculture in a favored class so far as determination of lawfulness of rates is concerned, the resolution did lead the Commission to lower many rates on agricultural products.

The more permanent importance of the Hoch-Smith Resolution lies in the apparent opportunity which it provides the Interstate Commerce Commission to make a complete overhauling of the railroad rate structure. For example, under it the Commission could apparently set up a new system of railroad rates, based more completely upon distance. The Commission has undertaken a general investigation of the rate structure, but no general overhauling has resulted.

2. Underlying Principles in Setting Particular Rates. The fair-return doctrine is not applicable to setting particular rates. An individual rate may be unreasonably high even though a carrier is not earning a fair return. As the Supreme Court has pointed out:

> Where the rates as a whole are under consideration, there is a possibility of deciding, with more or less certainty, whether the total earnings afford a reasonable return. But whether the carrier earned dividends or not sheds little light on the question as to whether the rate on a particular article is reasonable. For, if the carrier's total income enables it to declare a dividend, that would not justify an order requiring it to haul one class of goods for nothing, or for less than a reasonable rate. On the other hand, if the carrier earned no dividend, it would not have warranted an order fixing an unreasonably high rate on such article.[1]

Although certain underlying principles which have guided the Commission in fixing particular rates can be selected, it is not to be inferred that they represent the basis for an accurate formula applicable to the rate structure. The procedure of commission regulation is not subject to rigid formulas. Various principles are given varying weight as the circumstances of each case demand. The "zone of reasonableness," either of rates *per se* or of relationships

[1] *I.C.C. v. Union Pac. R.R. Co.*, 222 U.S. 541, 549 (1912).

of rates with each other, is broad. It must be remembered that regulation of railroad rate structures is a highly practical matter. Economic development of industries has been influenced in no small way by railroad rates. And the Commission can hardly upset these fine balances by rigorously applying any single theory or inflexible set of principles of rate-structure regulation.

a. Cost. The strongest reason why there is a rate-structure problem, as separate from the problem of reasonable rate levels, is that individual rates cannot be fixed upon an overall cost basis. This is due to the existence of a large proportion of overhead costs in the railroad industry. Not only are these costs relatively constant, regardless of traffic, but they arise for the most part from fixed investment not easily transferred, if mobile at all.

The proportion of overhead costs to total costs, under average operating conditions, has been estimated at from one half to two thirds.[1] Irrespective of the exact proportion of overhead and variable costs to total costs, or to the way this proportion differs under traffic conditions, the existence of a high degree of fixity in railroad expenses is important in determining cost as a basis of rates.

The railroads are normally subject to decreasing cost in the sense that the existing plant is seldom utilized to its most efficient point. This is true in another sense also, for a larger plant in most cases would bring lower per unit costs. But the existence of decreasing cost in the first sense is ordinarily more important in the railroad field. As a consequence of this cost situation, an increase in traffic can be handled at a lower per unit cost than an average overall cost. A rate is economically wise if it brings an increase of traffic at a return above the variable cost incurred in obtaining it, thus making a contribution to the overhead costs.

Obviously all traffic cannot be carried long for variable cost, or even slightly more, for the overhead costs must be met if the railroad is to continue in business as a going concern under private ownership. This means that some units of traffic must contribute more to the overhead than others. For if an attempt were made arbitrarily to prorate the overhead, and the resultant cost were used as a basis for fixing rates, some traffic would be driven from the rails. If this traffic were business which could pay something more than variable cost, to exclude it would make necessary the dividing up of the overhead cost over a smaller volume of traffic. Hence, there is no way by which an accurate and

[1] Of course these estimates depend upon the range of time considered. Moreover, many expenses which are economically constant have been actually subject to fluctuations in the past years. For example, maintenance, depreciation, and sales (traffic) expenses were cut in the early days of the depression. This may mean, however, that the cuts in appropriation were at the expense of capital investment. Furthermore, the student should realize that the proportion of fixed to total or variable costs will vary with the volume of traffic and that the percentage used here is approximate. It is the estimate used by such writers as Ripley (*Railroads: Rates and Regulation* [New York: Longmans, Green and Company, 1912], p. 55) and Jones (*Principles of Railway Transportation* [New York: The Macmillan Company, 1924], p. 77). Acworth, an English economist, estimates fixed costs at one half of the total (*Elements of Railway Economics* [Oxford: Clarendon Press, 1905], p. 55).

economically wise computation of total cost for a particular haul can be made.

The amount over variable cost which can be collected from a particular unit of traffic depends largely upon the value of that service to the shipper or passenger. Despite criticism of railroad management's application of a "what-the-traffic-will-bear" principle, the determination of cost can hardly overlook considerations of the value of service.

The Interstate Commerce Commission has recognized this problem by admitting that there is a "zone of reasonableness" within which rates should fall. It has held that railroads may voluntarily, in certain situations, fix rates which will little more than cover variable costs.[1] This is the practical minimum at which rates can be fixed. The practical maximum is that certain rates may not be set so high as to bring unrestricted monopoly profits to the railroads. As the Commission has so often said, this question of unreasonableness "involves the exercise of an informed judgment." [2] As a matter of fact, this maximum is more usually a question of relationship between rates, that is, a problem of discrimination, than a problem of reasonableness *per se*. But it is clear that a rate on any particular commodity haul may be higher than the overall average of costs.

However, where a rate is attacked by a railroad as being confiscatory, the Supreme Court has held that individual rates to be adequate should cover not only variable costs, but a fair proportion of the fixed costs as well.[3] But this problem would not arise unless a regulatory commission forced lower rates on a railroad when higher rates could be collected on a certain kind of traffic. The setting of rates at a point lower than overall costs attributable to a portion of traffic would normally be made voluntarily by a carrier desiring to obtain business which could not be obtained otherwise.

Little progress has been made in systematic railroad cost finding. While serious problems exist as to allocation of overhead, the advance of cost-accounting technique has made it possible to make fairly satisfactory estimates of this allocation;[4] that it will always have to be tempered by the value of service factors is clear, but the importance of both should not be overlooked. As Professor Taussig has pointed out:

> In its most common aspect — as a freight carrier — a railway is simply an instrument by which things are made cheaper because transported from a place where they are made to advantage... All agencies of transportation are but means of furthering the geographical division of labor... It follows from this obvious but forgotten fact that a railway is not economically advantageous to the community unless it pays its way... No gain comes from carrying a thing from one place to

[1] *American National Live Stock Asso. v. A., T. & S.F. Rwy. Co.*, 122 I.C.C. 609, 617 (1927).

[2] *Louisiana Oil Ref. Co. v. St. L. S.W. Rwy. Co.*, 122 I.C.C. 503, 504 (1927).

[3] *Nor. Pac. Rwy. v. North Dakota*, 236 U.S. 585, 604 (1915).

[4] See Federal Co-ordinator of Transportation, *Cost Finding in Railway Freight Service* (June, 1936).

another unless it can be produced at the first place so much more cheaply that it can afford the cost of carriage to the second.[1]

In computing variable costs of transport for particular commodities, several factors may affect this cost and consequently, through classifying these commodities, find effect in rates. The likelihood of loss or damage and the extent of the railroad's liability will affect this cost. Some articles load with more weight in a particular space than others. Thus, furniture cannot often be loaded with much weight in a standard car, and will take a higher rate than would steel fittings or wire nails. Some commodities require special equipment and special services, such as icing, feeding, or expedited transit. As for hauls, various matters besides distance affect their variable costs. Some of these are special terminal handling, interchange between lines or on the same line at junction points, and extent of empty-car movement because of prevailing flow of traffic.

b. Value of service. Another factor which underlies the setting of a particular rate is the value of the service to shippers. "Value of service" is simply another way of saying that the demand for transportation services is, in some degree, elastic. Except for rare cases, railroad transportation is not indispensable for shippers. The value of service measures the degree of dispensability. If carriage of a particular kind of traffic is not much affected by the freight rate, its value of service is high, its elasticity of demand is low. If, however, traffic is sensitive to rates in that changes in them would greatly affect the volume carried, this is evidence that the value of service (by the railroad) is low and its elasticity of demand high.

One factor influencing the value of transportation service is the difference in cost of producing the same article at the two points between which shipment is considered.[2] The measure of value of such service must also take into account competition of other carriers. With some products this competition may not be important, but the development of other agencies of transport has immeasurably increased the elasticity of demand for railroad service.

It is quite true that the value of service for a high-priced commodity may be higher than that for a low-priced one. This is so because the part of the former commodity's costs which is represented by freight is not enough to make much relative difference in price. This difference in value of a commodity is important in determining value of service, but is not a factor separate from the effect of elasticity of demand in fixing rates.[3]

[1] *Principles of Economics* (New York: The Macmillan Company, 3d ed., 1921), vol. 2, pp. 390–91. By permission of The Macmillan Company, publishers.

[2] But those who know business practices are aware that articles made in town A are often shipped to town B, where an article physically the same is made, and the articles from B may be shipped to A. This shipment of goods cannot be explained in terms of cost alone. The answer to this apparent economic dilemma is found in the development of product differentiation. Although physically identical and having like manufacturing costs, it is not unusual for X brand of shoes, manufactured in A, to be sold in B, where Y brand of shoes is made, and for Y brand to be sold in A.

[3] For this point of view see Locklin, D. P., *Economics of Transportation* (Chicago: Business Publications, rev. ed., 1938), pp. 157–58.

The elasticity of demand for goods themselves will affect the value of transportation service. If a good has an inelastic demand, the demand for transportation service may be inelastic unless it can be produced at almost any point. If the demand for a good is elastic, the demand for transportation service will also tend to be elastic. However, the demand for railroad service may not be the same as the transportation demand for the good, since the use of alternative transport agencies almost inevitably increases the elasticity of demand for railroad services.

c. Social need. Some individuals claim that since the railroad controls economic development and affects prices so much through the rates charged, these should be fixed with a view to social need. Indeed, there is evidence that the Interstate Commerce Commission has given some effect to social need in fixing rates, although this is estimated to have exerted only a minor influence.[1] In passing the Hoch-Smith Resolution in 1925, Congress showed that it desired the Commission to pay attention to the need for favorable rail rates by the depressed agricultural industry. In some of the cases growing out of this resolution, the Commission demonstrated that it was not unmindful of this charge. In recent cases, particularly in the 1931 freight-rate case, it gave some effect to the need of industry for freedom from burdensome freight rates.

Some effect to what might be termed social need is given in connection with certain competitive rates. The Commission has fairly consistently refused to allow rates which would take away a natural economic advantage of a particular locality. Moreover, rates have been fixed at times to encourage development of an industry. But the element of social need has perhaps actually played its greatest part in curtailment by the Commission of wasteful transportation hauls induced by competitive rates, which increase the volume of ton-mileage without increasing the utility of goods to the consumer.

E. RATE DISCRIMINATION

If the railroad industry were one in which all costs were variable, there would be no problem of discrimination, because it would be uneconomic to carry any traffic which did not pay its full cost. But the high proportion of overhead costs makes it desirable for the railroad to charge different rates where classification of traffic and rates will contribute variable costs, plus something toward the overhead.

Furthermore, if the business of transportation were perfectly competitive, rate discrimination would hardly be possible. The fact that more than out-of-pocket costs can be obtained from some kinds of traffic is evidence not only that the services are different and not freely substitutable, but that competition is restrained. For if competition worked perfectly, in the short run at least, there would be a tendency for all rates to fall to out-of-pocket costs. Hence,

[1] Sharfman, I. L., *op. cit.*, vol. III B, pp. 519–21.

the existence of discrimination must indicate the presence of monopolistic elements in the transport business and unused productive capacity.

Public interest in rate discrimination arises from several causes. Where a railroad occupies a monopolistic position, it might be in the interests of profits to charge a rate which would seem to the public unduly burdensome to shippers or passengers. Where competitive factors enter in, the course of cutthroat competition might lead to preferences being given to geographical location and to persons, a practice which might seem unreasonable and burdensome to others, and might cause impairment of railroad service with ultimate extinction of weaker lines. In any case, unbridled discrimination would tend to enhance transport monopoly with the attendant disadvantages to the public. While this tendency was more important in the days when the railroad had few competitors, it still exists in spite of the development of new transport agencies.

Rate discrimination is fundamentally of three types: that between persons, that between commodities, and that between places. Discrimination is simply the differential pricing of service where, for business reasons already mentioned, a firm finds it profitable to charge differently for the same kind of service. Thus, transportation service from New York to Chicago may be looked on as transportation of goods or passengers for a certain number of miles. But it may be profitable for carriers serving these two cities to charge different rates for different commodities, different rates to different shippers, and different rates for similarly distant hauls between these cities.

Differential pricing may be in the public interest if it means that traffic could not move unless something less the overall costs were charged. As has already been indicated, a rate slightly more than variable costs on traffic which could not move without such a rate does not burden other traffic, because it reduces the share of overhead costs that the latter might have to bear. But where differential pricing is not in the public interest, or is arbitrary, capricious, or "unfair," discrimination becomes an evil that regulation aims to eradicate. In other words, laws against discrimination do not forbid all differential pricing, but merely pricing inconsistent with what is conceived by legislature, commission, or court as incompatible with public interest.

1. Discrimination Between Persons. Discrimination between persons may take many forms. Shippers of large quantities may be given preferential rates over shippers with small quantities. As a matter of fact, an adaptation of this method is found in the variation between carload and less-than-carload rates. A form of personal discrimination is the granting of free passenger passes to favored shippers. Rebates of part of the freight rate paid have been employed. Another type of personal discrimination is found in payments to shippers for services rendered by them. By giving excessive rents for private cars, by granting excessive fees for trucking, switching, or warehousing services, or by approving excessive damage claims, certain shippers may be favored. Another common way is to offer to buy supplies and materials from shippers who will give business to the railroad.

a. Legislative basis of control. The law to regulate commerce gives the Interstate Commerce Commission adequate control over personal discrimination. Section 1 gives it jurisdiction over auxiliary carrier services, such as private cars and terminal facilities. This section also contains the "commodities clause" under which railroads, other than lumber railroads, may not carry in interstate commerce an article which they may own or in which they may have a business interest, except commodities necessary and intended for use in their own business. Section 2 makes it unlawful for a carrier to collect different rates from one person than another for "like and contemporaneous service . . . under substantially similar circumstances and conditions." Section 3 forbids any common carrier under the act to give any undue or unreasonable preference to any person. Other sections of the law require notice for changes of rates, and make both carrier and shipper liable to fine and imprisonment for charging a rate different from that published. The issuance of free passes has also been limited by law to railroad employees, others who have a legitimate right to free transport, and workers in certain religious and charitable institutions.

b. Commission practice. The clearest cases of personal discrimination have disappeared as the result of the punitive features of the law and the growth of higher business ethics in the railroad industry. Nevertheless, difficulty is still experienced in the interpretation of "substantially similar circumstances and conditions" and in the fixing of reasonable payments for shippers' services and damage claims.

The Commission has been rather strict in its application of the law. Lower carload than less-than-carload rates have been allowed, and sometimes required, on the grounds of cost differences. But the Commission went no further until 1939, when trainload rates were allowed upon molasses.[1] It has adhered rather rigidly to the rule of equality of charges unless the circumstances are clearly dissimilar. Preferential rates for railroad coal over commercial coal were rejected by the Commission, a position upheld by the Supreme Court;[2] but its rejection of preferential rates on traffic of foreign origin over domestic traffic was reversed by the Supreme Court on the ground that foreign origination of traffic caused conditions to be substantially dissimilar.[3]

Through a long series of investigations and orders over the years since 1906, the Interstate Commerce Commission has sharply reduced cases of personal discrimination arising out of excessive payments for shipper-performed services and for such other matters as damage claims. That these abuses still exist is hardly open to question, but investigations have been made and eradication of most discrimination of this sort has resulted. In carrying on this work the Commission has proceeded on the basis that it will look at the substance

[1] *Molasses, New Orleans to Peoria and Pekin,* 235 I.C.C. 485 (1939).
[2] *I.C.C. v. B. and O. R.R. Co.,* 225 U.S. 326 (1912).
[3] *Texas and Pac. Rwy. v. I.C.C.,* 162 U.S. 197 (1896).

of the arrangement between carrier and shipper, rather than to any subterfuge which may make the dealing appear to be *bona fide*.

2. Discrimination Between Commodities. The whole freight-rate structure is permeated with discrimination between commodities. Commodities are classified into groups for application of distance rates. Ratings are given to every one of the thousands of commodities and the ways they may be packed. Since the freight rates are different for the same haul for each class rating, the result is differential pricing based upon commodities.

a. Legislative basis for control. Often discrimination between commodities is really a discrimination between places because of the geographical location of shippers of a particular commodity. As such it will fall under place discrimination, to be discussed below. But the Interstate Commerce Commission has adequate power to deal with discrimination between commodities under section 3 of the Interstate Commerce Act. This section makes it unlawful for any common carrier subject to the act to "subject . . . any particular description of traffic to any undue or unreasonable prejudice or disadvantage in any respect whatsoever."

b. Commission administration. On the whole, the Interstate Commerce Commission has upheld differences in commodity rates which can be traced to cost factors. Higher rates on bulky articles, on articles peculiarly subject to loss or damage, and on freight requiring special services have generally been allowed. The Commission has also upheld carriers in making rates conforming in some degree to the value of the commodity.

There are exceptions to application of the value of commodity theory in rate-making. The Commission will not allow value to be considered to exclusion of cost factors, nor can small changes in values be given effect in freight classification, lest the classification become extraordinarily complex.

In order for a case to arise as a commodity discrimination warranting a finding of undue preference or prejudice, the commodities involved must be competing ones. The commodities themselves may be different, but if they are in fact in competition, and if differences in rates would cause injury to a shipper, a finding of undue prejudice may be made. This does not mean, however, that all competing commodities must be given an equal rate. Cost differences and value of the article differences may justify a different rate, even for competing articles.

The degree of competition between commodities necessary to justify equality of treatment is often difficult for the Commission to decide. If the effect on competition is negligible or remote, equality will not usually be found necessary. If the relationship is so close as to affect commodity prices, profitable production, or the shipment of a competing good, then ordinarily application of the principle of equality will cause differences in commodity rates to be a basis for undue preference.

3. Discrimination Between Places. The most difficult kind of discrimina-

tion to deal with is that which involves rates from one point to another. When departure is made from the distance principle in rate-making, whether it be over the same line or route or over different routes or lines serving the same points or market areas, the determination of reasonable discrimination is more complicated than in the case of personal and commodity discrimination.

Place discrimination takes several forms. Rates may be the same for unequal distances or they may be different for equal distances. Rates may also be made which are less for longer distances than for shorter hauls, even over the same line or route. Because this last type of rate discrimination has been dealt with under a separate section of the Interstate Commerce Act, and because it presents some peculiar problems, it will be treated separately below. But the student should recognize that long- and short-haul rates are essentially rates involving discrimination between places.

Place discrimination has arisen as the result of competitive factors affecting the elasticity of demand for railroad service on a particular railroad. Different railroads may compete with each other at common points they serve, although their length of haul to these points may be different. Or a railroad may compete with other transport agencies at these points. Railroads may compete for the traffic to or from a particular market, even though they do not directly compete with each other or with other transport forms serving that market. Thus, California oranges and Florida oranges compete in many localities. If a rate on California oranges, say, to Pittsburgh were based upon distance alone, the proximity of Florida would place Florida oranges at an advantage. Strictly speaking, the railroads from Florida to Pittsburgh do not compete with those from California to Pittsburgh, but because the rates they charge do affect the flow of oranges to the market, the competitive influence is a factor necessarily affecting their rates.

This market competition may be that of rival producers for a common selling market, as in the case of oranges, or it might be competition of rival selling markets for the output of a certain producing area. Thus, Norfolk, Baltimore, Philadelphia, New York, and Boston are commercial centers which compete for the export traffic from the inland United States.

a. Legislative basis for control. The Interstate Commerce Commission's power over place discrimination is found, for the most part, in section 3 of the Interstate Commerce Act. By this section it is unlawful for a common carrier subject to the act "to make, give, or cause any undue or unreasonable preference or advantage to, . . . or to subject any . . . locality, port, port district, gateway, transit point, region, district, territory, . . . to any undue or unreasonable prejudice or disadvantage in any respect whatsoever." Along with the long- and short-haul clause, the minimum- and maximum-rate powers, and other administrative provisions of the law, the power of the Commission over rates involving place discrimination is apparently adequate.

b. Commission practice. The question as to when place discrimination is "un-

reasonable" is one for administrative interpretation. Here again, no mathematical formula of Commission treatment can be computed, for each case must be decided in light of its pertinent and peculiar facts. But a few principles of Commission practice may be summarized.

The prejudice or advantage must be clearly undue or unreasonable. Rates which are reasonable *per se* may well be unreasonably discriminatory. Equal rates may cause undue prejudice if the services given are unequal. In order for a showing of undue or unreasonable advantage or prejudice in a rate, the complaining locality must prove that it has suffered, or would suffer, injury as the result of the rate. This injury must grow out of the rate and not other factors, such as disadvantageous location or relative inefficiency.

Place discrimination may be found to be reasonable under certain conditions. Differences in transportation conditions have been admitted by the Commission to make place discrimination reasonable; differences in expenses of carriage, in volume of traffic, and the "tapering of charges" in long hauls are examples.[1] Competition between carriers at certain points may justify departure from strict distance rates at these points, without causing undue discrimination against places where that competition does not exist. In allowing departures for this reason, however, the Interstate Commerce Commission usually requires that this competition be beyond the control of the carrier making the discriminatory rate. But where such advantageous rates are made to certain points, like rates must be made between points similarly situated. Furthermore, discriminatory rates to meet competition must not be such as to rob a place of natural transportation advantages. A third guide to what constitutes reasonable place discrimination is found in commercial factors. As Sharfman points out, there is evidence that the Commission has been influenced by established rate relationships, and that rate changes which may unduly disturb the delicate balance of shippers' cost of production in a particular market are likely to be found undue or unreasonable.[2]

4. Long- and Short-Haul Discrimination. The law is much more explicit in regard to long- and short-haul rate-making. Although a type of place discrimination, it is so extreme and has been regarded as so open to abuse that special regulatory provisions have been applied to it. A long- and short-haul rate results when a carrier makes a rate between two points which is lower than between points of lesser distance along the same line or route.

a. The clause. Section 4 of the Interstate Commerce Act deals with long- and short-haul rates, even though such rates would also fall under section 3, which deals with discrimination against places. Section 4 makes unlawful the charging of a lower rate for a longer than for a shorter distance in the same direction over the same line or route. But the Commission can allow railroads to file such rates, subject to certain restrictions on the Commission's authority. First, the lower long-haul rates must be reasonably compensatory. Second, where lowered to meet water competition, that competition must be actual

[1] Sharfman, I. L., *op. cit.*, vol. III B, p. 571.

[2] *Ibid.*, pp. 656–93.

and not merely potential. Third, when rates are reduced because of water competition, a later increase must be based on grounds other than the elimination of that competition.[1]

b. Commission interpretation. Regulation of long- and short-haul rates presents some points of difference from regulation of other place-discrimination rates. In the first place, a carrier cannot even file a tariff for long- and short-haul rates without first receiving permission from the Interstate Commerce Commission. In the case of other rates causing place discrimination, carriers need no permission to file tariffs, although the rates are subject to suspension upon complaint by shippers or upon motion of the Commission. In the second place, the Commission's administration of rates under section 4 is subject to some definite rules covering the granting of relief.

As criteria for a "reasonably compensatory" rate, the Interstate Commerce Commission set up the following in 1922: (1) a rate must "cover and more than cover the extra or additional expense incurred in handling the traffic to which it applies"; (2) it must be "no lower than necessary to meet existing competition"; (3) it must "not be so low as to threaten the extinction of legitimate competition by water carriers"; and (4) it must "not impose an undue burden on other traffic or jeopardize the appropriate return on the value of carrier property generally."[2]

Wherever competition has been advanced by carriers to justify relief, the Commission has required that this competition be "actual" and "of controlling force in respect to traffic important in amount."[3] Since 1920, when special provision to protect water carriers was written into the law, the Commission has been strict in granting relief only where water competition is in existence and not merely "strongly potential." By competition of "controlling force" is meant competition which cannot be eliminated by adjustment of railroad rates by the railroads themselves. As for "traffic important in amount," while railroads would not ordinarily be interested in making long- and short-haul preferences where a small amount of traffic is involved, this principle has caused some difficulty. Since a water line is likely to be a smaller business than a railroad, the effect of diversion of traffic may be serious for the water carrier, without being great for the railroad, in relation to the total traffic of the railroad. This fact, along with the fact that the Commission is directed

[1] Until repealed by the Transportation Act of 1940, a fourth limitation applied. Long- and short-haul relief to railroads on account of circuitous routes was required to conform to the rule that rates to intermediate points no farther from the place of origin than the distance of the most direct through route between competitive points should not be higher than the through rate. For example, suppose two carriers, X and Y, operate between points A and B, the route of carrier X being longer than that of carrier Y. On a rate from A to B, carrier X might have been allowed to charge the same rate as that charged by Y. But non-competitive points between A and B over X, which were no farther from A than the mileage from A to B over Y, could not be charged rates greater than the through rate between A and B. Despite the repeal of this clause, the principle may still be applied by the Commission in refusing to grant long- and short-haul relief to unduly circuitous routes, since it has wide discretion in this matter.

[2] *Transcontinental Cases of 1922*, 74 I.C.C. 48, 71 (1922).

[3] *Re Southern Rwy. and Steamship Asso.*, 1 I.C.R. 278, 291 (1887).

by law to "promote, encourage and develop water transportation . . . and preserve in full vigor both rail and water transportation," [1] has led it on several occasions to withhold relief from the long- and short-haul clause.

c. Proposed repeal. For several years, carriers and certain shippers have proposed repeal of the long- and short-haul clause. Opponents of the clause claim that it has tended to introduce an element of inflexibility in rate regulation and has tended to make the Commission too strict in allowing low long-haul rates. Since these rates may be supported by the same cost and value of service considerations under which other place-discrimination rates are made, opponents of the clause declare that the same provisions should apply to long- and short-haul rates. Those who favor retaining the clause claim that its repeal would result in cut-throat competition between railroads and water carriers and long-haul trucks, by which shippers at non-competitive points would be seriously injured.

Repeal of the long- and short-haul clause would not mean freedom in long-haul rate-making. Place discrimination could still be handled adequately under other sections of the act, notably section 3. All that repeal would surely do is to change the technique by which long-haul rates are made. Railroads would no longer have to ask permission to file such rates, but could do so subject to complaint or investigation. Of course, it is possible that repeal might be interpreted by the Commission to mean that Congress desires a more liberal policy to be pursued in allowing railroads to make low long-haul rates without reducing rates on shorter hauls.

F. EVALUATION OF COMMISSION RATE POLICY

Of all regulatory tasks in the field of government control of business, rate regulation is perhaps the most difficult and most complex. Furthermore, the regulation of railroad rates is surely the most complicated of all rate regulation. This subject has been treated somewhat in detail, not only for these reasons, but because it represents a case of government control in which continuing supervision by the federal government has been subjected to its longest and most trying test.

It is an almost impossible task to evaluate Commission rate policy. If complete responsibility for railroad rates were in the hands of the Interstate Commerce Commission, this might be done. But the carriers themselves have been responsible in part for rates. Competitive and general business conditions have also been responsible. Where a divided responsibility exists, allocation of blame or credit for results cannot easily be made, if at all.

In evaluating the regulation of railroad rates, one should look to the results of this task in terms of the adequacy of the rates to support an efficient service needed by the public. Most students seem to be agreed that the railroad system has furnished an adequate, improving, and efficient transportation service.

[1] I.e., by section 500 of the Transportation Act of 1920.

Whether this service will continue to be sufficient in the face of inability of the railroads in recent years to make reasonable payments for the use of capital is open to question. Whether private ownership of railroads can be maintained in the future is also subject to question. Should the railroads fail to keep capital flowing into the industry or cease to exist under private ownership, such a result would be at least an indictment, if not a conviction, of public regulation.

Railroad rates have not been particularly adequate in terms of return, as indicated by Table I. While the average rate of return on investment does not disclose cases of higher or lower returns, it does serve to show that serious question exists as to the adequacy of rates. At no time since 1920 have the railroads earned on the average six per cent on their investment,[1] and returns since 1930 have been lamentably low.

The Interstate Commerce Commission has been criticized by some persons for not allowing the railroads to charge higher rates during the 1920's, when, it is contended, higher rates could have been collected. The low rate of return earned by the railroads is often compared with the much more prosper-

TABLE I. INVESTMENT AND RETURN OF OPERATING STEAM RAILWAYS *
(Excluding switching and terminal companies)
(millions of dollars)

Year	Investment in Road and Equipment	Depreciation in Road and Equipment	Investment less Depreciation Reserve	Net Railway Operating Income	Per Cent Return on Investment	Per Cent Return on Investment less Depreciation
1923	$21,373	$1,408	$19,965	$ 975	4.56	4.87
1924	22,182	1,550	20,632	984	4.43	4.78
1925	23,217	1,681	21,536	1,137	4.90	5.29
1926	23,881	1,811	22,070	1,229	5.14	5.56
1927	24,454	1,947	22,507	1,078	4.40	4.79
1928	24,876	2,044	22,832	1,182	4.75	5.19
1929	25,465	2,170	22,295	1,263	4.96	5.66
1930	26,051	2,361	23,690	874	3.25	3.74
1931	26,095	2,521	23,574	528	2.02	2.25
1932	26,087	2,633	23,454	325	1.25	1.38
1933	25,902	2,708	23,194	477	1.84	2.05
1934	25,682	2,765	22,817	466	1.81	2.04
1935	25,500	2,771	22,729	505	1.98	2.22
1936	25,432	2,809	22,623	676	2.66	2.99
1937	25,636	2,951	22,685	598	2.33	2.64
1938	25,596	3,045	22,551	377	1.48	1.67
1939	25,538	3,103	22,435	596	2.33	2.66

* I.C.C., *Statistics of Railways, 1938*, pp. S-142-43 (1940), and 54th *Ann. Rep. I.C.C.*, p. 149 (1940).

[1] Since for railroads as a whole valuation figures have not been much different from investment figures, computing percentage on investment is a close approximation of return on value.

ous rate of return earned by local public utilities and industrial companies. However, Sharfman finds this criticism "largely wanting in substance when tested by reference to the basic objective of maintaining such railroad credit as is necessary for adequate and efficient service." [1]

It is true that the railroads were able to obtain new capital during the 1920's; some were even able to do so by the sale of stock. But is this an accurate criterion of adequacy of rates? The railroads are subject to the fluctuations of the business cycle and to competitive influences. To claim that rates are adequate because they enable a regulated business to obtain new capital in a decade of prosperity is to take a short-sighted view of the essence of adequacy. An adequate return would seem to imply the ability to support capital needed for efficient service over periods of depression, as well as prosperity. In other words, recognizing the flexibility of railroad business, a higher than absolutely necessary return should be allowed during the years in which it could be collected, to make up for the lower return in years of depressed business. As judged by this criterion, the Interstate Commerce Commission seems open to condemnation to the extent it had power to see that the railroads obtained this return.

The problem of railroad rate regulation has been somewhat complicated by an inconsistent regulatory policy. Railroads have been regulated along principles applied to monopolies affected with the public interest; yet not only has competition between railroads been encouraged, but rate regulation has been guided, under congressional mandate, by the necessity of preserving competition between railroads and other forms of transport. Moreover, railroad rate regulation has been undertaken in the face of growing competition from these other carriers, the rates of which, until very recently, have been inadequately and perfunctorily regulated, if at all.

In the regulation of railroad rate structures, the tendency toward placing greater emphasis on cost is clearly perceptible. While general principles of charging "what the traffic will bear" are still a fundamental part of rate-making, and probably always will be, the element of cost has been projected into it by regulatory authorities to an increasing degree. If and when adequate regulation of all transport agencies is achieved, cost, if properly computed, may be a basis for rates which will reflect the economic position of all carriers.

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CHAPTER

7

RAILROAD REGULATION:
Service, Safety, Labor

RAILROAD service is perhaps more important to the public than railroad charges, and society demands that it be furnished efficiently. The problem of rates cannot be separated from the problem of service, for rates have little economic and social significance unless related to quality, adequacy, and safety of service. Furthermore, since the nature of railroad service depends so much upon the efficiency and continuous performance of labor, and also because wages have exerted such great influence on railroad costs and rates, railroad labor is selected for special consideration.

Service regulation has been nearly as complicated as railway rate control. This is partly due to the fact that adequate jurisdiction over service dates only from 1920, and also to the fact that competitive influences have usually served to maintain high standards. Except for some aspects of entry and abandonment, regulation by the Interstate Commerce Commission has been largely a matter of administration, in which the Commission has co-operated with carriers and in which few complicated problems of general application have arisen.

So far as labor regulation is concerned, the Interstate Commerce Commission has had relatively little jurisdiction. Regulation of labor matters has been scattered over various governmental agencies, both federal and state. Even when it is considered *in toto*, it represents an aspect of railroad regulation which is incomplete and irregular.

A. ENTRY INTO SERVICE

Although several state governments, beginning with New York in 1892, passed laws forbidding the building of new railways or extensions of existing ones, this legislation was inadequate to meet the problem of entry into service by interstate railways. Even this regulation came too late to prevent much

uneconomic extension of intrastate railroad building. It is rather surprising that the federal government should not have entered this field before 1920, because notorious cases of competitive and unsound building of railroads were clearly evident years before. The building of the West Shore Railroad across the Hudson River from the New York Central, and the construction of the New York, Chicago, and St. Louis parallel to the Lake Shore and Michigan Southern are examples of speculative building to force the older roads to buy the newer at a profit to the promoters, in order to avoid disastrous competition.

1. LEGISLATION ON NEW CONSTRUCTION. The Interstate Commerce Commission was granted jurisdiction over new construction and extensions in 1920; this is limited to interstate carriers. Nevertheless, where proposed construction is entirely within a state but is to be done by an interstate carrier or is closely related to interstate commerce, it falls under the jurisdiction of the Commission. The law requires a carrier to obtain a certificate of convenience and necessity before it may embark on new construction. In granting this certificate the Commission may attach such terms and conditions as future public convenience and necessity seem to require. Ordinary construction of such facilities as spur, industrial, team, switch, or side tracks is excepted from the law.

The law respecting entry into service also gives the Interstate Commerce Commission the authority to require a railroad to extend its lines. To order such extension the Commission must find that "it is reasonably required in the interest of public convenience and necessity," and that the "expense involved therein will not impair the ability of the carrier to perform its duty to the public." This provision of the law represents an apparent expansion of the common-law obligation of common carriers to serve adequately their respective territories. However, there is nothing in the statute itself which would limit the Commission to ordering extension of lines in the territory a railroad professes to serve.

2. VOLUNTARY CONSTRUCTION. In administering the law in respect to voluntary extension the Commission has laid down several principles. It will not allow new construction in territory where service is already adequate and may be had on reasonable terms. But it will do so in territories previously served exclusively by one carrier if the new line will improve service, serve new communities, or shorten routes.

The Commission has even approved of competitive building where there is evidence that competition will stimulate an existing carrier to improve its services.[1] A number of the members of the Commission, however, have dissented from this position. In general their opinion is based upon the argument that competition implies some duplication of facilities, a result which the Transportation Act of 1920 was designed to avoid, through placing emphasis on an adequate and efficient national system of transportation. To this might

[1] *Construction by Wenatchee Southern Rwy. Co.*, 90 I.C.C. 237 (1924).

be added the argument that regulation of the railroads along monopolistic principles implies encouragement to monopoly. The recognition of competition as a goad to adequate service or reasonable rates appears to be an admission that regulation cannot be successfully accomplished by direct administrative action.

Another principle followed by the Commission in allowing new construction is that the new line must show promise of being self-sustaining. The application of this test is usually made in conjunction with the need for service. For example, the Commission refused to allow construction of a new line between Pittsburgh and New York because it believed, not only that there was no need for an additional trunk line between these points, but that the return on the capital invested would be inadequate.[1]

3. INVOLUNTARY CONSTRUCTION. There are, in fact, relatively few cases where the Interstate Commerce Commission has ordered a railroad to extend its lines. In most instances when shippers have complained that existing facilities were inadequate and have asked for extensions, the Commission has refused to require them, largely because of the uncertain financial results of the projects.

In one case, the Commission ordered a rather extensive construction. In 1927 the Public Service Commission of Oregon asked it to require construction of a 185-mile connecting line to serve the central part of the state. The federal commission ordered a subsidiary of the Union Pacific Railroad to undertake the construction after finding that the line was needed and that the expense would not impair the Union Pacific in its duty to the public; the Commission even maintained that the extension would be profitable to that railroad.[2] However, the order was set aside by the Supreme Court, largely on grounds of statutory construction.[3] The majority of the Court held that the power of the Interstate Commerce Commission to require new construction "is confined to extensions within the undertaking of the carrier to serve, and cannot be extended to embrace the building of what is essentially a new line to reach new territory."[4] The Court based its conclusion in the first place on the fact that the law placed extension of car service and of lines in the same clause, not thereby making clear that extension of lines into new territory was intended. In the second place, the Court pointed to the legal doctrine that public-utility extensions cannot be required into areas which the public utility has not held itself out to serve, and that the Transportation Act of 1920 must have been made with this constitutional principle in mind.

This restriction of the power of the Commission has been strenuously objected to on the ground that it impairs its ability affirmatively to control the

[1] *Construction of New York, Pittsburgh and Chicago R.R. Co.*, 187 I.C.C. 598 (1932).
[2] *P. S. Comm. of Oregon v. Central Pac. Rwy. Co.*, 159 I.C.C. 630 (1929).
[3] *I.C.C. v. Oregon-Wash. R.R. and Nav. Co.*, 288 U.S. 14 (1933).
[4] *Ibid.*, p. 40.

railroads in order to develop an adequate and efficient national transportation system. As Justice Cardozo said in his dissenting opinion:

> Congress does not transcend the limits of the Constitution when it establishes a national system of transportation by rail. It does not transcend those limits when in aid of the system thus established, it lays a duty upon the railroads to furnish the extensions requisite for the attainment of the end in view.[1]

B. ABANDONMENT OF SERVICE

In the early common law, there was apparently no obligation of a common carrier to continue service. So long as he professed to serve, he was under obligation to serve adequately, but he might withdraw from the service completely. With the granting of corporate charters and powers of eminent domain to railroads, however, the right of any business affected with the public interest to abandon service became restricted. For example, in a Connecticut case in 1885, the court held that the sovereign powers conferred on a railroad corporation by the state were granted upon the theory that they were to be used to promote the public welfare, and that when a corporation had exercised these powers it had no right to abandon the enterprise against the will of the state.[2]

The free right of railroads to abandon their property was admittedly restricted before the Transportation Act of 1920, although the Supreme Court has held that where the company was compelled to continue operating at a loss, it was deprived of its property without due process of law.[3] Abandonment of railroad property was largely a matter of state-commission jurisdiction and railroad-charter provision before 1920, at which time the Interstate Commerce Commission was given authority over abandonments in interstate commerce.

1. LEGISLATION CONCERNING ABANDONMENT. The Transportation Act of 1920 provided that no carrier under the jurisdiction of the Interstate Commerce Commission might abandon "all or any portion of a line of railroad, or the operation thereof, unless and until there shall first have been obtained from the commission a certificate that the present or future public convenience and necessity permit of such abandonment." The law specifically excepts industrial, spur, team, or switching tracks located within one state, as well as street, suburban, and interurban electric railways not operated as a part of the general system of any carrier subject to the act. As in the case of new construction, the Commission may attach such conditions as it desires and the railroad may abandon without securing the approval of any other agency.

2. RELATION OF STATE AND FEDERAL AUTHORITY. Some difficulty has arisen over the question as to when federal authority and when state authority is controlling in railroad abandonments. Most such abandonments remove

[1] *Ibid.*, p. 49. [2] *Gates v. Boston and N.Y. Air Line*, 53 Conn. 333 (1885).
[3] *Brooks Scanlon Co. v. R.R. Com. of Louisiana*, 251 U.S. 396 (1920).

lucrative taxable property from the rolls of state subdivisions, and in many cases cause relative hardship to small business groups. As a consequence, political pressure has been brought to bear on state authorities to block the abandonment.

After some litigation, the Supreme Court has laid down some general principles on the controversy respecting federal and state powers in an abandonment proceeding. Even though intrastate trackage is involved, the Interstate Commerce Commission may authorize abandonment if continued operation would burden interstate commerce. In a leading case,[1] the Supreme Court upheld an order of the Commission allowing abandonment of intrastate operation of a branch line where, in the Commission's judgment, continued operation would affect the ability of the carrier to carry on its interstate business. The Supreme Court pointed out that it was unnecessary for the Commission to prove that the operation of the branch line would impair the ability of the carrier to earn a just compensation. The sole test made in the statute was public convenience and necessity, and so long as the Commission found adequate evidence to support its order, its judgment respecting the applicability of this test was controlling.

3. Commission Abandonment Policy. From 1920 to October, 1940, the Interstate Commerce Commission approved the abandonment of 26,580 miles of railroad. For these abandonments 1585 certificates were issued and applications covering 6644 miles of line were withdrawn or refused.[2] In practically every case abandonment came as the result of operating losses on the lines, these usually being due to exhaustion of natural resources in the area which the line was built to serve, highway competition, excessive railroad competition, and other factors causing a decline of traffic. Most abandonments have been branch lines, tap lines, or other short lines which were a part of a single interstate carrier's system.

In allowing abandonments, the Commission attempts to balance carrier and community interests. Where abandonment will not seriously inconvenience the public, the request of the railroad will be approved almost invariably. On the whole, the Commission allows abandonment where operation of a branch line will seriously affect the earnings of the carrier system. But losses on a part of a carrier's line are not adequate basis for allowing abandonment if the railroad serves a definite public need. Even in these cases, the Commission has indicated that there is a point beyond which unprofitable operation cannot go, regardless of the prosperity of the carrier system. Where reasonably adequate substitute services are available, or where the losses incurred are clear evidence of the lack of great public need for the line, the Commission usually allows abandonment. But where there seems to be a possibility that the continuance of service will bring improvement, due either to special attempts to increase

[1] *Colorado v. U.S.*, 271 U.S., 153 (1926).
[2] *Annual Reports I.C.C.* (1934–1940).

traffic or to the institution of economies, the Commission ordinarily rejects the application, at least for a trial period.

C. ADEQUACY OF SERVICE

As has already been stated, under the common law a common carrier was obligated to serve adequately. This really meant that he was to furnish convenient accommodation, safe facilities, continuous service, and non-discriminatory service. In all events under the common law, the duty to serve was not absolute but was an obligation to do all these things "reasonably." Thus, the Supreme Court has held that the right of a shipper to obtain adequate service "is not an absolute right and the carrier is not liable if its failure to furnish cars was the result of sudden and great demands and which it could not reasonably have been expected to meet in full." [1]

While the Interstate Commerce Commission and state commissions have been given rather complete power over railroad service, the student should not forget that the obligation to serve is still a common-law obligation. As such, the courts will entertain and adjudge suits for damages or for injunction or mandamus from an aggrieved shipper or passenger in cases where a common carrier does not observe this obligation.

1. Legislative Basis for Adequacy of Service. As distinguished from discrimination in service and safe service, the law regarding the regulation of service adequate to meet transport demands is found in various parts of the Interstate Commerce Act. A part of this law is the authority to require extension of facilities, dealt with above. The Interstate Commerce Commission has also been given power to establish reasonable rules with respect to car service. Because car service is interpreted to mean "use, control, supply, movement, distribution, exchange, interchange, and return of all vehicles — including cars, locomotives, and special equipment — and the supply of all trains," [2] it is fairly clear that this provision gives the Commission power to deal with most problems concerning adequacy of service.

The Commission also has authority to require carriers to establish reasonable and proper facilities for the interchange of traffic between carriers, both by rail and by water. In this connection it may require establishment of through routes over the lines of connecting carriers. It may also require the joint use of terminals by two or more carriers when this is in the public interest.

In case of emergency in which the Commission believes immediate action to be necessary, the law grants it authority to suspend existing car-service rules and to issue new ones without regard to ownership rights of carriers, so long as the latter are designed to "promote the service in the interest of the public and the convenience of the people." These emergency powers are extensive;

[1] *Penn. R.R. Co. v. Puritan Coal Co.*, 237 U.S. 121, 133 (1915).

[2] Sharfman, I. L., *op. cit.*, vol. III A, p. 57.

they give the Commission authority to manage the railroads and to subordinate carrier rights to public interest.

2. ADMINISTRATIVE CONTROL FOR ADEQUATE SERVICE. The Interstate Commerce Commission has co-operated with the railroads in exerting control over service. The latter have been allowed to take the initiative in instituting changes in car-service rules and in asking for joint use of facilities; the former has acted more as an arbiter of conflicting interests, both carrier and shipper, and has seldom undertaken any service changes as the result of independent investigation. Competition of railroads for business has been, for the most part, an effective stimulus for giving adequate service.

Where disagreements over car distribution or the use of terminal and other facilities have occurred, the Commission has attempted to adjust the difficulties by informal contact of members of its staff with the parties concerned. Consequently, relatively few mandatory orders have been issued.

When effective movement of freight was impaired by strikes in 1920 and 1922, the Interstate Commerce Commission exercised its emergency powers on a country-wide basis. Orders were issued for roads to expedite movement of traffic over the fastest routes, regardless of instructions of shippers or carriers, or ownership of cars. Preferential shipment of certain commodities to consignees most in need was directed. In effect the Commission assumed managerial control over service. These powers have also been assumed in restricted areas where strikes, floods, or other conditions have threatened to impair the efficient movement of traffic. The power of the Commission could also be effectively utilized where necessary for national defense.

The Federal Co-ordinator of Transportation, during the three years (1933–1936) of existence of the office, made many recommendations for the improvement of efficiency and quality of railroad service. Consolidation of all merchandise freight service, store-door delivery and pick-up, and liberalization of packing requirements were recommended. Pooling of all freight cars in the interests of improved service and economy of equipment was suggested. Other recommendations included increased speed and frequency of freight service, distribution of freight by way trains from terminal centers, and increased joint use of terminal facilities. No orders requiring adoption of these service improvements were made, but the reports have furnished the railroads with suggestions that can be worked out voluntarily through the Association of American Railroads.

D. SERVICE DISCRIMINATION

Under the common law, common carriers may not discriminate unreasonably in respect to service between shippers or commodities. Most state public-utility commission laws made undue or unreasonable discrimination, whether of service or of rates, unlawful. The original Interstate Commerce Act of 1887

forbade undue preference or advantage and declared that carriers must provide "reasonable and equal facilities for the interchange of traffic," but service discrimination in other respects was left to the common law.

Discrimination in service has not been as serious a problem as discrimination in rates. Nevertheless, competition for traffic has led railroads to give better service to shippers whose business is large. This has taken the form of preferential allocation of equipment, allowing some shippers to use cars as warehouses without strict enforcement of demurrage rules, and unequal granting of various free services.

1. Commission Authority over Service Discrimination. Through its general powers to require adequate service, the Interstate Commerce Commission has a means of regulating cases of service discrimination. For example, the authority to enforce "just and reasonable rules, regulations, and practices with respect to car service" may be used to remove discriminatory practices as well as to require adequate service. Similar authority is given by the section of the law dealing with undue prejudice or advantage. Here it is made unlawful for a railroad to make or give to any person, company, corporation, locality, or kind of traffic in any respect whatsoever any undue or unreasonable prejudice or advantage. This same section has been discussed under rate discrimination (pp. 114–16), where it has been most important, but its provisions apply to service discrimination as well.

2. Removal of Service Discrimination. In administering the law concerning service discrimination, the Interstate Commerce Commission has usually dealt with the problem in connection with rate discrimination. If a different service is given for the same rate, or the same service at different rates, the problem of discrimination is often one of both rate and service discrimination, the adjustment being made through rates. For example, when lighterage service is given by carriers not having terminals on Manhattan in New York City, the question of whether undue prejudice or advantage exists is basically one of determining whether an additional charge should be made for this service by carriers with terminals in New Jersey. Or, where privileges for fabrication in transit are granted on a through rate, the problem of this additional service is closely related to the rates charged.

However, there are some cases of clear service discrimination apart from the question of rates. The general rule the Commission has followed is that shippers or commodities equally situated should have equal treatment. A departure from this principle must be based upon circumstances or conditions substantially dissimilar. The Commission has ordered removal of discrimination in cases where a carrier has furnished adequate cars to one shipper in preference to another. Likewise, granting switching service to one shipper and withholding it from another similarly situated has been a cause for finding undue prejudice or advantage.

While there are many reasons why a railroad may refuse shipments, such as

improper packing, dangerous commodities, articles of extraordinary value, or certain shipments when traffic congestion exists, the railroad may not unreasonably discriminate in doing so. The Commission has also found unjust service discrimination to exist in cases where better train service existed for a particular product between two points than between two other competing points.

E. SAFETY OF SERVICE

In matters respecting safety of railroad service, the states still exert notable control under their police power. The federal government has armed the Interstate Commerce Commission with a wide control over safety requirements, but where Congress has not legislated, the states have a free hand in passing laws reasonably designed to promote safety. They have passed laws regulating the minimum crew on trains; a few have even limited the length of freight and passenger trains. Protection of grade crossings, as well as elimination of such crossings, has been left to state control. But in matters of hours of service, safety appliances, signals, locomotives, and accident investigation in interstate commerce, the Interstate Commerce Commission has exerted the dominant control. Because of the different types of control in the interest of safety, both by federal and state governments, the problem of safety will be treated by brief analysis of the legislative provisions and administrative treatment of the more important types.

1. SIZE OF CREWS. State laws concerning the minimum size of crews on trains differ. Some states require a minimum of five men on a train, others four or six. While one would not doubt that the interests of safety require that trains be adequately manned, the danger of such legislation lies in the possible interference with efficient operation. In the case of one- or two-car gas-rail trains, safe operation may require far fewer men than the minimum prescribed by the state; in the case of certain large trains, efficient and safe operation would necessitate more.

While the states or the federal government may supervise manning of trains, prescription of an arbitrary minimum is likely to constitute unwise interference with railroad management, with the result that efficiency of operation is impaired. As is generally known by students of transportation, too often agitation for full-crew laws has come from labor groups interested in creating additional employment. Since state laws vary and some states have no full-crew laws at all, labor has been pushing for a federal law on this subject. If such legislation is passed, sound governmental control would seem to demand that the fixing of adequate crews be left to the Interstate Commerce Commission for administrative treatment in the light of genuine safety needs.

2. LIMITATION OF TRAIN LENGTH. A few states have attempted to limit the length of freight and passenger trains, and federal legislation on this point has

been pressed in Congress. The usual plan is to limit freight trains to seventy cars and passenger trains to fourteen cars. This legislation is supposedly based upon safety needs, its proponents claiming that the jerking action of long trains endangers railroad employees, and that safety of operation is hindered by the inability to transmit signals between the head end and rear end of trains.

This type of safety legislation is in reality advanced in the interests of increasing employment. Studies have indicated that the increased hazard of more trains at grade crossings, and the increased exposure of more trainmen to other railroad accidents which vary directly with the number of trains, would more than offset any doubtful reduction of accidents attributable to long trains.[1]

3. Grade Crossings. Protection at grade crossings is usually determined by state railroad, public-utility, or highway commissions, or in some cases by local governmental authority. Of course, in many cases the interest of the railroad in reducing accident claims makes compulsion by any governmental authority unnecessary. Even in these cases, however, the kind of protection — gate, watchman, lights, bells, or separation of grade — may be determined by public authority.

Except for protection by separation of grade, the railroad bears all the expense of making these crossings safe for highway users. But most states now have statutes providing for the division of the cost of grade separation between the railroads and the government concerned. In some states these divisions are determined by prescribed ratios; in others the allocation of costs between state and local governments and the railroads is placed in the hands of a state commission with power to make a division of expense according to the facts of each project.

In recent years there has been a tendency for governments to pay a larger share of the cost of grade-crossing elimination. Railroads still pay a larger share than the benefits they receive from such expenditures. After all, the need for such crossing elimination has arisen from increased highway traffic, and fairness would seem to demand that the principal recipients of the benefit pay an increasing share of the safety protection obtained.

4. Safety Appliances. As Sharfman has pointed out, the safety legislation of the federal government has developed independently of the other "main channels of regulation structure."[2] This economist notes that these laws are primarily social in character rather than economic, even though safety regulation has increased costs, enhanced efficiency, and improved service. Moreover, they have been largely technical in nature, rather than a regulation of business relationships, and have called for routine enforcement through a technical staff.

[1] On this legislation see the author's article, "The Drive of Labor for Shorter Freight Trains," 20 *Public Utilities Fortnightly*, pp. 747–59 (December, 1937).

[2] Sharfman, I. L., *op. cit.*, vol. I, pp. 247–48.

Safety regulation was given earlier and more adequate treatment than any other aspect of service control. Through a series of acts dating from 1893, a complex of laws touching for the most part on specific matters has developed. Safety regulation by the federal government may be divided into safety appliances, signals and train control, locomotive boiler inspection, accident investigation, and hours of service.

Congress has passed laws requiring the adoption of certain safety appliances by railroads. Federal statute has ordered the use of automatic couplers, power brakes on locomotive driving-wheels, continuous-power train brakes, secure hand irons on cars, standard height drawbars, and other safety appliances. In addition, the authority of the Interstate Commerce Commission to make rules for "safe and adequate" car service gives it grounds for requiring safety measures which it deems advisable. Furthermore, in the law of 1920 the Commission was given power to require such other safety devices as in its discretion it should feel necessary to prescribe.

In most cases the laws requiring adoption of safety appliances allow the Commission to exercise a certain degree of discretion in prescribing the time of compliance. The task of enforcing such laws has been of a routine administrative nature, and little difficulty has been experienced in gaining compliance. Where the Commission finds violations, it reports these to the proper district attorneys for prosecution. The safety statutes have been a reasonable policing of interstate commerce and the Commission has administered them reasonably, as attested by their almost consistent upholding by the federal courts.

5. Signals and Train Control. Another field in which statutory authority to require safety devices has been given to the Interstate Commerce Commission is that of train control. Under the Transportation Act of 1920 the Commission was granted authority, after investigation, to order any railroad under its jurisdiction to install automatic train-control devices under such specifications and to such extent as the Commission should prescribe.

The Commission has proceeded cautiously under this power. After years of investigation, it announced in 1923 that the time had arrived when carriers should be required to install automatic train-control devices which would meet certain specifications. In 1924 the Commission ordered nearly fifty carriers to make installations on a part of their roads. By 1929 Commission orders had resulted in such devices being adopted by more than eight thousand miles of road and on nearly eight thousand locomotives, in addition to the three thousand miles of road and one thousand locomotives on which such control had veen voluntarily installed.[1] Block signals had been adopted by that year on more than a hundred thousand miles of road, most of the mileage of which was operated by automatic block signals. Owing to the depression following 1929, additional installations were not ordered, although some additions have been made, but as the need for new signal and train-control devices

[1] 43d *Ann. Rep. I.C.C.* (1929), p. 39.

arises, or as carriers become able to finance them, they will probably be extended.

6. Locomotive Boiler Inspection. Another important piece of safety legislation was the Boiler Inspection Act of 1911. Under this law the Interstate Commerce Commission was empowered to inspect locomotives and to prohibit the use of locomotives which were found to be defective under the rules and regulations prescribed by the Commission.[1] Through additional amendments this inspection was extended to all parts of the locomotive and tender. Inspection of locomotives, like the adoption of safety-appliance devices, has been a routine administrative task, and little difficulty has been experienced in formulating fundamental principles of policy. Some conflict has occurred between federal regulations and state requirements, but even where locomotives are operating intrastate their connection with interstate commerce has usually been enough to place them under the exclusive power of the Commission.

7. Accident Investigation. Since 1910, the Interstate Commerce Commission has had power to require complete reports on railroad accidents. These must be made on every accident causing serious injury to persons or loss of property. The law requires every railroad to specify an officer who is responsible for making a report disclosing both the nature and the believed causes of any accident. In addition, the Commission may investigate such accidents itself and make reports and recommendations for remedial action. As the result of being able to obtain such complete data on accidents, the Commission has been able to make orders appropriate to safety requirements. Moreover, the railroads themselves, being forced to make a complete investigation, have found this requirement a valuable aid in removing causes of accidents. The enviable accident record of railroads is compelling evidence of the wisdom of such research into the nature and causes of railroad mishaps and methods of averting them.

8. Hours of Service Legislation. Although all restriction of hours of railroad labor might be regarded as safety regulation, some distinction between limitations for that purpose and for others should be made. As will be noted presently, the legal prescription of the basic eight-hour day was not primarily a safety measure. However, limitation of hours of service has been provided for as a means of reducing accidents caused by human failure resulting from long hours on duty.

In 1907 regulation of hours of service was provided by Congress after repeated requests from the Interstate Commerce Commission. Under the law carriers may not require or permit employees engaged in or connected with train operation to stay on duty longer than sixteen consecutive hours, or to re-

[1] Strictly speaking, locomotive inspection is under the control of an independent chief inspector, appointed directly by the President. But the Interstate Commerce Commission is empowered to pass on regulations and actions of the chief inspector and to appoint district inspectors.

turn to duty after such period until a period of ten hours has elapsed. Where service is not continuous but the total service in any twenty-four hours amounts to sixteen hours, a rest period of eight consecutive hours is required. A stricter limitation is applied to those who handle train orders by telephone or telegraph, the hours of duty in any twenty-four being limited to nine to thirteen, depending upon whether the operation is in a daytime office or a night-and-day one.

The prohibitions on hours are absolute, except for cases of wreck trains, relief trains, unavoidable accident, or act of God, or where delay was the result of a cause which could not be foreseen when a train left its terminal. These exceptions have been the cause of some difficulty in enforcing the law, for where longer than maximum allowable service occurs, railroads have found it easy to plead that the delay was of an unavoidable nature. Through its power to transmit data on violations to the federal prosecutors, the Interstate Commerce Commission has done much to separate cases of excess hours where unavoidability was real and excusable and those where it was used as a subterfuge. Owing to fair court support of Commission administration of the law, as well as to the tendency to shorten hours generally and to high wage costs arising from overtime rates, violations of the spirit of the hours-of-service law are now relatively unimportant.

F. LABOR: SETTLEMENT OF DISPUTES

Because of the specialized nature of government control of railroad labor, and because of its relationship to other phases of railroad regulation, this problem is separated from labor regulation in general. Special laws have been passed for the adjustment of labor disputes; special legislation has been provided for in the field of railroad retirement allowances; special treatment has been accorded railroad labor in regard to hours and unemployment resulting from co-ordination and consolidation. Yet, beyond the regulation of hours of service for safety purposes and unemployment following upon combination, regulation of railroad labor is one phase of control of interstate rail carriers which has not been placed under the jurisdiction of the Interstate Commerce Commission.

Railroad labor is in a peculiarly important social position. Not only are the million railroad employees a large single group of workers, but the public interest in railroad service is so great as to render a country-wide stoppage in it a real national calamity. The dependence of the country on continuous railroad transportation is well known. Where a strike in another industry would cause loss and hardship, in no other industry would one bring on such industrial paralysis and general personal hardship as in the railroad field.

To the railroads themselves, railroad labor is important in terms of costs, adequacy and quality of service, and ability to meet competition. Labor

costs generally account for more than three fifths of railroad operating expenses. Moreover, railroad labor is well organized, various railroad employees having membership in forty different unions. Of these unions, by far the most powerful are the "Big Four," to which belong engineers, firemen, conductors, and trainmen. These train-service employees have been organized for a long time, and their unions comprise most of the workers engaged in actual train operation.

Dealing with train-service labor is complicated by a system of established working rules as well as by the powerful character of these unions. Thus, the problem of railroad wages is not only one of a wage rate, but is as much the unit of service on which these rates are based. In the field of train operation a dual system of wage payments is used, under which employees are paid on an hourly rate or a mileage rate, whichever gives the higher wage.[1] Such a system does not allow improvements resulting in increased mileage covered per hour to reflect their labor-cost-reducing benefits, since wages for faster service are calculated on a mileage basis. Other rigid operating rules, by which special payments must be made for certain services performed by rail employees, tend to increase the cost of railroad labor.

Congress has followed several practices in enacting legislation to assist in the settlement of labor disputes. In a series of railroad labor acts from 1888 to 1934, it has employed voluntary arbitration, mediation, and a limited sort of compulsory arbitration, as well as encouragement of collective bargaining and the use of public investigation and force of public opinion.

1. RAILROAD LABOR ACTS OF 1926 AND 1934. Present regulation of railroad labor disputes is found for the most part in the acts of 1926 and 1934. The former divides railway labor disputes into two classes: those arising from the *making* of agreements between labor and management concerning pay, rules, and working conditions; and those arising from the *interpretation* and *application* of these agreements.

On disputes arising from the making of agreements, the law provides for a permanent Board of Mediation. This board is charged with the duty of intervening as a mediator in such disputes with a view to effecting a peaceable agreement. Should mediation fail, the board is to encourage submission of the dispute to a special board for arbitration, the latter to consist of three to six members, with equal representation from labor and management and with one or more neutral members chosen by these representatives. While a dispute is voluntarily submitted to such an arbitration board, the law makes its decision final. Should either labor or management refuse to arbitrate, and if, in the view of the Mediation Board, interruption of interstate commerce is threatened, that board may so notify the President of the United States. He

[1] For example, in the road freight service, 100 miles or 8 hours may constitute a day's work. If a wage rate is $9 for a freight engineer on a particular run, he receives that amount as a minimum for 8 hours or less, but if his mileage in 8 hours should be 125, his rate would be calculated at 9 cents per mile and his day's pay would be $11.25.

is authorized to appoint a fact-finding board which must investigate and report to him in thirty days, during which period, and for thirty days following this special report, the disputants must maintain the *status quo*. The report of the fact-finding board is binding on no one, but the obvious purpose of the law is to delay a strike and to allow public opinion to force acceptance of the fact-finding board's conclusions.

As for disputes arising from interpretation of agreements, a different procedure is specified. Under the law as amended in 1934, a National Adjustment Board of thirty-six members (eighteen selected by carriers and eighteen by national labor organizations) is created. While the law encourages the settling of disputes by conference, disputes involving the interpretation or application of agreements which cannot so be settled must be submitted to the Adjustment Board. For purposes of administration the work of the board is allocated to four divisions, each with jurisdiction over disputes of certain groups of railway workers. Because the membership of each of these divisions is made up of equal representation of labor and management, deadlocks occur in many cases. In order to meet this contingency, the law provides that the Adjustment Board select an impartial referee to break the deadlock. In case the board cannot agree on a referee, the Mediation Board is directed to make such a selection. Decisions of the Adjustment Board are binding on the parties involved. An order compelling observance by a carrier may be obtained from a federal district court, but the law does not provide for such an order against a labor union.

In addition to the arbitration and mediation machinery set up by these laws, the 1926 act, and more particularly the 1934 act, provide for complete independence of employees in joining labor organizations of their own choosing. Interference of any kind by employers in such freedom is forbidden.

2. Collective Bargaining. The Railway Labor Act of 1926 stated explicitly that railroad employees should be free to bargain collectively through agencies of their own choosing. As such, this law was a precursor to collective bargaining rights in other fields granted by the Recovery Act of 1933 and the National Labor Relations Act of 1935. The significance of this provision was hardly appreciated in the railroad industry until 1930. At this time the Supreme Court upheld an order of a lower court directing the disbanding of a company union as an interference with the rights of employees to bargain collectively.[1]

The provisions of the 1926 law were elaborated in 1934 so as to forbid more clearly company unions and the methods used to encourage them. Interfering in any way with the free right of organization and bargaining was definitely outlawed. The majority rule in selection of a bargaining agency was provided for and the Mediation Board was given the authority to certify representatives.

[1] *Texas and N.O. Rwy. Co. v. Rwy. and Steamship Clerks*, 281 U.S. 548 (1930).

The main effect of these provisions has been to outlaw the company union. To some extent they have been a stimulus for increased unionization of railroad labor. But among the train-service and shop employees unionization had proceeded rapidly after the first World War, when the government administration of the railroads encouraged organization. Hence in these fields railroad unions were remarkably strong, even before 1926, and by 1934 were relatively free from managerial coercion or interference.

However, the guarantee of these rights has served to strengthen the power of labor unions in other fields of railway employment, notably among office workers. The Supreme Court has held in a recent case that this protection extends to all workers having any relationship to interstate railway service. In this case the Court maintained that federal authority to guarantee rights extended to railroad shop employees, since refusal by management to recognize their collective bargaining rights might interfere with interstate commerce.[1]

3. NATIONAL RAILROAD ADJUSTMENT BOARD. Although the decisions of the National Railroad Adjustment Board have not been spectacular, they have been important when taken as a whole. Most of the decisions arise as the result of minor disputes, since they have to do with the interpretation and application of agreements and working rules. The cases often result in outright awards of cash to aggrieved employees who feel that they have not been receiving adequate wage allowance for particular work done.

Occasionally cases settled by the Adjustment Board involve large sums of money and result in decisions materially affecting railroad costs. Perhaps the most sensational case which resulted from interpretation of an operating rule was that of the Lehigh Valley awards made in 1937. Because an operating rule was interpreted to mean that a day's run ended when a train reached the terminal, over $241,000 was awarded to fifty Lehigh Valley trainmen and engineers to give a full day's pay for the short trip from the Pennsylvania Station in New York to the yards in Long Island a distance of about four miles.

It is difficult to appraise the work of the National Adjustment Board.[2] Thousands of cases of minor character have been handled, and perhaps much has been done to make smoother the course of railroad labor relations. But most of the cases are brought at the instigation of labor unions who want to "get something" for their members. Only those cases where labor may gain by favorable interpretation of the rules seem to be brought to the board. As a result, the decisions have perhaps been on the whole favorable to labor. Furthermore, it is clearly unfair for the law to provide that a court order can only force compliance by carriers. Perhaps, so long as labor unions are

[1] *Virginian Rwy. Co. v. Sys. Fed. No. 40*, 300 U.S. 515 (1937).

[2] For a detailed discussion of the work of this board see Spencer, W. H., "The National Railroad Adjustment Board," 11 *Journal of Business*, part 2, pp. 1–65 (April, 1938), and Garrett, Garet, "Peace on the Rails," 212 *Saturday Evening Post*, pp. 8–9 (September 9, 1939).

unincorporated, it is legally difficult to force compliance by them. If this is true, the discrimination against the railroads could be removed by compelling the incorporation of labor unions.

4. National Mediation Board. As presently constituted, the main task of the National Mediation Board is to mediate disputes arising from the making of wage and other agreements between carriers and workers. A second function has been to certify representatives for purposes of collective bargaining; much of the time of the board has been consumed in doing this job in recent years, particularly after the law of 1934 made clearer and more exclusive the power of employees to select organizations of their own choosing for collective bargaining, a right first granted in 1926. A third task of the board is to assist the National Adjustment Board in cases where the influence of a mediator may be desirable to help settle a dispute.

In the field of mediation the board has not been subjected to many tests, especially since the amendments of 1934.[1] Most disputes over the making of agreements have been averted by railroad management and railroad labor's coming to terms without the necessity of mediation. In one case, the proposed wage cut of 1938, a chance for operation of the mediation machinery was given. The National Mediation Board failed to gain an agreement between management and labor, the dispute going to a fact-finding commission.

As a matter of fact, little can be expected from the Mediation Board in disputes over such important matters as general railroad wages. As the law is now constituted, the real burden rests with the fact-finding board appointed by the President after the failure of mediation proceedings.

It can hardly be said that the device of a special fact-finding board has met with a real test. To be sure, in 1938 the special board found that the general wage reduction asked by the railroads was not justified. In response to this finding, and the unwillingness of railroad management to assume responsibility to the public for a railroad strike, the pay-reduction order was withdrawn and the strike averted. The real test of the present machinery for settling labor disputes will come when a fact-finding board rules against railroad labor. While public opinion may serve as an adequate goad to force labor's compliance with the board's recommendations, there is danger that labor will not accept the defeat as management apparently has. Reliance upon voluntary compliance with recommendations, backed only by a public opinion supposedly favorable to them, is hardly a lasting and adequate method of dealing with labor disputes.

[1] Between 1926 and 1934, the Mediation Board did settle more than five hundred controversies by mediation and obtained more than two hundred agreements to arbitrate. Only five major disputes went to a fact-finding board, and in all these cases no strike resulted; but in none of them was the decision really adverse to railroad labor.

G. LABOR: HOURS

Government regulation of hours in the interest of safe operation of railroads has already been noted. To some extent the maximum hours so established were superseded by the Adamson Act of 1916, setting a basic eight-hour day for train and engine employees. This law was rushed through Congress at the insistence of President Wilson in order to meet a strike threat over the issue of the eight-hour day.

1. THE EIGHT-HOUR DAY. The establishment of a basic eight-hour day was not advanced as a safety measure, but as a statutory means of averting a strike. Because its adoption did not forbid the working of more hours, merely making eight hours the standard for computation of pay, it was attacked as a wage-regulation measure. This ground for attack seemed to be supported by the section of the law which forbade, during a period of investigation, reduction of the standard daily wage by virtue of the decrease in the standard day to eight hours.

The measure was upheld by the Supreme Court in 1917 by a close decision.[1] The opinion of Chief Justice White recognized that the law might be as much a wages law as an hours law. But regardless of its real character, the majority of the Court held that Congress had the power to pass such a law, especially since doing so was "an essential prerequisite to the uninterrupted flow of interstate commerce."

As a regulation of hours, the establishment of a basic eight-hour day is not very important. No actual limitation of hours is made by the law, the eight-hour day being merely "basic." This means that computation of daily wages is based upon eight hours and that longer hours make payment of overtime obligatory.

It is interesting that no further limitations have been placed on the hours of railway workers. The National Recovery Act of 1933 specifically exempted employees in businesses under the jurisdiction of the Interstate Commerce Commission. Even the Fair Labor Standards Act of 1938, by which minimum wages and maximum hours are prescribed for a substantial part of businesses which affect interstate commerce, did not include the regulation of hours of railroad employees within its purview. Present hours regulation of railroad labor is found in the safety laws and in the eight-hour-day law. The limitation of hours of service for the purpose of safety is the only real restriction. Even state laws regarding hours worked by train-service employees must conform to the federal law, so that no additional limitation comes from this source.

There seem to be two reasons why additional limitation of working hours has not been applied to the railroad field. In the first place, the very nature of the

[1] *Wilson v. New*, 243 U.S. 332 (1917). Note that just prior to this decision the carriers and labor had made an agreement which included the provisions of the law and which definitely established the eight-hour day without reduction of pay.

transportation business makes it difficult to require a maximum eight-hour day or forty-hour week. The necessity for certain workers to finish a run or stay on the job until it is completed arises out of the nature of the service done. In the second place, in the operating field at least, labor unions exert an active influence in allocating hours or mileage to be worked within a month. Labor itself apparently prefers to maintain some flexibility in working time and to direct the quantity of working hours according to its own union rules.

2. PROPOSED SIX-HOUR DAY. Railroad labor has pressed for the six-hour day. But, as in the case of the eight-hour day, labor does not contemplate actual limitation of hours to six each day. What is really intended is that the basic pay now applied to eight hours would become applicable to six hours. Since railroad-operating workers with enough seniority are usually "allowed" so many days' pay per month by union-carrier agreement, this would mean for these employees, at least, that the same pay could be received for fewer hours and overtime rates would begin sooner than with the eight-hour day.

The Interstate Commerce Commission has made a study of the effect of statutory adoption of the six-hour day.[1] It agrees that the adoption of such a law would apparently increase employment by 100,000 to 300,000 men, but that costs would amount to over $600,000,000 per year.

H. LABOR: UNEMPLOYMENT

Besides activities of federal and state governments in behalf of unemployment in general, the federal government has applied three measures to the problem of railroad unemployment. These have to do with compensation for unemployment arising from consolidation and co-ordination, limitation of unemployment following combination, and special railroad unemployment insurance.

Strictly speaking, the federal government has had no law requiring compensation to workers displaced by co-ordination and consolidation. But in the law of 1933 creating the temporary office of Federal Co-ordinator of Transportation, that official was directed not to order co-ordinations which would cause displacement of railroad workers. When the office of Co-ordinator was allowed to lapse in 1936, the railway executives did draw up a "voluntary" dismissal compensation agreement, rather than risk the almost certain passage of a more rigorous law by Congress. The Transportation Act of 1940 also placed definite safeguards around unemployment resulting from combinations of railroads.

In the field of unemployment insurance, railroad employees were first placed under the state plans created by the Social Security Act of 1935. However, in

[1] I.C.C., *Ex Parte 106: Six-Hour Day Investigation* (1932), summarized in Bureau of Labor Statistics, U.S. Dept. of Labor, *Handbook of Labor Statistics*, pp. 1068–69. Bull. 616 (1936).

1938 a special unemployment insurance law was passed for interstate railway employees.

1. DISMISSAL COMPENSATION. The dismissal-compensation agreement can be traced to the move for railroad consolidation and co-ordination which crystallized in the creation of the office of Federal Co-ordinator of Transportation. As has already been noted, this law included the anomalous requirement that co-ordinations or consolidations undertaken at the request of the co-ordinator should not reduce railroad employment or place an employee in a worse situation with respect to wages. As is generally realized, this provision had much to do with making fruitless the work of the Federal Co-ordinator.

The compensation agreement reached by the American Association of Railroads and the Railway Labor Executives in 1936 is not a governmental measure. Nevertheless, governmental action would probably have been undertaken had this agreement not been made. Under it, employees affected by co-ordination or consolidation are to be given ninety days' notice by the employing railroads. In case the employee is to be displaced, he is entitled to an allowance to be paid for periods from six to sixty months, depending upon the previous length of service. The allowance itself for these periods is to be 60 per cent of the usual rate of pay. If a displaced employee prefers, he may accept a lump-sum payment of three to twelve months' full salary. In case the employee is not displaced but is obliged to change his place of residence, the agreement grants to him the expenses incurred in making this transfer.

Regardless of the social justice of this arrangement for displaced workers, it can hardly be upheld as sound regulatory policy. To be sure, in form the agreement was voluntary and not legally required, but in substance the government, by threatening legislation less favorable to railroad management, is really responsible for the policy. Care of workers displaced by progress would seem to be a cost which society as a whole ought to bear. Not only does this saddle one privately owned industry with a social cost not similarly borne by other industries, but it tends to retard co-ordinations and consolidations that might economically be made.

2. UNEMPLOYMENT FROM COMBINATION. Under its power to approve railroad combination found to be "in the public interest," the Interstate Commerce Commission in recent years has insisted that railroad labor displaced by a combination be cared for if the public interest is to be satisfied. This attitude of the Commission was written into law and made even more strict by the Transportation Act of 1940. By this legislation the Commission was directed not only to take into account the interests of railroad employees affected by a combination, but also to require a fair and equitable arrangement to protect these interests. Moreover, the law requires that the Commission shall see to it that, during four years from the effective date of a combination order, such combination will not result in employees of the railroads concerned being in a worse position with respect to employment. The

only exception allowed is that for employees whose service with the railroad has been less than four years, in which case the protection of the law is made to extend only for a period in the future equal to the employees' length of service.

Although this labor provision causes an important impediment to combination of railroads, and seems unnecessary in view of the voluntary dismissal-compensation agreement, it is perhaps even more interesting as an example of congressional intent to protect railroad workers from unemployment. It also indicates the strength of the railroad-labor lobbies in Washington, and may furnish a precedent to similar action in other fields of business in which the government may gain control. As yet, however, no such limitation to unemployment is found in any other business. Even the state and federal governments reserve the right to cause unemployment when, in pursuance of an administrative reorganization of governmental agencies, efficiency may be obtained.

One may question such a restriction upon unemployment due to combination from the point of view of workers themselves. By impeding efficiency which could be obtained from combination, workers may actually be increasing costs and diminishing the possibility of the railroad industry's maintaining or enlarging employment. Furthermore, the law does not say that workers may not be laid off owing to a decline in business or an inability to meet payrolls. And such layoffs may be the indirect result of wastes which could be removed by combination.

3. UNEMPLOYMENT INSURANCE. Since general provision for unemployment insurance is to be treated in a later chapter, its details under state laws, with federal supervision and encouragement, will not be discussed. Suffice it to say that from 1935 to 1938, when railroad employees were under state unemployment compensation laws, several difficulties arose. Railroad employees often work in several states within the same month or week, and administration of an unemployment insurance law by states is exceedingly complex. Again, state laws differ as to benefits, amount of compensation, and eligibility for benefits. Railroad labor, being organized along national lines and working in an interstate industry, would naturally press for a national law.

The railroad unemployment insurance law, passed in 1938 and amended in 1939 and 1940, is administered by the Railroad Retirement Board. Employees of interstate railroad carriers and their agencies[1] receive benefits for each day in excess of seven during the first fourteen-day period of unemployment and for time in excess of four days in succeeding periods. Daily benefits

[1] The act covers every interstate railroad carrier subject to the Interstate Commerce Act, as well as railroad associations, traffic associations, traffic bureaus, demurrage bureaus, weighing and inspection bureaus, collection agencies, and other agencies controlled and maintained principally by carriers, and engaged in services in connection with or incidental to railroad transportation. Even railroad labor organizations, organized in accordance with the Railway Labor Act, are included.

range from $1.75 for those with less than $200 compensation during the base year to $4.00 for those with $1600 and over. During any particular year, maximum benefits to any employee may not exceed one hundred times the daily benefits.

In order to receive benefits an employee must have earned $150 in railroad employment in his base year.[1] Several causes of unemployment will exclude an employee from benefits. These include: voluntarily leaving work without good cause; unemployment due to a strike; failure, without good cause, to accept suitable work. "Good cause" for failure to accept work includes: refusal to accept a position vacant because of a strike, lockout, or other labor dispute; a position in which remuneration, hours, or other conditions are less favorable than those prevailing for similar work in the locality; a position in which remuneration is less than the union wage rate for similar work in the locality; refusal where, as a condition of being employed, a worker would be required to join a company union or resign from or refrain from joining any *bona-fide* labor organization.

Contributions are collected only from employers in an amount equal to three per cent of the compensation, not in excess of three hundred dollars per month, payable to the employee. The contributions are collected by the Retirement Board and placed on deposit with the Secretary of the Treasury of the United States.

In addition to the general powers to interpret and apply the act subject to court review, the Retirement Board may establish, maintain, and operate free employment offices and provide for the registration of unemployed persons. It may also appoint national or local advisory councils to represent employees, employers, and the public for the purpose of aiding the formulation of administrative policies.

Since the Supreme Court has upheld the unemployment insurance provisions of the Social Security Act,[2] there is little doubt as to the constitutionality of the general features of the railroad unemployment compensation law. Since unemployment insurance for other industries is handled by state plans under general principles established by the federal Social Security Act, and since these plans vary, it is difficult to compare the railroad law with those of the states. A few general comparisons can be noted, however. The contribution rate is similar to that prevailing in the state laws, although a few states provide for employee contribution. The benefit provisions are similar, except that railroad benefits are calculated on a daily basis and that the yearly minimum and maximum receivable are somewhat higher than are usual under state laws. The waiting period is also smaller under the railroad act, although it is applicable to each fourteen-day period.

[1] The base year is the calendar year preceding the period of unemployment, if the benefit year begins on July 1 of any calendar year. Otherwise the base year is the next to the last completed calendar year.

[2] *Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937).

1. LABOR: RETIREMENT LEGISLATION

As a part of the move in recent years to provide retirement pay to workers, special railroad retirement laws were passed in 1934, 1935, and 1937. The Railroad Retirement Act of 1934 was held unconstitutional by the United States Supreme Court in 1935 [1] because certain details seemed to the Court to violate due process, and because the law was not regarded a proper regulation of interstate transportation.

The pension law of 1935 was designed to remove these constitutional infirmities. The provisions to which the Supreme Court had objected as being contrary to due process were deleted or modified. Furthermore, instead of basing the plan on the interstate commerce power, Congress passed companion taxing and appropriation acts whereby such plan would be based on the taxing and spending powers of Congress. Operation of this second law was enjoined by a federal district court in 1936 on the ground that it was substantially the same as the 1934 act, which the Supreme Court had held to be unconstitutional.[2]

Because the railroads were not actually opposed to retirement pensions, most carriers having had some kind of plan before 1934, the court injunction against the 1935 law led to conferences between labor and management in 1936 with a view to adoption of a mutually agreeable pension plan. As a result of these negotiations, carriers and employees agreed on a retirement plan which Congress made law in 1937. This plan has not been tested by the courts and probably will not be, unless some carrier or labor organization chooses to break away from the general agreement under which the law was adopted.

This act provides for a tax of 5½ per cent on payrolls not in excess of three hundred dollars per month for any employee, to be increased gradually to 7½ per cent at the end of twelve years. The tax is shared equally by employers and employees, is collected by the Railroad Retirement Board, and is paid into the Treasury of the United States.

An employee is eligible for retirement pay at the age of sixty-five. If he has served thirty years, he may retire any time after he is sixty years old, but must suffer a reduction in retirement pay of one fifteenth for each year under sixty-five. An employee need not retire at sixty-five, but if he does not, he still must pay taxes and may not receive credit for additional years' service over that age. If an employee retires and engages in some other regular gainful employment, he may not receive retirement compensation during the time he is so employed.

Retirement pay is computed in the following way. The total years of service, not exceeding thirty, is used as a multiplier to apply to certain percentages of average monthly pay in order to arrive at monthly compensation. These percentages are 2 per cent for the first $50 of average monthly pay, 1½ per cent for the next $100, and 1 per cent of compensation in excess of $150, but no

[1] *R.R. Retirement Board v. Alton R.R. Co.*, 295 U.S. 330 (1935).

[2] *Alton R.R. Co. v. R.R. Retirement Board*, 16 F. Supp. 955 (1936).

recognition is given to monthly pay over $300. Thus, if an employee has served thirty years upon reaching sixty-five, and has had average monthly earnings of $200, his retirement allowance would be 2 per cent of $50 plus 1½ per cent of $100 plus 1 per cent of $50, the total multiplied by thirty, or a monthly pension of $90. The minimum receivable is $20 per month and the maximum, assuming $300 per month average for thirty years, would be $120. In case an employee dies before retirement, a lump sum is paid to his widow or if he had made proper arrangements an annuity may be paid.

In comparing the railroad pension plan to the old-age provisions of the Social Security Act, applicable to other employments, several interesting differences may be noted. The railroad law provides for a higher contribution rate and a higher retirement pension. Where the general law makes contributions vary from 2 to 6 per cent between 1937 and 1949, the railroad plan provides for 5½ to 7½ per cent. Where the general law provides for payments of $10 to $85 per month, the railroad plan involves payments of $20 to $120. Hence, approximately one million employees in the railroad industry have a pension plan far more favorable (and more costly to themselves and their employers) than the twenty-six million persons in other covered employments.

J. LABOR: CONCLUSIONS

In surveying the main regulations of railroad labor as a part of the whole field of railroad regulation, one notes that labor provisions are generally administered by some other agency than the Interstate Commerce Commission. Practically all aspects of interstate, and even intrastate, railroad operation are subject to the jurisdiction of the Commission. Except for the regulation of hours of service as a safety device and some regulation of unemployment caused by combination, regulations dealing with disputes, collective bargaining, unemployment, and retirement are outside its control.

A second feature is that in several respects railroad labor has obtained laws more favorable than those applying to other industries. In no other field has government attempted to curtail unemployment due to moves in the interest of efficiency, such as consolidations and co-ordinations. In no other field has pressure been brought to bear, at least as effectively, to place the burden for displacement of labor through progress directly upon the industry rather than upon society in general. Railroad employees have also been more favorably treated than other workers in the matter of retirement pay. To levy higher taxes on railroads for retirements and grant higher retirement pay not only is unfair to the railroad industry, but is hardly sound social-security policy.

Favorable railroad labor laws become even more questionable when extended to make-work legislation such as unreasonable full-crew and train-limit legislation. With this kind of legislation, where it is not clearly in the genuine interest of safety, the railroads are burdened with excessive costs, and

railroad labor as a group is harmed. The demand for railroad labor is not perfectly inelastic. Reducing its efficiency is not a means of increasing either employment or total railroad wages.

The only way in which railroad labor as a group can receive more work and higher wages is through increasing its efficiency. Reducing costs per unit of railroad service is the surest method of increasing employment, through increasing the sales of railway service. This is also the soundest way of increasing total railway wages, unless, of course, one regards as sound the payment of high wages through government subsidy to the railroads, whether under private or public ownership. To be sure, if a small group of railroad workers can keep wage rates inflexible and reduce labor efficiency, this group, as labor monopolists, may be able to gain for its members a larger proportion of the national income than would otherwise be possible. Even for them, however, the apparently highly elastic character of demand for railroad service may make their real interests lie in undertaking methods for the increase of efficiency of railroad service.

What seems to be needed is a railroad labor law which recognizes that railroad labor is as much dedicated to the public service as is railroad capital. Strikes in the railroad business should be outlawed as being opposed to safe and uninterrupted interstate commerce. Disputes which cannot be settled by negotiation should be subject to compulsory arbitration. This arbitration should be handled by a completely non-partisan board, or even a division of the Interstate Commerce Commission.

Consistency in regulation would seem to require that all aspects of regulation, including labor, be placed under the same commission. The labor disputes board might be separate from the commission, but for the sake of unity in regulation, appeal to the commission should at least be granted. If necessary to force compliance with decisions of a disputes board, railroad labor unions, particularly because of the quasi-public position of railroad labor, should be incorporated.

Compulsory arbitration might be a step in the direction of regulation of wages and working rules by a government body. Regulation of the railroads, complete in so many respects, still overlooks the importance of labor and labor costs in integrating and unifying control policy.

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CHAPTER

8

RAILROAD REGULATION: *Combinations*

FOR the purposes of this chapter, the term "combination" will be used in a broad sense to include any device whereby a management group, acting in concert, controls all or part of the policies of two or more carriers. While most combinations are limited to railroads, some attention will be given to the problem of combination where transport forms other than rail carriers are placed under single managerial control. The growing importance of transport agencies competitive to the railroads has led naturally to combination of these other carriers with them.

The meaning in which "combination" is used will be more apparent when we consider the methods by which combinations are consummated. The most common of such methods are informal agreements, pooling agreements, interlocking directorates or officers, outright consolidation by merger or amalgamation, acquisition of control through lease or controlling stock ownership, and control through the use of a non-operating holding company. In some cases the combination is complete and its management controls every detail of railroad policy. In other cases it is partial, in that the constituent railroads combine for certain purposes, but beyond these each carrier retains its independence. Thus, outright consolidation involves complete concentration of control in the hands of one railroad company. In so far as the holding company has working control over a railroad the stocks of which it owns, it[1] may exercise an effective and unified management. In the case of traffic agreements, where carriers have agreed to a rate policy or a policy in competitive services, whether or not this agreement involves a pool, all other matters are left to the individual members. As the regulation of combinations progresses, this varied nature of combination devices will be more thoroughly explained.

There are certain economic characteristics of transport agencies in general, and railroads in particular, which account for a natural tendency toward

[1] For a discussion of the holding company as a device, see *infra*, pp. 349–51.

expansion. Owing to the relatively large fixed investment required and the large proportion of fixed costs, railroads are usually operating under conditions of decreasing cost. Until operations can be undertaken at the point of maximum efficiency, additional traffic can be handled at a low cost. This fact, in the absence of strict regulation, would lead to cut-throat competition and the destruction of the weaker competitors. Moreover, the existence of decreasing cost with existing plant, plus the possibility of lessening costs by construction of a larger plant,[1] make it profitable for most traffic areas to be occupied by a single railroad. There may be some areas where the traffic is so dense that two railroads of the most efficient size could operate most profitably side by side.

From the point of view of service, a single railroad could perhaps give better co-ordinated and more efficient service than could several in a particular area. Furthermore, desirable sites for terminals and line are limited, so that a single railroad, by using the most advantageous terminal or line location, could probably give a better service at a lower cost.

As for the entire transport system within a particular traffic area, there is a basis for believing that the most efficient operation and best service could be obtained by combination. If this is true, it is evidence of a somewhat natural tendency toward monopoly. Because most commercial transport agencies must have equipment and other facilities for peak demands, because regular schedules must be adhered to, and because terminal facilities are usually scarce, there is a general tendency for operation under decreasing cost. To be sure, the extent of decreasing cost with the highway or motor carrier is not nearly so great as with the railroads. But there is enough evidence of operations at less than capacity, at least at times, as to lead one to believe that a co-ordinated rail-water-highway-air service, under central management, would have advantages in lower cost.

Superior service through monopoly of transport in a certain traffic area would seem to be a clear result of elimination of wasteful competitive runs, as well as a better scheduling of transport operations. Considering the cost, it is not at all certain that the user of transportation service is benefited by competition between agencies for the traffic of each other. A greater benefit would seem to follow from the development of *total* transportation business.

The transportation business in any particular transport area has seldom been a monopoly. Transportation today is ordinarily anything but monopolistic. This has been due in large part to the narrow jealousies of transport managers, to the freedom which has often characterized entry into the transportation business, and to the policy of government control in this field. It is this policy which the present chapter will analyze. Interest here is directed primarily to

[1] Thus, a double-track railroad line could handle more than twice as much traffic as a single-track one, and a four-track line more than four times as much. In addition, other costs are likely to be less with the larger plant, although of course this tendency toward lowered cost does have a limit. Indeed, this limit may be at a smaller size than many railway operators realize.

control of railroad combination; and because the federal government has exerted most of it, the analysis will be limited to control under federal laws. The policy of federal and state governments whereby transportation competition has been encouraged through subsidizing water carriage will be discussed in a later chapter.

A. RAILROAD COMBINATIONS UNDER THE ANTI-TRUST LAWS

In recent years regulation of railroad combination has been almost entirely under the jurisdiction of the Interstate Commerce Commission. But three decades ago the most important control came from the enforcement of the federal anti-trust laws by the United States Department of Justice. Since the government anti-trust policy has been applied to all businesses the combination of which affects interstate commerce, and the railroads are only one of such businesses, the more detailed study of the anti-trust laws is reserved for a later chapter.

1. THE ANTI-TRUST LAWS. The first federal anti-trust law was the Sherman Act, passed in 1890. This law declared that "every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several states, or with foreign nations" was illegal. Penalties of fine or imprisonment were provided for any person who made such a contract.

Additional anti-trust legislation was passed in 1914. Of particular interest to railroads following out a combination policy was the prohibition of certain intercorporate stockholdings and certain cases of interlocking directorates, where the effect would be substantially to lessen competition. Intercorporate stockholdings of railroads for the purpose of aiding in construction of branch and feeder lines, or extending main lines, were excepted from the law, so long as there was "no substantial competition between the company extending its lines and the company whose stock, property, or an interest therein is so acquired." Combination through intercorporate stockholdings, which substantially lessened competition, had been interpreted as forbidden under the Sherman Act, and consequently this provision of the Clayton Act had little more significance than representing a restatement of the policy of Congress to subject railroads to the anti-trust laws.

The Clayton Act made it unlawful for railway companies to make supply-purchase contracts, security-purchase contracts, or contracts for construction amounting to more than $50,000 in one year with any company between which and the railroad there were interlocking directors or officers, unless the dealings were made by competitive bidding in accordance with regulations prescribed by the Interstate Commerce Commission.

It is interesting to note that, in spite of increasing authority over railroad combinations being given to the Commission, the federal anti-trust laws are

still applicable. To be sure, under the Transportation Act of 1920 the railroads were relieved from the operation of these laws so far as necessary in order to give the Interstate Commerce Commission power to allow consolidation and co-operative agreements between railroads. Moreover, in the Transportation Act of 1933 the railroads were exempt from the anti-trust laws to the extent necessary to allow co-ordination agreements approved by the Federal Co-ordinator of Transportation.

2. RAILROADS AND THE ANTI-TRUST LAWS. Action against railroad combination under the anti-trust laws is now largely superseded by authority over them given to the Interstate Commerce Commission. But unless specific exemption is given in the operation of anti-trust statutes, these laws still apply, and give adequate authority for the federal Department of Justice to act if the Commission does not do so. The more important instances in which the anti-trust laws have been applied to the railroads are now, for the most part, of historical interest. But the historical interest is not without meaning in the present, because enforcement of the anti-trust laws against the railroads several decades ago did much to halt the extension of railroad combination.

In 1897 and 1898, the United States Supreme Court upheld the Department of Justice in its attempt to dissolve two railroad rate agreements. In the first of these cases, an agreement between railroads operating west of the Missouri River, whereby freight rates were to be maintained, was held to be a violation of the Sherman Act.[1] Holding that the act applied to rate agreements between competing railroads, the Court declared that the attempts of the freight association to maintain rates was an illegal restraint of trade.

In the second case, an agreement of thirty-one railroads operating east of Chicago to observe certain freight rates and division of traffic in the territory was held to be a violation of the anti-trust law.[2] The railroads pleaded that the Sherman Act violated the right to freedom of contract. To this the Court answered that the power of Congress to regulate interstate commerce could extend to such measures as the promotion of freedom in this commerce, such as that envisaged by the Sherman Act.

The Northern Securities Company case of 1904 hit at combination of railways through the use of the holding-company device.[3] The Northern Securities Company was incorporated in 1901 to hold the controlling stocks in the Great Northern and Northern Pacific railroads, two lines competing, for the most part, in the territory from St. Paul and Minneapolis to Portland and Seattle. Believing that a holding company was outside the scope of the Sherman Act, since the mere acquisition of securities was not commerce, the promoters of the combination felt that the holding-company device was perfectly legal.

[1] *U.S. v. Trans-Missouri Freight Association*, 166 U.S. 290 (1897).
[2] *U.S. v. Joint Traffic Association*, 171 U.S. 505 (1898).
[3] *Northern Securities Co. v. U.S.*, 193 U.S. 197 (1904).

The United States Supreme Court, in a close decision, sustained an order providing for the dissolution of the company. The Court held that the question of combination of two competitors was a matter of substance and not merely form. The Court pointed out that

> The result of the combination is that all the earnings of the constituent companies make a common fund in the hands of the Northern Securities Company to be distributed not upon the basis of the earnings of the respective constituent companies, each acting exclusively in its own interests, but upon the basis of the certificates of stock issued by the holding company. No scheme or device could more certainly come within the words of the act... or could more effectively and certainly suppress free competition between the constituent companies.... The mere existence of such a combination and the power acquired by the holding company as its trustee, constitute a menace to, and a restraint upon, that freedom of commerce which Congress intended to recognize and protect, and which the public is entitled to have protected.[1]

B. REGULATION OF POOLING AGREEMENTS

A pool is an agreement between producers under which prices may be fixed, profits divided according to a certain ratio, output restricted or allotted, or markets divided. It is often a loose agreement, but is accompanied in many cases by contractual features and penalties for non-observance of the agreement. In the railroad field, pools have taken the form of price agreements, price and profit agreements, and agreements to divide territory for expansion of service.

The railroad pooling agreement was a product of the wasteful competition of the last half of the nineteenth century. Although many pools were highly successful prior to the Interstate Commerce Act of 1887 and the Sherman Anti-Trust Act of 1890, the inability of participating carriers to enforce pooling agreements and the intense public opposition to the pool constituted weaknesses of this form of combination organization. Even before any anti-monopoly laws, it was usually difficult to enforce a pooling contract because such contracts were held at common law to be conspiracies to restrain trade. It is interesting that the anti-pooling policies of the laws of 1887 and 1890 did so much to usher in a period of railroad consolidation around 1900.

1. FEDERAL LAWS ON POOLING. The Interstate Commerce Act of 1887 embodied an unmistakable anti-pooling policy. Section 5 of the law provided "that it shall be unlawful for any common carrier subject to the provisions of this Act to enter any contract, agreement, or combination with any other common carrier or carriers for the pooling of freights of different and competing railroads, or to divide between them the aggregate or net proceeds of the earnings of such railroads, or any portion thereof."

Not until 1920 was this anti-pooling clause modified. Then, as the result

[1] *Northern Securities Co. v. U.S.*, 193 U.S. 197, 327 (1904).

of greater appreciation of the inefficiency of railroad competition, derived from the war experience of federal railroad control, Congress modified the pooling clause. The Interstate Commerce Commission was given power, with the assent of all carriers concerned, to authorize, on application or on its own initiative, any pooling agreements involving traffic or earnings, so long as they would "be in the interest of better service to the public, or economy of operation" and would "not unduly restrain competition." Of course, where authority to enter a pooling agreement was approved by the Commission, exemption from the anti-trust laws followed.

2. Effect of Authorizing Pooling. The permissive features of the Transportation Act of 1920 under which pooling could be authorized have not been very important, except to the extent that they represent a departure from the previous policy to enforce competition between railroads. By 1920, the Interstate Commerce Commission had adequate rate powers to stop rate wars that might occur between railroads. Moreover, pooling of traffic or revenues is usually a temporary expedient to meet a particular competitive situation. Again, more direct combination of physical facilities is likely to bring greater economies than the division of traffic or revenues. A factor which should not be overlooked, too, is the keen competition which has developed between many railroads.

Nevertheless, relaxation of the anti-pooling laws should not be underestimated. Where two or more railroads have offered a competitive passenger or freight service between points that cannot support such duplication of service, the pooling of traffic has been authorized. For example, in 1926 railroads serving Minneapolis, St. Paul, and Duluth pooled passenger service between these points; the three railroads concerned offered a joint service and pooled the earnings. As the result of researches by the Federal Co-ordinator of Transportation, as well as encouragement by the Interstate Commerce Commission, it is not at all unlikely that the pooling device will be used more frequently in the future. It may even become a step in bringing about closer combination of competing railroads.

3. Commission Policy. The Interstate Commerce Commission has looked favorably upon pooling agreements. As early as 1894 annual reports of the Commission recommended permissive pooling. Since 1920 it has taken many occasions in rate and revenue cases to suggest pooling of freight and passenger traffic. As the Commission said in 1931, "a little has been done in the way of pooling competitive train service by rival lines, although the opportunities in this direction are far from exhausted." [1]

Wherever there has been evidence of improvement of earnings and service, the Commission has readily approved pooling agreements, although reserving the right to modify its approval, or even to revoke it if conditions in the future make such a course desirable in the public interest. However, there have been

[1] 45th *Ann. Rep. I.C.C.* (1931), p. 118.

relatively few pooling arrangements placed before the Commission. In the few instances where pooling has been tried by the railroads the practice has apparently proved profitable, but the deterrents mentioned above have kept this device from being used as freely as efficiency and economy would seem to dictate.

4. PROMOTION BY THE CO-ORDINATOR. In the few years in which Commissioner Eastman held the office of Federal Co-ordinator of Transportation, pooling or some other means of co-operation was strongly encouraged. In the studies of both passenger and freight services, Commissioner Eastman pointed out many means of improving service and reducing costs by pooling.

Besides suggesting the pooling of line and terminal facilities, the co-ordinator offered a plan for the pooling of freight rolling stock. Under this plan, freight cars were to be assigned to a general pool under control of the Association of American Railroads. Until the pool could become the owner of all the cars, it was planned to pay the car-owners from the rentals received from the users of cars. By this scheme, the substantial volume of empty-car mileage, caused by the desire to get "foreign" cars back to "home" lines, would be reduced, and cars could be used in a far more efficient way.

Despite encouragement to railroad co-operation, of which pooling is one of the most feasible ways, few concrete results have followed the abolition of the co-ordinator's office. The Association of American Railroads is still maintaining some research on the general problem of co-operation, but with relatively little result. To be sure, the railroad labor dismissal-compensation agreement, referred to in the previous chapter, has had much to do in restricting the incentive to pooling. At the same time, the individualistic tendencies of railroad managements have caused them to overlook the possibilities of savings in this method of combination.

C. INTERLOCKING DIRECTORATES

The possibility of obtaining unified control of several "independent" corporations through interlocking directors and officers has long been recognized. Corporate entities may be kept separate, but a community of interest and unity of policy can easily be obtained by having the same person act in a directorial capacity for two or more companies. Even where only one or two officers or directors are the same, there is always the possibility that these individuals can act as a liaison between the companies.

In many cases the existence of interlocking directorates is beneficial. A director with experience on the boards of other railroads may be very valuable to a company. Where two railroads have somewhat identical interests or may be competitive, a certain co-operation in policy may be advantageous for efficiency and economy. Where representatives of investment bankers sit on

the boards of several companies, the financial advice these individuals are able to give may be beneficial to successful financing of the various companies.

Congress has sought to deal with interlocking directorates by legislation. Proceeding on the basis of the desirability of competition in the railroad field, it has attempted to bring under regulation all devices for eliminating competition. Through the community of interest created by interlocking directors and officers, competition between railroads could readily be reduced, if not removed entirely. Furthermore, the interlocking of interest between railroads and investment bankers or supply houses has often caused railroads to make uneconomical contracts for goods or services. Financial investigations of such railroads as the New York, New Haven and Hartford, the St. Louis and San Francisco, the Rock Island, the Milwaukee, and others showed instances where properties were exploited by directors benefiting from their connections with banking houses and supply concerns.

1. Legislative Basis of Control. Since the railroads have been subjected to the federal anti-trust law, and since interlocking directorates are combinations within the meaning of that law, the use of this device has been unlawful where the effect was unduly to restrain competition. This interpretation was explicitly placed in the anti-trust law by the Clayton Act of 1914, discussed briefly at the beginning of this chapter. In 1920, the Transportation Act (sec. 20*a*) made it unlawful for any individual to hold the position of officer or director in more than one railroad unless the Interstate Commerce Commission permitted it as being compatible with the public and private interest.

The law against interlocking directorates was strengthened in 1940 by giving the Commission wider powers over the acquisition of control through the ownership of stock. Under the Transportation Act of 1940, it is made unlawful for any person to accomplish control or management of two or more railroad companies by any means whatever without obtaining permission of the Commission.

2. Commission Policy. In the two decades since the Interstate Commerce Commission was given authority to allow or disallow interlocking directors or officers, relatively few of the applications to sit on the boards or act as officers of other companies have been denied; nearly 95 per cent have been approved, and most of the others were withdrawn rather than denied. This is not necessarily an indication of liberality on the part of the Commission, for relatively few applications have been made where the grounds seemed in conflict with the purpose of the law.

In granting or denying applications for interlocking directors and officers, the Commission has adhered to no definite rule; a few principles may nevertheless be noted. Where railroads are in direct competition with each other an authorization is almost surely denied. Where they are not in competition an application may be denied if there is a likelihood that the interlocking

arrangement will lead to discrimination in interchange of traffic between the roads concerned and other roads. Possible financial mismanagement has also been a ground for denial. In some cases, also, the Commission has refused to allow directors or officers of one road to serve another where the effect would be to combine carriers in systems different from those conceived by the Commission's consolidation plan. If a director has interests in other companies which the Commission finds to be in conflict with the welfare of the railroad corporation, he may be disqualified.

3. Difficulties in Control. Allowance or disallowance of interlocking arrangements has not caused much trouble. The restriction can be fairly easily circumvented by the use of "dummies," hand-picked and controlled persons who act for an interested individual. The Interstate Commerce Commission has recognized that common purposes "expressed in separate personalities" can effectively nullify the law.

Acquisition of stock control, whether by ownership of a minority or majority of the stock, must be effectively regulated before the evils of interlocking directorates can be averted or controlled. Once an individual or a group of persons interested in one railroad has stock-ownership in another, it becomes difficult to separate the unity of interests, even though the same person is not allowed to sit on the boards of both companies. As long as stock-ownership in two railroads was permitted, or not forbidden, the Commission was faced with the practical problem of allowing this stock to name representation on the boards of directors, even though the result was an interlocking directorate. In cases such as the foregoing it has often allowed interlocking directorates to exist for the purpose of giving stock fair representation, but has usually reserved the right to take such future action as it deemed wise.[1]

Since the Interstate Commerce Commission was given the power in 1940 to attack this problem at the source, by being granted authority to approve acquisitions of stock by any person or persons for the purpose of control or management, the regulation of interlocking directorates may take on new vigor. No longer need the Commission feel obligated to allow stock representation if the result is to allow common control of two or more railroads, since it is empowered to approve or disapprove the very holding of stock which leads to the common management.

Events of recent years have seemed to indicate that the Commission has been too liberal in authorizing interlocking directors. The Wheeler investigation of railroad holding companies and affiliated companies [2] has disclosed many cases of financial mismanagement and combination activity traceable in part to the conflict of interests between interlocking directors and officers and the

[1] See, for example, *Application of Leonor F. Loree*, 145 I.C.C. 521 (1928), and *Interstate Commerce Commission v. Kansas City Sou. Rwy.*, 156 I.C.C. 359 (1929).

[2] *Investigation of Railroads, Holding Companies and Affiliated Companies.* Hearings before a Subcommittee of the Committee on Interstate Commerce, U.S. Senate, 75th Cong., 1st. Sess. (1937–41).

corporation for which they act. Sharfman has held that the "time appears to be ripe . . . to apply a more stringent control." [1]

D. DIRECT ACQUISITION OF CONTROL

Perhaps the means most often employed of combining railroads into one "system" has been the acquisition of control by stock-ownership, or by long-term lease. In the first case an operating railroad buys up controlling interest in the voting stock of another railroad and proceeds to operate it as a part of the system. With the second means of direct control, an operating railroad contracts with another railroad for the long-time use of its facilities, at a stated annual rental or at a guaranteed dividend on stocks and interest on bonds. Often these two methods are used together. In some cases stock control is obtained, and then, by virtue of it, a long-term lease contract is entered into.

These direct acquisitions of control are important means of combination without merger or amalgamation. This may be seen from examination of the stockholders' report of the Pennsylvania Railroad Company.[2] Investment in stocks of affiliated companies is over $400,000,000, or one third of the amount invested in road and equipment of the company. The return applied to leases or guaranties of securities constitutes an amount nearly twice as much as the interest on the company's own funded debt.

1. COMMISSION AUTHORITY OVER ACQUISITIONS. Power to approve acquisition of control was not given to the Interstate Commerce Commission until 1920. By Section 5 of the Transportation Act such acquisitions, by lease, stock purchase, or in any other way "not involving the consolidation of such carriers into a single system for ownership and operation," was to be approved by the Commission, after hearing, whenever it deemed it to be in the public interest. In granting this permission the Commission was empowered to attach such terms and conditions which it feels to be just and reasonable.

As contrasted to the consolidation provisions of the law, to be treated presently, Commission authority over acquisition was relatively general. Until 1933, the whole problem of permitting such acquisitions was left to the Commission's discretion, for the law required only that it find the combination by acquisition of stock, by lease, or by contract to be in the public interest. In 1933 Commission approval of all forms of combination was lumped together, and the law expressly provided that the Commission might authorize acquisitions of control when it found them to be in harmony with its consolidation plan, as well as in the public interest. In order to give the Commission a free hand, in the case of acquisition, as in the case of other combinations, its action was to be relieved from any restraint by state or federal anti-trust laws.

By the Transportation Act of 1940, the requirement of a consolidation plan

[1] Sharfman, I. L., *op. cit.*, vol. III A, p. 403.

[2] 92d *Ann. Rep.*, *The Pennsylvania Railroad Company*, 1938.

was dropped from the law. As the law now stands, the Interstate Commerce Commission has the power to approve any kind of unification, whether by consolidation, stock-ownership, lease, or otherwise. In approving the unification the Commission is directed to consider the public interest, the effect upon competition, the effect upon the public interest of including, or failing to include, other railroads in the territory involved, the total fixed charges resulting, and the interest of employees concerned.

2. Commission Control of Direct Acquisitions. Although the consolidation provisions of the Transportation Act of 1920 were to be the heart of the law respecting consolidation, experience has proved that most of the unification since 1920 has resulted from stock-ownership control or lease. Many railroad systems have been extended and many have been brought together more closely in the interest of efficient operation by these methods.

Under its broad grant of discretion, the Commission has forged some fairly definite principles as to when acquisition of control is "in the public interest." It is only natural that it should administer this authority in the light of combination requirements of the act in general. One distinct requirement is that there must be a clear showing of public gain. This has been taken to mean not only that competition must not be unduly repressed and channels of trade not unreasonably disturbed, but that the unification should show possibilities of improving service and reducing costs.

Because such acquisitions of control are often tantamount to consolidation, or are the first steps in the direction of outright merger or amalgamation, the Interstate Commerce Commission naturally paid attention until 1940 to its scheme for consolidation in granting such authorizations. This proved to be somewhat difficult during the 1920's, for the "final" consolidation plan was not published until 1929, and many authorizations were granted which proved not to be entirely consonant with the plan.

Where acquisition of control embraced weak lines related to a strong system, the Commission has looked particularly kindly upon the unification. Noting that the Transportation Act of 1920 was designed in large part to solve the weak and strong railroad problem, the Commission made reference in several cases to the desirability of incorporating connecting short lines with the larger and stronger systems.[1]

The Interstate Commerce Commission has also required that the general financial plan for the unification be just and reasonable, in terms both of sound finance and of protection of minority interests. The proposed unification of the Nickel Plate, Chesapeake and Ohio, Hocking Valley, Père Marquette, and Erie by the Van Sweringen interests in 1926 was denied largely because of a financial plan which the Commission deemed to be improper.[2] The unifica-

[1] See, for example, *Nickel Plate Unification*, 105 I.C.C. 425 (1926), and *New York Central Unification*, 150 I.C.C. 278 (1929).

[2] *Nickel Plate Unification*, 105 I.C.C. 425 (1926).

tion plan of these carriers provided for control of properties, with nearly a billion dollars' capitalization, by $174,000,000 of voting common stock. The Commission felt that the plan did not adequately protect the preferred stockholders, who represented about twice as much capitalization as the common and who had no voting power. As the Commission said:

> We believe it to be self-evident that the public interest requires that the entire body of stockholders of a railroad which is bonded in excess of one-half of its investment, and not a powerful few, shall be responsible for its management. This can be done only by giving them the power to control the management. The lethargy of ordinary stockholders in exercising their power to control the management of these large corporations has often been commented on, but nevertheless the power should be in their hands to use as they see fit. It is inimical to the public interest to strip stockholders of their voting power, thus rendering it so much easier to control a great transportation system by a comparatively limited amount of investment.[1]

If experience is any guide, control over acquisitions will continue to be important in regulating combination. Although the legal requirement of consolidation according to plan has been dropped from the law, the Interstate Commerce Commission will still probably be guided in its approval of combination by the desire for well-planned transport combinations. Until 1940, the bases for approving consolidations were different from those for approving acquisitions of control by stock purchase, lease, or other means. Since acquisitions of control are often followed by consolidations, they should be regulated in the same way and along the same principles as consolidations. Even before 1940 there was some evidence that the Commission had done this, although many acquisitions of control were allowed, especially before the consolidation plan was published, which were inconsistent with the plan. By the amendments of 1940, all kinds of unifications are placed under practically the same requirements, and, even though the consolidation plan has been abolished as a legal requirement, the Commission may now treat consolidations and other means of control uniformly.

E. CONSOLIDATION

Perhaps more legislative attention, Commission planning, and public hearing have been given to control of railroad consolidation than to any other aspect of combination regulation. When the change in legislative policy toward the railroads occurred in 1920, its most dramatic aspect was the recognition of the desirability of combining railroads into larger systems. In envisioning this welding of weak and strong railroads into great competing systems, both the legislature and the public felt that combination would be effected by outright consolidation.

Although the Transportation Act of 1940 did away with consolidation ac-

[1] *Nickel Plate Unification*, 105 I.C.C. 425, 444 (1926).

cording to prescribed plan, it should not be implied that the government is no longer interested in consolidation or in the orderly combination of railroads. Some sort of consolidation of railroads into large systems is still thought by many to be the ultimate solution of the railroad problem, although it is generally agreed that it will have to come by government compulsion. Moreover, the abandonment of the prescribed plan does not mean that the Interstate Commerce Commission will no longer be guided by the desirability of having combination proceed along the lines of economically sound integration of facilities. Consequently, the experience under the consolidation provisions of the Act of 1920 is worth brief analysis.

As used in the law, consolidation embraces both merger, whereby one or more corporations combine their assets with an existing corporation, and amalgamation, whereby a new corporation is formed to take over the assets of the existing ones. The distinction between an amalgamation and a merger is purely technical, however, the significant feature in either instance being the outright combination of the assets of several carriers under a single corporate roof. All other methods of combining properties were conceived to be ancillary to consolidation, the real heart of the congressional policy toward combination, as enunciated in 1920.

1. Legal Requirements as to a Consolidation Plan. By the law of 1920, the Interstate Commerce Commission was directed to prepare as soon as practicable a plan for the consolidation of railroad properties into a limited number of systems. The law provided that the Commission should prepare a tentative plan, hold hearings upon it, and then publish a final one. The latter could be modified at any time such change seemed to the Commission to be in the public interest.

The law laid down two fundamental requirements for the plan. In the first place, competition between systems was to be preserved "as fully as possible" and existing routes and trade channels were to be maintained; in other words, recognition of the desirability of consolidation was not recognition of the desirability of monopoly; the policy before 1920 promoting competition between railroads, was not actually reversed. A second requirement was that "the several systems shall be so arranged that the cost of transportation as between the competitive systems and as related to the values of the properties through which the service is rendered shall be the same, so far as practicable, so that these systems can employ uniform sales in the movement of competitive traffic and, under efficient management, earn substantially the same rate of return upon the value of their respective railroad properties." This requirement represented the desire of Congress to solve the weak and strong railroad problem by the creation of systems incorporating both kinds of lines. Through the establishment of competitive systems of fairly equal strength, the problem of competitive rate levels was to be solved, at the same time making possible economies of large-scale operation.

The law made consolidation under the plan voluntary. But if consolidations were proposed, the Interstate Commerce Commission was to approve them only if found to be in accordance with the plan of consolidation and in the public interest. In order to safeguard against overcapitalization in consolidation, the law provided that the par value of securities upon consolidation should not exceed the value of the consolidated properties as determined by the Commission.

2. THE CONSOLIDATION PLAN. Proceeding immediately to its job, the Commission published a tentative plan in 1921. This plan, largely the work of Professor William Z. Ripley of Harvard University, provided for the consolidation of railroads into nineteen systems.[1] Hearings were begun in 1923 and extended for eighteen months, twelve thousand pages of testimony being taken. So wide was the conflict over the tentative plan, which represented an able treatment of a complex problem, that the Commission hesitated in publishing its final plan. As a matter of fact, in 1924, it requested Congress to relieve it of that duty. In the following years this request was repeated until 1929, when the Commission apparently despaired of being relieved and published a so-called "final" plan.[2]

This plan provided for twenty-one railroad systems in the continental United States. A few observations can be made concerning the proposal, although the reports on the tentative and final plans should be studied closely for real understanding. In every large traffic area, at least two systems were provided for so that competition might be preserved. Thus, two systems were created in New England, five in the trunk-line area (Chicago and St. Louis to the eastern seaboard), two on the Atlantic seaboard north and south, three in the Middle West States to the south, five from Chicago and St. Louis to the Pacific coast, and several other systems in various parts of the country.

The plan also attempted to take into account existing railroad groupings and alliances, though there were many cases where long-standing interests were to be disturbed. Combination of the weak and the strong is easily discerned in the Commission's plan. Geographic divisions were clearly followed. While individual systems varied greatly as to mileage and volume of traffic, there is evidence that the Commission plan did establish systems the return upon the property of which would be quite uniform.

The Interstate Commerce Commission did not publish this plan without misgivings. Its desire to be relieved from publishing it at all has been noted. When it finally appeared, the Commission made it clear that changes would be effected as shown advisable by experience. Commissioner Eastman's concurring opinion when the plan was made public seems to express the dominant view of the Commission. He admitted that he did not approve of the plan

[1] For details of the plan, the Commission's report, and Professor Ripley's excellent analysis, see *Consolidation of Railroads*, 63 I.C.C. 455 (1921).

[2] For details see *Consolidation of Railroads*, 159 I.C.C. 522 (1929).

"in important respects," but that "it has many good features," that under the law some plan must be adopted, and that, since the plan may be modified as desired, "it is not very important, after all, whether or not it is the best plan that could be devised." Experience since 1929 has shown that the Commission has been willing to change the plan whenever good reason for modification appeared.

3. Consolidation Under the Plan. If success is measured by results, the consolidation provisions and the plan made thereunder were a conspicuous failure. There are many reasons for this. Following 1929, the depressed condition of business generally and of the railroad industry in particular was not conducive to consolidation. While a period of depression might seem to be a desirable time for the economies of consolidation to be investigated and taken advantage of, depressed security prices and earnings make it well-nigh impossible to agree upon consolidation terms or to float the necessary financing.

Even had the depression not occurred when it did, there is doubt that the consolidation plan would have met with success. In the first place, voluntary consolidation leaves too much to the doubtful combining motives of jealous and independent railroad groups. Furthermore, consolidation moves by certain strong railroads could not be undertaken under the Commission's scheme of things unless certain weak railroads were cared for, minority interests adequately protected, and other conditions met. A third deterrent is the doubt entertained by many railroad managements as to the real economies obtainable by such unification; this is given added strength by the success of railroad labor in forcing an agreement whereby benefits must be paid to labor displaced by consolidation or co-ordination.

Until 1933, when all the combination devices were written into a law giving the Interstate Commerce Commission complete control over these methods, railroads found that they could effect combination of lines without resort to the restrictions imposed by the consolidation provisions. Prior to that time, lack of jurisdiction over non-railroad holding companies, plus regulation of acquisition through stock-ownership and lease, separate from consolidation, made it difficult for the Commission to apply its plan to all unifications. Where the railroads desired combination, they naturally took advantage of these gaps. Moreover, the resort to holding companies, leases, and direct stock-ownership avoided the intricacies and practical difficulties of effecting unification through merger or consolidation.

4. Consolidation Provisions of the Act of 1940. As has already been noted, the Transportation Act of 1940 has brought about some changes in the law regarding railroad consolidation. The requirement of consolidation according to a prescribed plan has been dropped from the law. Consolidations are placed in a category with other unifications and are required to meet the same requirements. The general nature of these was noted in the discussion in the previous section on combinations through acquisitions of control. In

the preceding chapter (pp. 141 ff.) the special requirements in connection with the interest of labor in combination were also noted.

The effect of the 1940 law is to give the Interstate Commerce Commission more discretion in some respects in allowing consolidation than has existed since 1920, although in the matter of protection of labor it is given less latitude. One should not gain the impression, however, that the statutory necessity of looking out for labor which might be displaced by consolidation or other combination represents an entirely new departure. As early as 1938 the Commission, as a condition for approving the merger of two railways, attached a detailed proviso dealing with the compensation and safeguarding of labor affected by the merger.[1] The Commission appended a schedule of dismissal payments, compensation for employees whose position would be worse with the merger, and payments for expenses of employees transferred. A like decision was made the same year in approving the lease of one railway's properties to another.[2]

The Commission went even further in protecting railroad labor, under its authority to define what is in the "public interest," in another case in 1938. It refused to allow nine railroads to dismember a bankrupt railroad system, because of the abandonment of mileage planned.[3] The Commission pointed out that the abandonment of over three hundred miles of the system's road would leave twenty-one small towns and villages without railroad service and would require the dismissal of two thousand railroad employees, who would be subject to "great hardship and possibly loss of their investment in homes."

Although the authority of the Interstate Commerce Commission to consider the effect of combination on labor in applying the concept of public interest was questioned, the United States Supreme Court has upheld it. In one case, the Court pointed out that what was in the public interest was for the Commission to define, and that including measures to protect labor as a condition to orders for combination was a reasonable interpretation of the public interest.[4]

Of course, the Transportation Act of 1940 goes far beyond the mere attaching of such conditions. As was noted in the previous chapter (p. 141), the Commission may not approve a plan at all unless it provides that no worker will be placed in a worse position with respect to his employment for a period of four years following the effective date of the plan, except in cases where the worker had been employed by the railroad for a lesser period in the past.

5. Consolidation and the Future. Future railroad combination will clearly be subject to the Interstate Commerce Commission, regardless of the means of consummating unification. Although consolidation according to prescribed plan has been abandoned, one can still expect some encouragement

[1] *Louisiana and Ark. Rwy. Co. Merger*, 230 I.C.C. 156 (1938).
[2] *Chicago, R.I., and Gulf Rwy. Co. Lease*, 230 I.C.C. 181 (1938).
[3] *Assoc. Rwys. Co. Acquisition and Securities*, 228 I.C.C. 277 (1938).
[4] *U.S. v. Lowden*, 308 U.S. 225 (1939).

by the government in the future. But consolidation can hardly be expected to proceed very rapidly. It is still voluntary, and the law has placed some real impediments in the way of its accomplishment. The financial difficulties involved, the legal conditions which must be met, the existence of jealousies between railroad managements, the opposition of organized labor, and the question of economy, especially in the light of the cost of displacing labor, do not augur well for the advancement of any kind of combination, let alone voluntary consolidation.

Many suggestions regarding railroad-consolidation policy have been made. These have ranged from complete absence of any governmental moves to suggestions for compulsory consolidation. Apparently the forces recommending abolition of a plan of consolidation and consideration of each combination on its merits as it arises have won out for the present. But the suggestions of those who would like to see compulsory consolidation adopted should not be completely overlooked. The English railroads were forced together into four systems by the English Amalgamation Act of 1921, and such a move may still be the eventual solution for the railroad problem in the United States.

If consolidation is desirable and if it is to be accomplished on anything but a piecemeal basis, some governmental compulsion would appear to be necessary. Should compulsion be applied, however, ways and means for effecting combination which will result in efficiency and economy, which will make easier the complications of merging conflicting equity and creditor groups, and which will not saddle individual private companies with deterrent expenses must be devised. While the public interest, including that of railroad labor and of small communities, must be protected, there is danger that this protection would be at the expense of private enterprise in the railway business. It may be that compulsory consolidation will necessarily result in the destruction of private ownership of railroads and that public interest cannot be served without such destruction. But the problem of forced unification, if it has such implications, should be dealt with as a phase of the larger problem of government ownership.

An interesting plan for compulsory consolidation without actual government ownership was advanced by Leslie Craven in 1934 when he was counsel to the Federal Co-ordinator of Transportation.[1] The key to this plan lies in the creation of the office of a permanent co-ordinator who would study, report on, and recommend consolidation, not in accordance with any inflexible plan but as consolidation appears to be economically desirable. The compulsory feature would be introduced after a short period of time in which co-ordination activities would show the way to efficient consolidation. The new consolidated companies would be federally incorporated, and would have on their boards a minority of public representatives who would be members of the staff of the federal co-ordinator. An amalgamation board would be set up by the

[1] *Regulation of Railroads*, Sen. Doc. No. 119, 73d Cong., 2d Sess., App. III, pp. 84–105 (1934).

Craven plan to approve or modify proposed plans. These plans would be worked out by the co-ordinator in co-operation with interested groups, and would involve an exchange of securities in the new company for the securities of existing companies.

The Craven plan would abolish the competitive requirement of the consolidation provision of the Acts of 1920 and since, and would allow monopolistic consolidation where the co-ordinator found this to be in the interests of efficiency and economy. According to Mr. Craven's interpretation of the law, based on an extensive study, such forced consolidation would be a valid use of the federal interstate commerce power.

This plan is an interesting compromise between government and private ownership. While the public participation on the boards of the new companies and the planning of consolidations are a sharp break from traditional free private enterprise, the plan does not represent so severe a breach when one considers how regulation has already enshrouded private enterprise in the railroad field. What is especially commendable about the plan is the emphasis upon economical unifications as indicated by study and experience under co-ordination activities.

F. THE RAILROAD HOLDING COMPANY

Reference has been made from time to time to the use of the holding-company device in effecting railroad combinations. This means of gathering together operating companies through a maze of holding corporations has not been as prevalent in the railroad field as it has in the gas and electricity utility industries. But the holding company has been used in a number of cases, and in a few cases on a grand scale.

The existence of ownership by one railroad of the stock of another has been commonplace in the development of railway systems. In a sense, such stock ownership makes the controlling railroad a holding company as well as an operating company. But the pure holding company, a non-carrier corporation controlling directly or through subsidiaries the stock of operating companies, has not been so common. Even so, investigation by a congressional committee, made public in 1931, showed a surprising number of non-carrier companies controlling railroads, as well as control through stock-ownership by investment trusts, individuals, and associations.[1]

1. DEVELOPMENT OF THE RAILROAD HOLDING COMPANY. As early as 1904, the United States Supreme Court disrupted the plans of railroad promoters to combine the Northern Pacific and Great Northern railway companies through the Northern Securities Company, a pure holding company.[2] The ground for dissolution of this holding company was that it constituted a combination in

[1] *Regulation of Stock-Ownership in Railroads*, H.R. No. 2789, 71st Cong., 3d Sess. (1931).

[2] *Northern Securities Co. v. U.S.*, 193 U.S. 197 (1904).

restraint of trade under the anti-trust laws. In 1920, the Reading Company, a holding company controlling the Philadelphia and Reading Railway Company and the Philadelphia and Reading Coal Company, was forced to divest itself of such control under the commodities clause.[1] Although the Reading Company was technically not a carrier and the railway company it controlled had no direct interest in the coal company, the Supreme Court held that this closely knit organization in reality did amount to a railway-coal company interrelationship forbidden by law.

It was the development of two large holding-company systems in the latter 1920's that led to the belief that the railroad holding-company device had reached dangerous proportions. These were the Alleghany and Pennroad companies. The Alleghany Corporation was the key holding company in a system developed by the Van Sweringen brothers, Cleveland real-estate operators. Starting with control of the Nickel Plate in 1916, these ingenious brothers built a system which by 1929 included the Erie, Chesapeake and Ohio, Père Marquette, Missouri Pacific, Chicago and Eastern Illinois, Texas and Pacific, Denver and Rio Grande Western, and Wheeling and Lake Erie, as well as numerous bus lines, mines, and other enterprises. With a bare half-million dollars derived from Cleveland real estate, the brothers borrowed, pyramided holding companies, juggled corporate funds, and issued non-voting securities, to bring about control of a three-billion-dollar railroad empire with twenty-three thousand miles of track.

The Pennroad Corporation, legally a separate offspring of the Pennsylvania Railroad, was organized in 1929 to gain control of railroad properties which the Pennsylvania Railroad could not obtain without asking the Interstate Commerce Commission for permission. With all its stock placed in a voting trust administered by officers of the Pennsylvania Railroad, the Pennroad Corporation sold its trust certificates to stockholders of the Pennsylvania. Along with the Pennsylvania Company, owned subsidiary of the Pennsylvania Railroad, and the Pennsylvania Railroad Company itself, the Pennroad Corporation made possible a system including, in addition to the already large Pennsylvania Railroad Company, the Norfolk and Western, the Detroit, Toledo and Ironton, the Long Island, the Wabash, the Pittsburgh and West Virginia, and the Boston and Maine, plus a voice in New Haven Railroad affairs.

2. CONTROL OVER HOLDING COMPANIES. Except where stock control was acquired by an operating company, the Interstate Commerce Commission had no control over railroad holding companies until 1933. In other words, a corporation which was not a carrier but which merely acquired stocks did not fall within the jurisdiction of the Commission. In annual reports in 1928 and 1929, it called attention to this gap, and pointed out how the non-carrier

[1] *U.S. v. Reading Co.*, 253 U.S. 26 (1920). The commodities clause placed in the Interstate Commerce Act in 1906 (see *supra*, p. 83) forbade railroads, except lumber railroads, to have any ownership interest in companies whose products the carrier transported.

holding company was able to effect virtual unification without Commission approval.

Following the Commission's recommendation, and after a legislative investigation, Congress amended the Interstate Commerce Act in 1933 by providing for control over acquisitions of carrier stock by a "holding or investment company or companies, a voting trust, or trusts, or in any manner whatsoever." Not only must such "control or management in a common interest" be approved by the Interstate Commerce Commission, but the Commission was given authority to restrict the exercise of voting power by existing organizations to the extent necessary to protect regulation of railroads generally and its own consolidation plan.

Where a non-carrier corporation is authorized to acquire control of operating railroads, it must submit to regulation of accounts, reports, and securities to the same extent as carriers under the Interstate Commerce Commission. While these provisions are much less drastic than control instituted over electric and gas public-utility holding companies by a law of 1935,[1] they do present a fairly adequate basis for control of these companies.

3. Commission Regulation of Holding Companies. The railroad holding companies were placed under the financial regulations applicable to operating railroads prior to 1933. Little has come from the control over these companies, however, for the depression not only brought extension of such control to a standstill, but many subsidiary companies have been severed by financial failure.

The recent financial history of railroads is replete with examples of operating carriers whose stocks were purchased by holding companies being in the courts as bankrupts. Most of the Van Sweringen lines and many of the Pennroad Corporation lines are in this category. Although the controlling systems often exert surprising influence in the selection of trustees of these lines, the holding-company spree in the railroad field has been hampered more by the depression than by administration of control by the Interstate Commerce Commission. Should a degree of railroad prosperity return, and should the financial picture, now clouded by bankruptcies and trusteeship, clear, the Commission's control over holding companies would probably have greater meaning.

The railroad holding-company problem is not an isolated one. As a method of unification the non-carrier holding company is no more important than other combination devices, if indeed as significant. In the treatment of combination, the holding company is only one phase of that problem. Unification is now dealt with under a single law, regardless of the device used. The railroad holding company may be more of a problem from the point of view of financial regulation; there is no doubt that it has been an integral tool of some recent "high finance." Nevertheless, the holding company is but one of the devices useful for questionable financial manipulation.

[1] See *infra*, pp. 362 ff.

G. CO-ORDINATION OF RAILROADS

Since 1933, when the office of Federal Co-ordinator of Transportation was created by Congress, attention has been called to co-ordination as a means of eliminating the duplications and wastes of competition. Although the capable work of Commissioner J. B. Eastman as co-ordinator was hampered and in 1936 brought to an end by the opposition of railroad management and labor, the problem deserves some attention.

Strictly speaking, the term "co-ordination" has been used in two senses. In a broad sense, co-ordination is advanced as a solution for the whole transport problem, and means the assignment of transportation business to those facilities which can best handle it at the lowest economic cost. As such, the term applies to any kind of co-operation between rail and other carriers whereby costs are lowered by reducing duplicating facilities. In the second sense, co-ordination implies co-operation between railroads with the purpose of reducing competitive wastes. It is primarily in the latter sense that the Transportation Act of 1933 was planned to deal with the railroad problem.

Co-ordination is not a new kind of combination device. Such co-ordination of facilities as envisioned could conceivably be effected by any device from an operating contract to a pooling arrangement, acquisition of control by stock purchase or lease, or outright consolidation.[1] The emphasis placed by sponsors of co-ordination, however, has been on the more informal co-operative devices under which the general independence of participating carriers is maintained.

1. CO-ORDINATION PROVISIONS OF THE ACT OF 1933. The primary purpose of the Act of 1933 was the encouragement, promotion, or requirement of action by carriers subject to the Interstate Commerce Act to avoid unnecessary duplication of services and facilities and to permit the joint use of terminals and trackage. In order to accomplish this purpose, regional committees, with membership appointed by railroads and the co-ordinator, were set up. These committees were instructed to study the possibilities of co-ordination and to attempt to effect it through voluntary action. Should this effort fail, the co-ordinator was authorized to order such co-ordination as he found to be within the purpose of the act.

The staff of the Federal Co-ordinator was directed to aid the regional committees in obtaining and compiling needed information. Provision was made for any interested party dissatisfied with an order of the co-ordinator to be heard by the Interstate Commerce Commission, sitting as a board of review of his orders. Special consideration was given to railroad labor. Labor committees for each region were established, and were given an opportunity to

[1] Note that the Interstate Commerce Commission in 52d *Ann. Rep.* (1938), p. 14, says of co-ordination that it is "cooperative action in a common interest at particular places or with respect to particular matters, but without actual unification of companies."

present the views of railroad labor on any proposed order which might affect the interests of employees. Moreover, the law provided that the number of employees in service in May, 1933, should not be reduced by reason of any action taken under the co-ordination provisions; nor should any employee be placed in a worse position with respect to his employment.

2. Results of Co-ordination Provisions. During his short term of office, the Federal Co-ordinator made no order forcing the adoption of any co-ordination. His contribution was largely limited to studies of possible projects and encouragement to railroads to continue the investigation and execution of such measures. Several reasons may be advanced for this lack of positive action. In the first place, the co-ordinator held an office of uncertain tenure and disliked to embark upon a constructive program which would require several years to consummate. Secondly, he was hindered by the labor clause which forbade ordering projects which would reduce employment, especially since estimates of savings from co-ordination placed labor savings at sixty to seventy per cent of the total. Thirdly, the co-ordinator was regarded with suspicion and antagonism by individual railroad managements, jealous of advantages which forced co-ordination might require them to share with others. Finally, the railroads themselves volunteered to carry on the work of co-ordination through the Association of American Railroads.

Several studies of projects were made by the co-ordinator. Plans for five thousand terminal co-ordinations were suggested, involving annual savings estimated at twenty-five to fifty-six million dollars per year. Little was done by the carriers, not only on account of the labor clause and the disinclination of carriers to surrender advantages, but because of complications in terminal mortgage contracts and the opposition of affected communities. Co-ordination of general shops for heavy repairs was suggested and studies of these possibilities were made. Other projects had to do with the co-ordination of uptown ticket agencies, pooling of freight cars, and co-ordination of other facilities where this would reduce expense.

3. Co-ordination and the Future. To say that the co-ordination of railroads has been stopped by the abolition of the office of Federal Co-ordinator would be erroneous. The records of the Interstate Commerce Commission's decisions since 1936 contain many cases where railroads are co-operating by pooling arrangement or other contracts, or where acquisition of control has led to reduction in duplication of facilities. But when one balances these cases against the almost innumerable possibilities for co-ordination, one finds that relatively little progress has been made.

Co-ordination in the sense of elimination of wasteful competitive practices is surely destined to play an increasingly important rôle. The co-ordination of railway facilities may be encouraged or required, or may be effected by some measure of compulsory consolidation. But it is more likely that future co-ordination will not be in terms of railroads alone, but will be dealt with as a

transport problem. Elimination of unnecessary, uneconomical, and duplicating transportation facilities is not primarily a railroad problem but a transport one, involving the relationship of all carriers, whether rail, motor, air, or water, with each other. As such, it is a part of the problem of national transportation policy, to be discussed in Chapter 12.

H. RAILROAD COMBINATION WITH OTHER CARRIERS

Examination of the holdings of any large railroad will disclose ownership interests in highway motor carriers, water lines, or air lines. Statistics for the year 1933 show that two hundred and nine steam and electric railways were engaged to some extent in motor-vehicle operations; most coastwise lines were owned by railroads, as were many ferry and lighterage companies, and several railroads held large investments in air lines.[1]

As competitors to railroads grew stronger, the rail carriers naturally sought to bring them under control, not only for protection from competition, but in order to adopt facilities for which the public had expressed a demand. Water carriers were early brought under control. Until restrictive legislation was passed in 1912, practically every coastwise, intercoastal, and inland water carrier was owned or otherwise controlled by the railroads. When the motor truck and bus gained importance after 1920, most railroads were slow to use this form of transport, since railroad managements regarded the motor vehicle as an unimportant competitor and an unnecessary adjunct to rail service. As late as 1927 only seven hundred and forty-five buses were operated directly, through subsidiaries, or by contract, by Class I railways, but this number had increased to thirty-one hundred in 1933.[2] Interest in air lines has not been undertaken by many railroads, and about the only railroad with extensive air-line holdings has been the Pennsylvania.

1. Legal Provision for Railroad Control of Other Carriers. Except for railroad control of certain water carriers, the law has not, until recently, had much to say about railroad acquisition of stock-ownership in other companies or direct rail operation of other means of transport. Until recent regulation of interstate motor carriers and air lines, the question of acquisition of control of these carriers was not dealt with by any commission, although combination by railroads with competing motor or air lines would subject the railroads to the federal anti-trust laws.

Because of the fear that the more powerful railroads would destroy the water lines, and because of the belief that water competition would have a salutary effect on rail rates, Congress early provided for the maintenance of competition between these two agencies of transport. In 1912, as the Panama Canal was nearing completion, Congress made it unlawful for any railroad or other com-

[1] *Regulation of Transport Agencies*, Sen. Doc. 152, 73d Cong., 2d Sess. (1934), App. A and E.
[2] *Ibid.*, p. 284.

mon carrier subject to the Interstate Commerce Act to control in any way water carriers with which such common carrier did or might compete for traffic. Except for water-line operation through the Panama Canal, where the restriction was absolute, the Interstate Commerce Commission was empowered to allow the continuance of control where the service was in the public interest and did not prevent, exclude, or reduce competition on the water line.

Under the Motor Carrier Act of 1935, by which interstate motor carriers are brought under the jurisdiction of the Interstate Commerce Commission, approval for consolidation, merger, or acquisition of control of highway carriers is provided. Under this power, in conjunction with others already granted over acquisition of control, the Commission apparently has adequate authority over rail-highway combinations. Moreover, in granting certificates of convenience and necessity to highway common carriers, the Commission possesses a formidable weapon to deal with railroad extension of influence in the motor field.

Like control over railroad or other common-carrier acquisition in air lines is provided by the Civil Aeronautics Act of 1938. Not only is the Civil Aeronautics Board (the Commission) empowered to exert strict regulation over consolidations, mergers, and acquisitions of control, but any interlocking relationships between air carriers and other common carriers are prohibited unless approved by the Aeronautics Board.

The Transportation Act of 1940 subjects combinations of railroads with water carriers or motor carriers to the same requirements as those applied to combinations of railroads. In the case of combinations of railroads and motor carriers, however, the law specifically directs the Commission to find that the transaction will be consistent with the public interest, will enable a railroad to use motor-vehicle service to public advantage in its operation, and will not unduly lessen competition between the carriers concerned. Thus, for railroad acquisitions of motor carriers mere economy of combination is not enough; the application for combination must prove that the service to the public will be improved.

2. Commission Policy in Inter-Carrier Combinations. The Interstate Commerce Commission has been called on many times to approve railroad operation and control of water carriers. A finding of actual or potential competition between the rail and the water carrier is above all necessary, for if such competition does not exist there can be no infraction of the law by railroad control.

In finding competition to be actual or potential, the Commission has used as a practical test the determination of whether divorcement of control would result in competition which had not previously existed. When the rail line is using the water line to stifle competition or is not operating it in the best interests of the public, a finding of unlawful competitive relationship is likely to be

made.[1] Thus, the Southern Pacific was allowed to maintain its ownership in water lines operating from the Atlantic coast to Gulf ports and the New Haven Railroad was permitted to own the New England Steamship Company, operating from Boston to New York. In both these cases the Commission found that water competition would not be increased by the divorcement of ownership. On the other hand, railroads controlling water lines on the Great Lakes were forced to give up their control because of evidence that they were strengthening their own traffic at the expense of the water carriers.

In authorizing railroad ownership of motor-carrier lines since 1935, the Interstate Commerce Commission has followed a policy similar to that applied to railroad ownership of water carriers. Principles for deciding such authorizations were enunciated in the so-called "Barker" case. In this case the Commission said:

> Approved operations are those which are auxiliary or supplementary to train service. Except as hereinafter indicated, non approved operations are those which otherwise compete with the railroad itself, those which compete with an established motor carrier, or which invade to a substantial degree a territory already adequately served by another rail carrier.[2]

This principle has been followed in a number of cases, and authorization has been denied where competition between rail and motor carriers would be affected. Some authorizations have been granted with the condition that the railroad-controlled motor carrier limit its activities to auxiliary or supplemental services.

I. COMBINATION POLICY

The history of railroad-combination policy has been one of confusion and inconsistency: confused, because of the shifting basis of regulation; inconsistent, because of the insistence upon competition in a quasi-public industry, where there are economic tendencies toward monopoly, and upon regulation, such as rate and service provisions, designed for a monopolistic public utility.

At first, reliance was placed on the general federal anti-trust laws to enforce the kind of competition desired in private, as contrasted to quasi-public, businesses. Not only did the anti-trust laws restrict the development of many combinations which would have been economically sound, but the uncertainty surrounding the meaning of these laws contributed to the confusion regarding the legality of combination. When special restrictions were placed on railroad ownership of water carriers in 1912, an obstacle was placed in the path of economical co-ordination of water and rail transport. Regulation ought to have been designed at this time to encourage monopoly and, at the same time, safeguards against abuses might have been provided.

[1] *So. Pac. Co. Ownership of Oil Steamers*, 37 I.C.C. 528 (1916).

[2] *Pennsylvania Truck Lines, Inc. — Control — Barker*, 5 M.C.C. 9, 11–12 (1937).

The experience of the World War taught the public the advisability of relaxing the restriction against railroad combination. The Transportation Act of 1920, with its allowance of pooling, acquisitions of control, and consolidation, was hailed as a new approach to railroad regulation. But this same law maintained the reliance upon competition found in the purpose of the anti-trust laws. While combinations might be permitted, the Interstate Commerce Commission was directed to allow such unification only where competition was not unduly restrained.

An artificial distinction was made in the law of 1920 between acquisition of control by stock-ownership, lease, or contract and by outright consolidation. In the case of acquisitions of control, authorization might be made where found to be in the public interest and where competition was not destroyed. But if outright consolidation was projected, the Commission had to find it in accord with the consolidation plan; this plan was not published until 1929. In the meanwhile, hundreds of acquisitions of control, with the effect of consolidation, had been permitted. This confusion was further heightened by the lack of Commission control over non-carrier holding companies through which virtual unification could be effected.

To be sure, most of these uncertainties were eliminated by the amendments of 1933, and the requirement of planned consolidation was removed by the amendments of 1940. As the law now stands, all kinds of combinations involving railroads are subject to control by the Interstate Commerce Commission. But the existence of such complete control does not insure the accomplishment of all the economic combination which seems wise, and the law places some rather important hindrances to such combination as might voluntarily be undertaken otherwise in the interests of economy.

With all the changes in the law regarding railroad combination, insistence upon competition has been maintained throughout the years. This principle of competition is grounded on the fear of railroad monopoly in the nineteenth century, before the widespread development of alternative agencies of transportation and the relative perfection of regulatory processes.

There are few to doubt the economic advantages to be gained from a monopolistic combination policy in the whole public-transport field, as well as in the railroad field. From an economic point of view, regional transport monopolies, embracing all forms of transportation, and limited only by the diseconomies in managing businesses on too large a scale, seem desirable. With public regulation developed to the point it is, the abuse of monopoly powers could surely be met. There is even the possibility that public regulation might be made easier through regional monopoly, for it should not be as difficult to deal with a few monopolistic companies as it is with the number of competitive companies giving rise to the many problems which competition itself causes.

Co-ordination is essentially monopolistic. Should government ownership be adopted, a rail or transport monopoly would in all probability be created.

The economies of monopoly would be recognized. The lack of unity in the transport business and the instability of the industry are not independent characteristics. The possibilities in a new combination policy hold a challenge for the future, whether this policy embraces railroads alone or all transport. As a transportation authority has said, "The railroad world is a kingdom divided against itself and brought to desolation. The Transportation Act of 1920 failed, as will any other transportation act which seeks to maintain that disunity. Clearly, it is possible to go a long way toward breaking down that disunity." [1] Perhaps a policy of disunity applied to all public transport is also doomed to ultimate failure.

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CHAPTER

9

RAILROAD REGULATION:
Securities and Finance

In discussing regulation of railroad securities and finance, a distinction should be drawn between this particular field of governmental interference and the regulation of security issuance generally as undertaken by state "blue-sky" commissions and the Federal Securities and Exchange Commission. In the public-utility industries, of which the railroad business is one, the interest of the public is primarily in soundly financed companies capable of efficient and continuous service. In the regulation of financial practices of other businesses, the fundamental purpose is to safeguard the security-buying public. Railroad and other public-utility investors are given some protection by financial regulation, for issuance of securities and other financial transactions are subject to the same safeguards as those applicable to business generally. But regulation in the quasi-public industries is also based upon public interest in rates.

Thus, regulation of securities of private businesses is limited to the publishing of reliable information and to the elimination of fraudulent issues. Other financial regulation, applicable to private businesses, is aimed primarily at the protection of the investor from the dishonesty or exploitative tendencies of those in a more powerful position. Regulation of the quasi-public businesses goes further. By recognizing that improper or unwise financial practices materially affect the cost and quality of service, the law in these fields has provided for far more strict control of those policies. Should public interest in the so-called private field of business extend to price and service as it has in the public utilities, then security and finance regulation would probably become more intensive.

In this chapter attention is devoted to the regulation of railroad securities, railroad reorganization and bankruptcy, and railroad accounting, as well as supervision of public loans to these carriers. The whole gamut of financial control would include combinations and rate-making, but these fields present problems other than the question of financial practices and have been treated

separately. The rather extensive discussion of financial regulation accorded to the railroads is undertaken largely for an exemplary purpose. Except for certain problems of the public-utility holding company, the questions presented here are similar to those in other transport and public-utility regulation.

A. PURPOSE OF SECURITY ISSUE CONTROL

The obvious purpose of instituting control of railroad security issues is the prevention of overcapitalization. Except for the moral questions of fraud and dishonesty, the public interest in practically every financial practice affecting investment lies in the evils of overcapitalization, and nearly every practice, from outright issuance of securities without value received to manipulation by unscrupulous financiers, has its effect on overcapitalization.

"Overcapitalization" is a term used loosely and is often employed to denote any opprobrious financial conduct. Even experts disagree on its meaning. Some hold it to be the situation where the total par value of stock and bonds outstanding exceeds the value of the assets as carried on the books. Others say that it is an excess of par value over the *earning* value of assets, as indicated by capitalizing reasonably expected future earnings at a proper rate of interest. Still others maintain that since railroad earnings are subject to regulation, the asset value should be calculated on the same basis as rate-making fair value, or with predominance given to cost of reproduction new less depreciation.

None of these definitions seem entirely acceptable. Surely a company not overcapitalized at the time asset and par values are entered on the books may become unable to support its capitalization in subsequent years. Or a railroad with a present cost of reproduction new less depreciation equal to, or in excess of, its capitalization might have no hopes of earning enough to pay interest on its bonds or reasonable dividends on its stock. The earnings test is admittedly subject to the fault that these earnings may be determined largely by the public authority endeavoring to regulate for the avoidance of overcapitalization.

Be that as it may, the term "overcapitalization" may be used broadly to signify those practices having to do with the investment financing of the enterprise which make it unable to keep capital, whether equity or debt capital, flowing into the business. Whether stocks are of par or no-par value is of relatively little significance in the existence of overcapitalization in this sense. In studying it, not only must the obligations attributable to securities issued by the business be considered, but also the commitments on account of lease rentals and guaranteed interest or dividends.

1. CAUSES OF OVERCAPITALIZATION. Both the past and recent history of railroad finance is replete with examples of the causes of overcapitalization. Whether it be the promoter anxious for excessive profits, the magnate desirous of extending his power over many companies, the investment banker dom-

inated by a desire for underwriting profits, or the well-meaning railroad executive working out intricate problems of financing, the result has often been the same.

The construction-company device was in part responsible for the overcapitalization of some railroad companies. In the latter half of the nineteenth century, railroad construction was often undertaken by a company in which the railroad promoter held stock, and which charged exorbitant prices for railroad-building. Early railroad financing also often followed the plan of selling bonds for funds and issuing stock free as an inducement to bondholders, or of issuing excessive amounts of stock to railroad promoters and financiers. Issuance of stocks and bonds below par value, with no attempt later to amortize the discount, has led to overcapitalization. The latter has also resulted from the payment of dividends or interest out of capital, either by direct accounting subterfuge or by skimping such items of operating expense as maintenance and depreciation.

Consolidations and other combinations have led to overcapitalization by reason of excessive prices paid for properties. The financial difficulties of the New York, New Haven and Hartford Railroad since 1914 can be traced to the wild plan to purchase all transport companies in New England regardless of the prices asked.[1] Many instances of overcapitalization can be traced to reorganization following receivership. In order to reduce fixed charges, bondholders often are given larger amounts of inferior securities to make up for their sacrifice. At the same time, preferred and common stockholders are not always forced to sacrifice much or any of their holdings. Thus, the Milwaukee Railroad went into reorganization with a total capitalization of $699,000,000 and came out with a capitalization of $707,600,000 and there was an increase in annual interest charges from $21,500,000 to $22,800,000, inclusive of $9,100,000 interest on income bonds.[2]

2. Extent of Overcapitalization. The extent of overcapitalization of railroads has long been a subject of interested dispute. Prior to the World War, public interest in railway capitalization was focused on the relationship between it and the rate base upon which the railroads were entitled to make a fair return. One of the primary purposes of the Valuation Act of 1913 was to find out the amount of overcapitalization in railroad financial structures. Valuation figures of January 1, 1937, give the cost of reproduction new less depreciation of railroads at $21,800,000,000.[3] At the same time, total rail capitalization in the hands of the public (that is, with intercorporate holdings eliminated) was $18,300,000,000.[4] Even if original cost figures were

[1] Details of this débâcle can be found in *The New England Investigation*, 27 I.C.C. 560 (1913); *Financial Investigation of the N.Y., N.H. and H. R.R. Co.*, 31 I.C.C. 32 (1914); *Investigation of the N.Y., N.H. and H. R.R. Co.*, 220 I.C.C. 505 (1937).

[2] *Chicago, Milwaukee and St. Paul Reorganization*, 131 I.C.C. 673, 723 (1928).

[3] *Fifteen Per Cent Case, 1937–1938*, 226 I.C.C. 41, 61 (1938).

[4] *Immediate Relief for Railroads*, House Doc. No. 583, 75th Cong., 3d Sess. (1938), p. 22.

used, there would be ample basis for saying that the capitalization of railroads as a whole was not in excess of such amount.

Although the valuation data of the Interstate Commerce Commission tend to dispel the notion that the issuance of railroad securities generally has been excessive, the fact remains that many railroads have been unable in recent years to earn interest charges, let alone reasonable dividends on stocks. Taking the valuation figures as *prima-facie* evidence, there would be found many cases of individual railroads overcapitalized on that basis. The inability of railroads not overcapitalized, as measured by valuation data, to support existing financial structures is due to many factors other than past financing. But the reliance in the past on fixed-return-bearing obligations, and the issuance of questionable amounts of stock on which dividends have been paid in good years, have had their effect upon the practical problem of the adequacy of earnings to support capital structure.

The problem of overcapitalization has little significance unless related to earnings. The problem does have significance when, owing to unwise, dishonest, or unsound management, properties are saddled with an excess capitalization, be it stock or bonds. While bankruptcies are ordinarily caused by undue burden of fixed charges, inability to pay dividends on stock has its ultimate effect on credit and the capacity of an enterprise to attract capital.

3. Overcapitalization and Rates. Under the "fair value" rule of determining the rate level, capitalization supposedly has no effect on the rate base and hence on rates. Actually, capitalization does often affect the rate base. It is sometimes used as an element of evidence of original investment. Seldom is a rate case pressed that capitalization and the amounts available to bondholder and stockholder are not presented to the court or commission. The usual implication is that these investors purchased the securities in good faith and should be protected. The original doctrine of Smyth *v.* Ames mentions the market value of bonds and stocks as an element of value. This factor is considered by the Commission, as is readily observable from a study of decisions.[1] Moreover, many former commissioners have admitted that, as a matter of fact, capitalization is almost never overlooked in a rate case.

Especially is it true that commissions attempt to set rates which will protect the bonds.[2] Whether valuations are stretched, the rate of return affected, or the resultant rate level set to reflect it, commissions dislike to allow public utilities to go into expensive reorganization, regardless of the past capitalization history. So far as the Interstate Commerce Commission is concerned, the rule of rate-making in the law of 1933 would seem to justify some attention to capitalization by directing the Commission to take into account cost of service and need of carriers for revenue.

[1] See, for example, *Fifteen Per Cent Case, 1937–1938,* 226 I.C.C. 41, 60 (1938).

[2] For cases where the valuations set by the Interstate Commerce Commission were apparently increased so as to cover underlying security issues, see Vanderblue, H. B., and Burgess, K. F., *Railroads: Rates, Service, Management* (New York: The Macmillan Company, 1923), p. 349.

Overcapitalization would apparently have a much more certain effect on rates through its influence on the rate of return. If a reasonable rate of return is one which allows capital to flow into a business, then the credit position of a carrier would be a prime factor in determining it. The relationship between capitalization and credit is close. When it is within the power of a commission to prescribe high enough rates, the necessity of allowing a return on an overcapitalized financial structure may force it to overlook the existence of "water."

4. Overcapitalization and Service. Not only is the railroad patron affected by overcapitalization through the rates he may be called upon to pay, but the service he receives may also be influenced. The pressure placed on management to pay interest and dividends is usually so great that needed maintenance may be reduced, marginal services curtailed, betterments delayed, and appreciation allowances foregone.

The history of railroads during the recent depression is very much a case in point. Maintenance expenditures were cut, in many cases to the bare margin of safe operation. Many trains were taken off lines and abandonments increased. Employees were laid off and many services greatly contracted. With the advent of new transportation devices and methods, many roads were unable to finance these improvements. While much of this economy and lack of funds was due to the falling off of traffic, the scramble to keep out of bankruptcy played an important part.

5. Overcapitalization and the Investor. Whether a railroad is overcapitalized or not often fades into insignificance when the railroad investor comes into the picture. The widespread holding of railroad securities by banks, trust companies, insurance companies, and individuals has served to place government officials under tremendous pressure to support railroad credit. The Interstate Commerce Commission has expressed its sympathy with the investor who has invested funds in an industry in which the government has allowed private enterprise to operate.[1]

The attempts by the government to support the railroads by loans arises from a fundamental desire to protect the railroad investor. In making these loans, the interest of present investors is often considered without regard to the financial history of the railroad. However, overcapitalization practices generally have a direct bearing upon the need for loans.

B. EXTENT OF RAILROAD SECURITY REGULATION

In the last part of the nineteenth century, several states provided for the regulation of securities issued by railroad and other public utilities. But in dealing with overcapitalization the states relied mainly upon regulation of rates, and by 1917 only twenty-three state governments had made any attempt to regulate railroad securities. Even where attempted, however, the regula-

[1] See especially *Advances in Rates — Eastern Case*, 20 I.C.C. 243, 259–60 (1911).

tion of issuance by states was none too successful, for with railroad enterprises stretching over several states, the few states which attempted such regulation found themselves without adequate jurisdiction to meet the problem.

The desirability of security regulation by the federal government was recognized shortly after the Interstate Commerce Act was passed. While the problem of financial abuses received the attention and condemnation of a congressional investigating committee as early as 1874, belief that such control was the proper province of the federal government did not become current until 1907.[1] Congress appointed a commission to study this question in 1910. Its report, rendered in 1911, opposed federal control of security issuance and suggested instead more stringent state control.[2]

As the result of general opinion in favor of security regulation, as well as recommendation of the Interstate Commerce Commission, repeated each year from 1907 to 1919, Congress finally included the regulation of security issuance in the railroad legislation of 1920. That this regulation should come so many years after the development of the railroads, and over three decades after positive federal control of these carriers, is an interesting commentary on the slowness of the wheels of regulation.

1. Securities and Assumption of Obligations. The Interstate Commerce Act as amended in 1920 made it unlawful for any carrier by railroad subject to the act [3] to issue securities or assume obligations with respect to securities of other corporations unless by authorization of the Interstate Commerce Commission. The law covered the issuance of securities by a company itself, whether stocks, bonds, notes, or any other evidence of ownership or indebtedness, as well as the assumption of guarantee under lease or contract of the securities of other companies. The only exception allowed was the issuance of short-term notes with maturities of not more than two years and totaling not more than 5 per cent of the par value of outstanding securities. The obvious purpose of allowing such notes to go unregulated was to permit railroads freedom from delay and formality in doing current and temporary business financing.

2. Conditions for Approval. In approving the issuance of securities or the assumption of intercorporate guarantees, the Commission has been given a wide discretion in attaching conditions which it believes to be in the public interest. Even the statement of principles which the Commission is directed to follow in authorizing a proposed transaction is exceedingly broad. It must find the security issue or assumption of obligation to be for some lawful object, consistent with the proper performance of common-carrier service and com-

[1] In an investigation in 1907, the Interstate Commerce Commission declared that "the time has come when some reasonable regulation should be imposed upon the issuance of securities by railways engaged in interstate commerce." *Consolidations and Combinations of Carriers*, 12 I.C.C. 277, 306 (1907).

[2] *Report of Railroad Securities Commission*, House Doc. No. 256, 62d Cong., 2d Sess. (1911).

[3] Except street, suburban, and interurban electric railways, not operated as a part of a steam railroad system.

patible with the public interest, and reasonably necessary and appropriate for these purposes. By this grant of power the Commission may not only use wide discretion as to whether the securities may be issued or obligations assumed at all, but may also decide whether the particular proposal will reasonably meet the object for which it is designed. Furthermore, the law gives it authority to deny the petition in part, make modifications as a condition of approval, and make supplemental orders whenever new developments make such a move wise.

With these discretionary powers, the Interstate Commerce Commission has ample grounds for fixing the amount, kind, and character of securities, the conditions of sale and the application of proceeds from it. The power is present, should the Commission so desire, for the regulatory agency to become the virtual dictator of new railroad finance.

C. PROBLEMS IN SECURITY CONTROL

With a power so broad, the Interstate Commerce Commission has naturally had to deal with a wide variety of financial problems. In order to place adequate safeguards around the issuance of securities and assumption of obligations, it has been led far into the financial transactions of railroads. Although only a few of the leading problems can be discussed here, it must be recognized that the positive control over security issuance provided by the Act of 1920 makes it possible for nearly every practice of railroad finance to be brought under the regulation of the Commission.

The Commission has had to face the results of the unregulated years of issuance. It has also lacked jurisdiction over many financial matters until security issuance or assumption of responsibility is contemplated, and continuing supervision has been hindered. The omission of the non-carrier holding company from the Commission's jurisdiction until 1933 has hampered its control over finances. In addition, inability properly to police transactions has resulted in a few cases of improper and unregulated financial practices.

1. JURISDICTION — FEDERAL AND STATE. Because most railroad corporations were created by the states, several state authorities maintained even after 1920 that the primary jurisdiction for allowing issuance of securities rested with them, if a federal question were involved at all. The Interstate Commerce Commission refused to be bound by the state laws regarding security issuance, and asserted complete jurisdiction over the control of railroad securities. While its position has not been approved by the United States Supreme Court, a lower federal court has assented to the stand taken [1] and state supreme courts have upheld the position of the federal commission.[2] The plain state-

[1] *Pittsburgh and W. Va. Rwy. Co. v. I.C.C.*, 293 Fed. 1001 (1923).

[2] See *People v. New York Central R.R. Co.*, 135 N.E. 967 (1922), and *Minneapolis, St. P. and S. S. M. Rwy. Co. v. R.R. Com.*, 197 N.W. 352 (1924).

ment of the law granting plenary jurisdiction to the Interstate Commerce Commission plus judicial support of federal control over state regulation in matters of interstate carriage [1] have served to make its position generally accepted.

While refusing to surrender any of its jurisdiction, the Interstate Commerce Commission has given some consideration to the provisions of state laws. Where state laws have limited the purpose for issue of securities,[2] or have prohibited the issuance of stock below par,[3] or where the carrier needed an amendment to its charter to issue stock or bonds,[4] the Commission has conditioned its approval upon compliance with the state law.

2. Past Overcapitalization. The control over railway capitalization was not given to the Interstate Commerce Commission until relatively late. By 1920 there were naturally a number of instances which had existed for a long time and on the basis of which security transfers had long been made. Nevertheless, the primary purpose of security regulation is to eliminate overcapitalization, whether for the past or future.

The Commission's treatment of this problem has been of a mixed character determined in the light of the practical situation. Where insistence upon reduction of overcapitalization as a condition for approval of a new security issue would cause damage to existing holders, or impair the carrier's credit and ability to serve, or put the carrier in danger of bankruptcy, the Commission has allowed securities to be issued even though the company were overcapitalized. There is a tendency to regard the past as a closed episode. Where, however, overcapitalization can be reduced by attaching various conditions for the granting of approval, and where these conditions would not bear too hard on the carrier, the Commission has in a few instances done so. In following this policy it has required companies to forego declarations of dividends for a time, or to capitalize in new securities only a part of capital expenditures made.

3. Capitalizable Assets. As a general rule, the Interstate Commerce Commission has strictly limited the issuance of securities to investments made for transportation service. New expenditure for road and equipment, including betterments made on leased property which is virtually owned, working capital reasonably needed, and investments in affiliated carrier property, such as joint ownership of terminals, are all allowed as proper items for capitalization. But attempts to capitalize outlays properly belonging to operating expenses, stock or bond discount, and the cost of issuing and selling securities have been rejected.

[1] See *R.R. Com. of Wisconsin v. C.B. and Q. R.R. Co.*, 257 U.S. 563 (1922), and *R.R. Com. v. Sou. Pac. Co.*, 264 U.S. 331 (1924).

[2] In *Securities of St. L. S. F. Ruy. Co.*, 79 I.C.C. 323 (1923), the Commission ordered a carrier to abide by a Missouri law which limited issuance of bonds to reimbursement for capital outlays.

[3] *Stock of Castleman Valley R.R.*, 90 I.C.C. 521 (1924).

[4] *Stock of Old Colony R.R.*, 124 I.C.C. 239 (1927).

The Commission has held to the principle that investments in non-carrier property or securities are not capitalizable, on the ground that they are not held for transportation service and do not necessarily represent a permanent part of railroad capital, since they may be liquidated and the cash be used for other purposes. Along the same line of reasoning, the Commission has disapproved capitalization of government bonds, special cash deposits, sinking funds, or other reserve funds. As it has declared, capitalizable assets are those "which have been provided and which are intended for continuing productive use in service of transportation." [1]

4. Basis of Capitalization. Not only must the Commission determine what items of property may properly be capitalized, but it must pass on the further problem of what basis shall be used in valuing them for capitalization. As a general rule, the Commission has relied upon reasonable cost of the capitalizable assets. Where new property is involved, the costs are ordinarily readily ascertainable, and usually present adequate evidence for the fixing of the reasonable amount of securities. Where these costs are excessive, the Commission has readily scaled down the amount of securities to be issued or obligations to be assumed.[2]

Most of the difficulties encountered by the Commission in this connection are in cases involving refunding of old obligations, consolidation, assumption of existing securities under lease or contract, and reorganization. Here it adheres to no definite rule. Where cost figures are obtainable and reasonably accurate, it has based its authorization on them. In some cases its finding of rate-making value has been used. While the Commission has rejected earning power as a means of determining value for capitalization, there are cases where it has reduced capitalization to an amount of securities upon which probable earnings would allow interest or dividends to be paid.[3]

In most cases of refunding operations and often in acquisitions of control, the Commission has accepted the par value of the old securities as a proper amount upon which to base the new issue, irrespective of the propriety of the old capitalization. At the same time, it has acted to prevent capitalization from being increased in refunding, as well as in conversion of securities, or in acquisitions of control.

5. Short-Term Notes. The limitation of Commission authority over short-term notes has meant that issuance of these securities has not played much part in its regulation. The Commission does require that it be notified with regard to such issues, so that it may know whether notes are kept within the limitation of 5 per cent of capitalization. The Commission also has complete powers over any contemplated issuance of longer-term securities in subsequent refunding of these notes.

[1] *Securities of L. and N. R.R. Co.*, 76 I.C.C. 718, 720 (1923). In this case the Commission discusses the principles to which it has generally adhered in determining capitalizable assets.

[2] See Sharfman, I. L., *op. cit.*, vol. III A, p. 513, and cases there cited.

[3] I.C.C., Bureau of Statistics, *Interstate Commerce Commission Activities, 1887–1937* (1938), pp. 167–68.

Some difficulty has been encountered in determining what securities should be deemed as outstanding in determining the capitalization upon which the 5 per cent limit of notes should be computed. In 1935, the Interstate Commerce Commission held that securities outstanding included only those securities which had actually been sold and delivered to a *bona-fide* purchaser for valuable consideration. It thus excluded securities repurchased or pledged for collateral trust bonds, and all short-term notes of two years or less.[1]

The apparent freedom of railroads in issuing short-term notes has been limited somewhat by the Commission's policy of closely scrutinizing the use of proceeds from such issues in the event refunding into longer-term securities is attempted. The Commission has not accepted the par value of these notes as *prima-facie* evidence of indebtedness in such cases, and has investigated them without reference to the fact that securities are already outstanding.

6. Issuance of Stock. Many state laws forbid the sales of stock below par. When a case arises under such a law, the Interstate Commerce Commission refuses to allow a railroad to make such sales. In other cases it has permitted issuance below par where the financial situation would not allow sales at par or better. This appears to be sound regulatory policy, since par value is often fictional in meaning and refusal to allow sales below par might force the railroad to finance by bonds, with a less desirable effect on financial structure and credit. Where sales below par have been allowed, the Commission has insisted upon proper recognition of this fact in the accounts of carriers.

The Commission has also allowed railroads to issue no-par stock, realizing that stock must be sold at a price not necessarily equal to par and that no-par stock has come into general corporate practice. While there are those who believe that par value should be retained in publicly controlled businesses, because of the desire to have capitalization and investment in definite amounts on railroad books,[2] the consensus of most experts is that retention of par value is secondary in importance to control of the character and value of capitalizable assets.[3]

In granting authorizations for sale of stock, the Interstate Commerce Commission has generally disapproved of the practice of limiting voting power of classes of security-holders. The policy of giving no voting power to holders of preferred stock and of some classes of common stock was not unusual in the 1920's, and was used as a method of extending control by groups with a minor portion of investment. The Commission has taken the position that disenfranchisement of stockholders leads to a concentration of control which is contrary to the public interest.

Issuance of stock as a dividend has caused the Commission some difficulty.

[1] *N.Y., N.H. and H. R.R. Co. Notes*, 207 I.C.C. 560 (1935). This was the first decision in which the Commission clarified this issue.

[2] See Commissioner Eastman's dissent in *Stock of El Paso and Southwestern Co.*, 70 I.C.C. 208 (1921).

[3] See discussion in Sharfman, I. L., *op. cit.*, vol. III A, pp. 528–34.

Overcapitalization may easily occur from stock dividends in excess of actual reinvested earnings. Moreover, stock dividends are a form of forced investment where the stockholder must accept stock rather than cash as a return. Because of this factor, as well as the possibility that too large an issue of stock may impair the ability of a carrier to raise new capital by sales of stock, the public has an interest in such a railroad-dividend policy.

The Commission has approved of the issuance of stock dividends in most cases. But the contention of some railroads that this is an absolute legal right so long as a surplus exists has been denied. The Commission's policy has been to determine whether and to what extent a surplus exists and to allow only a portion of the surplus to be capitalized. As it has pointed out, "a substantial surplus should remain uncapitalized as a support for the applicant's credit, providing for emergency needs, offsetting obsolescence and necessary investments in non-revenue-producing property, and serving as a general financial balance-wheel." [1]

7. Issuance of Bonds. The reliance of railroads on debt capital for financing has been a long-standing policy. In 1910, 54.9 per cent of capitalization was represented by funded debt, in 1920 56.0 per cent, in 1930 56.1 per cent, and in 1939 53.9 per cent.[2] The reasons for this policy are many. They include the desire to protect common-stockholder control, the profitability in getting capital at low interest rates from a vast reservoir of banking, trust, and insurance company funds, the difficulties in selling par-value stock at less than par, and the lack of market for stocks at many times in the development of railroads.

The large proportion of debt financing has borne hard on the railroads, particularly in recent years. The burden of fixed charges has forced many carriers into bankruptcy, while many industrial companies, with little or no debt, have weathered the depression in the face of small or no operating income. By harming railroad credit and endangering the very existence of railroad service in many localities, this financial policy is shown to be of real public concern.

The extent to which the Interstate Commerce Commission can be held responsible for the continuance of this debt-financing policy is difficult to say. The Commission has no apparent power to force the remaking of railroad capital structure. But in its control over security issues it can exert a material influence on capitalization. Although it showed itself to be clearly in favor of stock financing during the 1920's, there is doubt whether it did all it could to force the railroads to take advantage of the favorable stock markets of that decade. During the period 1920–30, the ratio of debt to capitalization remained practically the same despite considerable new financing. During the time industrial companies were refinancing their debt by sales of stock, the railroads did not depart materially from their debt-financing policy.

[1] *Stock of D., L. and W. R.R.*, 67 I.C.C. 426, 433 (1921).

[2] 43d *Ann. Rep. I.C.C.* (1929), p. 120, and 54th *Ann. Rep. I.C.C.* (1940), p. 148. The reduction in 1939 is largely due to matured debt unpaid, which is not included in these calculations.

Prior to the recent depression the Interstate Commerce Commission, while lending encouragement to stock financing, felt that where earnings were adequate it ought not to invade the sphere of management and require stocks to be sold in lieu of bonds. At the same time, it did occasionally require carriers to issue some stock, instead of carrying out all of a particular financing program by bonds.[1] An even stronger attitude was taken in 1926 with regard to the Chesapeake and Ohio Railroad, where an application to issue bonds was denied on the ground that the carriers could easily finance by stock.[2]

Stricter control policy has been developing. Realizing the current futility of refinancing by stock, the Commission announced in 1933 that it would favor the inclusion of sinking-fund provisions in all new bonds.[3] The obvious purpose of this policy is to provide for the retirement of bonds rather than leave them to the uncertainties of refunding when they mature. Since this time the Commission has been insisting upon such provisions in all new bonds wherever practicable.

8. Terms of Sale. Two of the most disputed problems in security issuance have been the questions of minimum offering price and competitive bidding. The Act of 1920 does not explicitly grant authority to the Interstate Commerce Commission in these matters, but it does provide that the Commission may attach such terms and conditions to its authorization as it deems appropriate in the public interest.

The Commission has undertaken to set the minimum offering price of new securities, despite the contention that such action amounted to an invasion of managerial discretion. The purpose in doing so is to see that the railroads receive as much actual capital as possible from the sale of securities. In many cases, owing to a lack of competition between investment bankers and a lack of familiarity with the market by railroad managements, the Commission has set a price materially above that offered by the bankers, with resultant increase of proceeds to the company. Where a railroad shows, however, that its suggested price represents the best obtainable, or has been set by a measure of competition between investment bankers, the Commission has shown a disposition to approve that price.

For many years railroads have been accustomed to sell new securities through established connections with certain investment-banking houses, of which the Morgan companies (now Morgan, Stanley and Company) and Kuhn, Loeb and Company have been outstanding. The advantages of having one house handle all financing are said to lie in the continuing expert advice possible, the confidence of the public in securities sponsored by such companies, the clientele that an investment banker can build up, and the general co-operation possible with this close borrower-banker relationship, which has been likened to

[1] See *Securities of Wichita Falls and Sou. R.R.*, 71 I.C.C. 694 (1922).
[2] *Bonds of C. and O. Ruy.*, 105 I.C.C. 748 (1926).
[3] 47th *Ann. Rep. I.C.C.* (1933), pp. 25–26.

that existing between physician and patient. On the other hand, opponents of this method have pointed out that competitive bidding enables the carrier company to get the highest possible price for its stocks and bonds and hence financing at the lowest cost. They also hold that too close banker control often leads to frequent maturities and much unnecessary new financing, as well as other policies not in the best interest of the carrier. As for preliminary or advisory work, they believe that either the carrier's own finance department could do it or an independent agency should be hired at a specific fee.

The Interstate Commerce Commission has left no doubt that it favors competitive bidding, largely because it believes this to be the most efficient means of railway financing. The Commission has noted the advantages of competitive bidding on many occasions and has suggested that the railroads resort to it. In a few scattered cases involving terminal bonds, it required competitive bidding before 1926, and at that time announced a policy of requiring such competitive sales for equipment obligations.[1] In some authorizations other than equipment trusts, the Commission has since ordered competitive bidding. On the whole, however, with the exception of this class of securities, it has been content to fix prices of sale and encourage the extension of competitive bidding.

The action of the Commission in this regard has been of great interest to the financial community. With the growth of government control over public-utility securities in particular and the advent of a measure of general security regulation, there is a growing belief that the requirement of competitive bidding may be adopted more widely by regulatory agencies.

9. Securities in Reorganization. With the wholesale resort to railroad reorganization since 1929, revamping of railroad financial structures has brought to the fore the problem of Commission regulation of securities in reorganization. Indeed, aside from refunding operations, the bulk of the Commission's work in railroad-security issuance has been coming from reorganization of railroads.

Before 1933 the Interstate Commerce Commission had little or no connection with railroad reorganization, except as the reorganized carrier applied for permission to issue securities called for by the newly accepted plan. This explains why the Commission did so little to direct thorough revisions of financial structure. As the Commission pointed out in a case where a particularly poor plan of security issues was approved, refusal to certify the securities would mean the complete undoing of the reorganization, with resultant delay and expense in working out a new plan.[2] Consequently, the fact that the Commission did not do much to control securities before 1933 cannot be traced to a lack of power, but to a reluctance to interfere with what is a very complicated and practical problem, over which the Commission had no control until the reorganization was virtually completed.

[1] *Western Maryland Equipment Trust*, 111 I.C.C. 434 (1926).
[2] *C., M. and St. P. Reorganization*, 131 I.C.C. 673 (1928).

Too few reorganizations have been completed since 1933 for any very accurate conclusions to be drawn as to the Interstate Commerce Commission's policy respecting security issuance, now that it has a part in the reorganization proceedings themselves. Of the plans approved by the Commission or proposed by examiners up to 1940, a few tentative observations can be made.[1] Long-term debt has been drastically reduced and fixed charges lessened. Study of some of the reports indicates that the Commission has not looked too favorably upon income bonds,[2] and has insisted upon sinking-fund provisions in new bonds. The Commission has also allowed excessive current liabilities to be funded and has shown a readiness to allow the issuance of no-par common stock. It has further refused to sanction unduly complicated financial structures.

D. REORGANIZATION

In the discussion of security-issuance regulation above, reference has been made to some aspects of Interstate Commerce Commission control over railroad reorganization. Notice has also been taken of the fact that the Commission had very little to do with the procedure of reorganizing after failure, prior to the laws of 1933 and 1935. Before that time regulation of financial reconstruction of railroads was largely a matter for the courts in their interpretation and administration of general receivership and reorganization law.

The present discussion will be limited largely to present reorganization legislation following from the new approach of 1933 and 1935. Because of the recentness of this law, the delay inherent in consummating reorganization in periods of depressed earnings, and the slowness of the Commission in enunciating general principles of regulatory policy, an accurate and adequate evaluation of this policy cannot be attempted now. As a result, treatment here will be restricted to a statement of the regulatory provisions and recognition of some of the problems presented.

1. RAILROAD FAILURES IN THE DEPRESSION. The years following 1929 have seen more railway mileage in the hands of receivers or trustees than ever before in the history of the railroads. At the close of 1938, a total of one hundred and eleven companies, operating 78,000 miles of road, or 31 per cent of the total mileage in the United States, were in the hands of the courts. This situation was serious, as is evidenced from the fact that even the "railroad" depressions of 1873, 1893, and 1907 elicited no such proportion of the mileage in reorganization.

[1] See 52d *Ann. Rep. I.C.C.* (1938), pp. 58–61; 53d *Ann. Rep. I.C.C.* (1939), pp. 58–67, and cases there cited. See also Friendly, H. J., and Tondel, L. M., "The Relative Treatment of Securities in Reorganization." 7 *Law and Contemporary Problems*, pp. 420–37 (June, 1940).

[2] Although income bonds have been included in many approved reorganization plans. See *Spokane International R.R. Reorganization*, 228 I.C.C. 387 (1938), and 54th *Ann. Rep. I.C.C.* (1940), pp. 53, 58–70.

Severity of railroad failures can be traced to many factors. Only a few can be mentioned here. The shrinkage in the volume of traffic in recent years, greater than can be ascribed to the general depression, is due in large part to the growth of competitive transport agencies and decentralization of many businesses which had previously used long hauls. Competition has not only caused diversion of traffic from the railways but has resulted in a decline in rates. This situation has been demoralized further by a substantial oversupply of transportation facilities, a condition in which the government as well as private management has had a part. Rigid labor costs resulting from strong union policy, operating rules and agreements which thwart efficiency, and make-work "safety" legislation have contributed their part to failures. Inflexible interest charges have followed the questionable practice of heavy debt financing without provision for retirement of these debts. Political control and unsound legislative policy, as well as shortsighted and reactionary practices of private management, have had their effect. Add to this the crushing burden of railroad taxation, and one can understand why the railroad industry has made so poor a recovery since 1929.

2. BANKRUPTCY AMENDMENTS OF 1933 AND 1935. The acknowledged need of special legislation to facilitate reorganization of railroads, and the continual criticism of reorganization procedure made by the Interstate Commerce Commission before 1933, account for the enactment of new railroad bankruptcy legislation. Because not all railroads have taken advantage of this legislation, known as section 77, some attention should be paid to the ordinary equity receivership procedure exclusively in effect before 1933. Railroads in reorganization before 1933, having started under the old procedure, have for the most part continued that way. In a few cases since 1933 the old procedure has been followed.

a. Procedure before 1933. Before the enactment of section 77, the procedure for handling a railroad which had failed was substantially like that of many other court procedures involving the adjudication of property rights. A creditor usually filed a bill in the proper United States District Court asking the court to appoint a receiver and administer the assets pending suits of creditors. This was done to place the railroad property temporarily beyond the legal powers of secured creditors to foreclose and seize mortgaged property. Because each federal court has a specified geographic jurisdiction, bills were simultaneously filed in all jurisdictions in which railroad property was located and ancillary receivers asked to be appointed. Ordinarily the court appointed a receiver or receivers to administer the property within the jurisdiction, and other courts having jurisdiction usually appointed the same receiver or receivers.

At this juncture protective committees were formed for the various classes of security-holders. These committees, whether self-appointed or representing some large investor, solicited deposits of securities. Armed with these depos-

its, which give the committee authority to act for the depositors, the committees negotiated with each other to effect a compromise or "composition" and draw up a new financial plan for the reorganization. After a process of "horse-trading" in security sacrifices, and reaching this composition, the committees and other parties proceeded to foreclosure of some mortgage.

Foreclosure was effected by the court's placing the property "on the block" and sale's being made to representatives of some mortgage. This "sale" involved the condition that new securities be distributed in accordance with the agreed-upon plan, that the expenses of the reorganization be paid out of the corporation's assets, and that security-holders not depositing their securities be provided for by payment of cash pro rata with their holdings to the sale price. After the dissident holders had been paid, and the reorganization manager, counsel, accountants, and committees reimbursed, the new corporation was created and new securities provided for. At this stage, and not before it, the Interstate Commerce Commission was asked to approve the securities and hence the reorganization plan.

This procedure, so simply outlined, is extremely complicated. Delays are incurred in reaching the composition and in meeting the many legal requirements necessary. The expenses in consummating the reorganization, with the numerous parties working on it, are ordinarily large. Moreover, the possibility of a minority group's holding out for better terms and making trouble for the majority is notoriously important as a cause for delay and expense.

b. Purpose of section 77. The purposes of section 77, as passed in 1933 and amended in 1935, have been pointed out by several authorities.[1] These include the obvious need for speeding up railroad reorganizations and for giving the Interstate Commerce Commission, with its expert knowledge and experience, an opportunity to work out a sound financial structure for the reorganized railroad. The new law also aimed at preventing the payment of excessive fees to receivers, protective committees, reorganization managers, counsel, and others connected with reorganization. Furthermore, the law was designed to force non-assenting security-holders to be bound by the will of a clear majority, and not to hold up the progress of the plan by collusive tactics which often turned out to be profitable to them. The purpose of the new legislation was also to remove some of the troublesome legal features, such as the requirement that all courts of jurisdiction through which a railroad passed have a part in the receivership proceedings.

c. Provisions of section 77. The changes wrought by the new law, as well as the part the Interstate Commerce Commission as a regulatory agency plays, can best be summarized by noting the procedure under section 77.[2] Any debtor railway corporation or a creditor owning 5 per cent of the total indebtedness

[1] See Rhyne, C. S., "Interstate Commerce Commission and Railroad Reorganizations," 5 *Geo. Washington Law Rev.*, pp. 749–78 (March, 1937), and Lisman, F. J., "Railroad Reorganizations and Section 77," 16 *Harvard Bus. Rev.*, pp. 22–40 (September, 1937).

[2] See Rhyne, C. S., *op. cit.*, p. 757.

may ask a district court to appoint trustees to administer the business believed to be insolvent. If the federal judge believes the carrier to be in need of reorganization and finds that the request petitioned for is in line with the law, he appoints a trustee or trustees.[1] But in contrast to the prior law, the selection of trustees by the judge does not become effective unless ratified by the Interstate Commerce Commission. The Commission has power to fix the compensation of these trustees and their counsel. Anyone wishing to intervene in the proceedings or form a protective committee for a class of security-holders must receive permission from the Commission. It may fix maximum allowances for such services at "actual and reasonable expenses," and may lay down rules regulating the procedure and activities of protective committees and other intervenors.

The debtor railroad is required to file a reorganization plan with the federal court and the Interstate Commerce Commission within six months, although the court may extend this from time to time for periods not exceeding six months. Plans may also be submitted by representatives of 10 per cent or more of any class of security-holders, or by others by permission of the Commission. After public hearings the Commission may approve, modify, or refuse to approve any of the plans submitted, or may file and approve a plan of its own making. Any plan presented must meet certain statutory requirements. It must include provisions modifying or altering the rights of creditors generally by issuance of new securities or otherwise. It must "provide for fixed charges . . . in such an amount that there shall be adequate coverage thereof," and it must provide adequate means for putting the plan into effect. The law permits any plan to include provisions altering or modifying rights of stockholders and protecting the rights of any security-holders not otherwise provided for, by giving them option to subscribe later to securities of the reorganized company.

When the Commission has approved of a plan, it is sent to the federal court. Upon approval by the court, the plan must then be approved by two thirds of each class of creditors and stockholders included in it. After certification of these results to the Commission and confirmance of the plan by the court, new securities are authorized and the reorganization completed. Dissenting security-holders may not block the plan if the requisite majority approve. The Commission is empowered to determine the conditions for satisfying the claims of these objectors, which determination may virtually force the security-holder to accept the plan approved by the majority.

3. Commission Regulation in Reorganization. Too little experience has been had to justify any conclusions respecting the Commission's policy. A few tentative observations were made above respecting its attitude toward securities issued by the reorganized railroad. As compared to costs incurred under equity receivership, the allowances made by the Commission for trustee,

[1] Under section 77 the temporary administrators are called "trustees" rather than "receivers."

counsel, and protective-committee services indicate that the expenses of reorganization have been materially reduced. The Commission has acted carefully in considering reorganization plans, and has apparently been quite liberal in allowing interested parties to present plans and criticisms. The power of the Commission to force acceptance of its own views by filing a plan of its own has been shunned as too great an interference and of doubtful constitutionality.

By feeling its way so carefully, the Interstate Commerce Commission has caused to rise some criticism from those who would see railroad reorganizations completed more rapidly. It has been slow to enunciate principles upon which reorganization plans should proceed. As a result, those formulating plans have complained that they have no way of knowing in advance what features the Commission will find to be in the public interest. Through resort to long-drawn-out hearings and rehearings, the Commission has also been criticized for emphasizing the formal approach. Reorganization, it is said, being primarily a problem of the meeting of minds of divergent interests, might best be handled by informal preliminary discussion of interested parties and a member of the staff of the Commission.

Late in 1940 the Interstate Commerce Commission announced that it had approved reorganization plans for 21 railroads, involving a reduction of more than $2,000,000,000 in railroad indebtedness and a decrease of $88,400,000 in annual fixed charges.[1] Of the plans approved by the Commission at that time, however, only four had been confirmed by the courts concerned and none of the railroads had completely emerged from the process of reorganization, although some consummated proceedings were expected in 1941.

4. Problems in Effecting Railroad Reorganization. The procedure of section 77, with the increased participation of the Interstate Commerce Commission, should result in better railroad financial structures, and placing the railroads on a sound financial footing would go a long way in bringing about order in the economic chaos of the last decade. At the same time, section 77 has not brought about as expeditious a settlement of the problem of railroad reorganization as expected. Indeed, there may be a question whether this new procedure has made reorganization any speedier than under the old equity receivership.

Some of the cause for delay lies in the machinery of the law itself. The constant shuttling of the reorganization proceedings from court to Commission and back necessarily retards reorganization. The many time-consuming and expensive hearings, while probably necessary, are nevertheless open to question. The fact that the law does not require the Commission to make a statement of principles to be followed, as well as its own disinclination to do so, has naturally caused delay. By requiring that plans be filed with the Commission before hearings are held, the law encourages delay, because the filing of

[1] 54th *Ann. Rep. I.C.C.* (1940), p. 66.

plans before divergent interests have a chance to reconcile their differences is likely to be futile.

Perhaps the primary cause for delay is the fact that security-holders, railroad managers, and the Commission are not convinced that railroad earnings have been near enough to "normal." The position is taken that they have been too low and too uncertain to justify the formulating of plans. Since the weighting of the relative values of old claims and the allocation of new securities, as well as the determination of a financially practicable total capitalization, depend upon a reasonably accurate prophecy of earnings, the merit in this position can readily be appreciated. There are those who claim that this should be no impediment, for the so-called "poor" times may be just the occasion in which the problem of reorganization can be dealt with most realistically.[1] On the other hand, if some classes of security-holders should be forced to make sacrifices, based on years of low revenues, real injustice might be done should these years turn out to be abnormally low.

E. SUPERVISION OF LOANS TO CARRIERS

The government does not usually aid private business, either by loan or subsidy, unless it sets certain requirements or conditions for the acceptance of such favor. Such requirements have been imposed in the cases of government loans to the railroads. Because their administration has been placed, in part, in the care of the Interstate Commerce Commission, a discussion of the policies applied by the Commission properly belongs in a study of railroad regulation.

1. LOANS UNDER ACT OF 1920. The federal government inaugurated a loan policy for railroads in 1920 for the first time. The Transportation Act of that year set up a revolving fund of $300,000,000 from which loans were to be made to enable carriers "properly to serve the public during the transition period" immediately following the end of federal wartime operation.[2] The Interstate Commerce Commission was charged with the task of administering the fund, although actual payments were made by the Secretary of the Treasury.

The law provided that the Commission should certify to the Secretary of the Treasury the amount, terms, and conditions for the loan, and make a finding that the prospective earning power of the applicant carrier, together with the character and value of security offered, furnished reasonable assurance that the carrier could repay the loan. The Commission certified loans aggregating over $350,000,000, all bearing interest at 6 per cent. As of October 1, 1940, over $325,000,000 of principal and nearly $91,000,000 in interest had been

[1] See Moore, W. H., "Railroad Fixed Charges and Bankruptcy," 47 *Journal of Political Economy*, pp. 100–27 (February, 1939).

[2] Other expedients to aid the railroads after federal control terminated in 1920 included a guaranty of net earnings for six months and reimbursement for deficits during the period when the government operated the railroads. In all these matters the Commission certified carriers and amounts allocable to the Treasury.

paid by carriers.[1] In certifying these loans, the Interstate Commerce Commission exerted some effective control over railway financial policies. At the same time, one may raise the question as to whether it did all it might have to bring pressure to bear for a sounder financial structure of the borrowing railroads To be sure, when carriers need such financial assistance, the time may not be opportune for requiring much change in basic financial policy.

2. LOANS SINCE 1932. In 1932 the policy of governmental loans to railroads was revised under the Reconstruction Finance Corporation Act. The Reconstruction Finance Corporation was directed to make loans to carriers after applications had been approved by the Interstate Commerce Commission. The Commission could refuse its approval of a loan or condition it upon the railroad's modifying its financial structure. Responsibility for adequate collateral security has remained with the Reconstruction Finance Corporation.

The Emergency Transportation Act of 1933 provided that, with the exception of loans for purchase of equipment, the Commission should approve no loans if in its opinion the carrier was in need of financial reorganization. While the Commission has been criticized as paying too little attention to prospective earnings in certifying carriers for loans, it has on occasion forced carriers into reorganization by refusing to approve applications. Denial of a loan asked by the New Haven Railroad had much to do with forcing that carrier into trusteeship in 1935.

Public-works loans were opened to railroad participation in the National Recovery Act of 1933. All such loans were subject to approval by the Interstate Commerce Commission if found to be "desirable for the improvement of transportation facilities." The responsibility for seeing that the loans were reasonably secured rested with the Public Works Administrator. Under this loan provision the Commission, by acting as an allocator of public funds, was placed in a position where it could and did exert pressure on railroad financial policies.

The extent of railroad aid given by loans from the two agencies referred to is shown by the table below.

Government Railway Financing:	December 31, 1939*
Total loans (RFC and PWA)	$866,084,961
Repaid by railways	273,411,953
Balance, December 31	$592,673,008
Of which there had been sold to the public at a net profit of $5,495,280	127,020,000
Still held by government	$465,653,008

* Assoc. of Am. Railroads, *A Review of Railway Operations in 1939*, p. 15 (1940).

It is significant that the two lending agencies from which the railroads have obtained most of their help are supposedly temporary in nature. Through extension of operations from time to time, these loans may be maintained and new ones made. Even though new loans should be discontinued, liquidation

[1] 54th *Ann. Rep. I.C.C.* (1940), p. 54.

of existing ones will not be completed for many years, and many may never be repaid. It is too early to say what effect this policy may have on the government ownership of railroads. The tendency for such a development and the size of the loans relative to total railway investment have doubtless often been overestimated. Any loan policy, however, bears watching for its results in terms of increased governmental interferences.

F. ACCOUNTING REGULATION

Effective control of railroads, or any other privately owned business, is conditioned to a very great extent by the regulation of accounts. Whether rate regulation, regulation of new construction and abandonments, control of new security issues, supervision of combinations, or regulation of many other features is undertaken, accurate and uniform accounts are a necessary part of a regulatory system.

Accounts of all carriers should reflect the same kind of transactions so that accurate comparisons can be made. To know accurately what has been invested for railroad service, not only should the accounts make a careful distinction between expenditures for this permanent investment, but they should indicate a separation between carrier and non-carrier business. To understand what the cost of giving railroad service is, and to know what earnings really are, operating-expense and income accounts should show clearly what these amounts are and what they represent.

If uniform and accurate accounts are to be brought about, government control is necessary. The several hundred railroad corporations reporting to the Interstate Commerce Commission could hardly be expected voluntarily to adopt and follow a uniform system of accounting. There are many honest differences of opinion among accountants as to how such records should be kept. Many possibilities for deception are presented by misuse of accounting processes. Moreover, if the accounts and statistics derivable from them and other sources are to meet the needs of regulation generally, a governmental body should draw up accounting requirements with these purposes in mind.

1. UNIFORM ACCOUNTING. Prescription of a system of uniform accounts for rail carriers dates from 1907. The original law of 1887 had authorized the Interstate Commerce Commission to require annual reports and prescribe uniform accounts. Because the enforcement provisions of the original law were weak, real accounting regulation did not come until after Congress, in 1906, gave the Interstate Commerce Commission complete power over railway accounts and reports. By this law it was empowered to prescribe, require compliance under penalty, and police a uniform system of accounts.

The accounting system, as revised in 1914, is essentially that in effect today. There have been certain minor changes, and other more important revisions having to do mainly with depreciation accounting. But a quarter of a century

of uniform accounts for the railroads has given rise to a body of comparable statistical data which cannot be found in any other industry.

The success of this accounting control can be traced to several factors. The Commission has proceeded in its accounting regulation only after obtaining the advice and assistance of railway accounting officers and other experts in the field. To enforce its accounting regulation it has placed examiners in the field. Through periodic tests, as well as detailed examination of all financial transactions over a long period of years for some railroads, the Commission has done a reasonably good job of supervision and enforcement. The tendency of its accountants to be diverted to congressional investigations, however, as well as curtailment in appropriations to the accounting bureau, has threatened to impair this work.

2. Depreciation Accounting. When the accounting regulations were promulgated in 1907, depreciation-loss accounting was practically unknown among American railroads; as a matter of fact, few other businesses paid much attention to it prior to the World War. In the face of opposition by railroad accountants and management, the Interstate Commerce Commission ruled that the carrier must account for depreciation on equipment after June 30, 1914.[1] As an optional matter, the Commission provided for depreciation charges on road and structures. Few railroads have made allowance for depreciation of road and structures. Pursuant to provisions in the Transportation Act of 1920, however, the Commission made a study of depreciation reserve accounting for these items and ordered the railroads to adopt such charges in 1931.[2] Because of the depressed conditions of rail earnings at that time and the almost unanimous objection of railroad management, the effective date of this order has been indefinitely postponed.

Railroad opposition to depreciation reserve accounting may seem difficult to understand when possible increases of operating expense without cash outlays and a resultant better case for higher rates are considered. Several factors probably account for this opposition. Railroads had pretty well reached their financial maturity by 1914. In previous years, replacements had been charged directly to operating expenses as they occurred. Railroad managements claimed that in a well-developed property, depreciation reserve accounting is not necessary, since replacements tend to assume a constant rate. Operating efficiency, they believed, could be maintained by replacement of units as they occur; and since a railroad is a permanent composite of units, depreciation in fact did not exist if operating efficiency were maintained. Moreover, during all the years before the time of the Valuation Act of 1913, no real attempt had been made by the roads to account for accruing depreciations. To concede in 1914, or later, that accrued depreciation (beyond deferred maintenance) existed would be to acquiesce in a lower fair value for rate-making purposes.

[1] I.C.C., *Classification of Operating Revenues and Expenses*, Issue of 1914.

[2] *Depreciation Charges of Telephone and Steam Railroad Companies*, 177 I.C.C. 351 (1931).

Sound financial practice adequately supports the Interstate Commerce Commission in its insistence upon railroad depreciation reserve accounting. If anything, the Commission should be criticized for not requiring it on road and structures at the time mandatory reserves were set upon equipment. Had more adequate, or even liberal, depreciation charges been made during the years that higher rates could have been collected, the railroad problem might not have been what it is today. By increasing expenses and reducing the earnings available for interest and dividends, charging depreciation would have meant that more funds would have been kept in the business. These funds might have been employed to amortize bonded indebtedness. In either case, the result would have been a reduction in the ratio of debt to operating assets. Such a result would have done much to ease some of the most vexing aspects of the recent railroad problem.

3. DETERMINATION OF COSTS. Railway accounting regulation has done very little toward the organization of a continuous and detailed system of determining costs. Attempts to introduce some kind of cost accounting have in general met with failure. Some statistical measures have been devised to aid railway managements and the Commission in determining their costs. Special cost studies have been made when needed in rate cases. In some railroad shops cost accounting has been used. But generally speaking, routine cost accounting has not been introduced and has not been received sympathetically by railroad accountants and managements.

As a part of a study on revising accounting procedures, the Interstate Commerce Commission published some plans for railroad cost finding in 1929.[1] Not confident that a workable plan could be arrived at, the Commission postponed action. Pursuant to a provision of the Transportation Act of 1933, the Federal Co-ordinator of Transportation advanced a scheme for railroad cost accounting.[2] No definite action has been taken on this report. The Commission has, however, continued its study of cost-finding methods and has developed some formulas. Late in 1937 the Commission instituted an investigation of cost finding for railway, highway, waterway, and pipe-line transportation service.[3]

The subject of routine cost determination will probably receive increased attention in future regulation of accounting. The tendency to place all carriers under a single regulatory agency makes the obtaining of comparable costs almost essential for fair rate regulation. Should an attempt be made to force co-ordination of transport through regulation, the relative costs of carriage of each kind of carrier would be information necessary for the Commission.

[1] I.C.C., Proposed Report in *ex parte* 91, *General Revision of Accounting Rules for Steam Railroads* (August 19, 1929).

[2] Federal Co-ordinator of Transportation, *Cost Finding in Railway Freight Service* (1936).

[3] 52d *Ann. Rep. I.C.C.* (1938), p. 112, and 53d *Ann. Rep. I.C.C.* (1939), p. 130.

G. CONTROL OF RAILROAD FINANCE — CONCLUSIONS

Financial manipulation and questionable financial practices are not entirely things of the past, but the enveloping control of the Interstate Commerce Commission has materially reduced the opportunity for such abuses. The wide scope of security-issue regulation has led the Commission into practically every phase of railroad finance. The long experience with regulated accounts, the effective policing of these requirements, and publicity arising from numerous financial investigations have pretty well closed the door to unscrupulous or deceptive financing. The increased participation of the Interstate Commerce Commission in reorganization processes should help in improving the financial structures of newly reorganized railroads. Perhaps no industry now subject to regulation has its financial policies and practices so completely and effectively controlled.

In the face of this widespread control, congressional investigation has disclosed many questionable activities of railroads, railroad holding companies, and individuals who control railroads.[1] Several instances of inaccurate and misleading statements have been unearthed. Since the law before 1940 required "specific" rather than "correct" answers, these actions seemed to the Commission not to be subject to penalty, even though they were intentionally false. The use of corporate subterfuges technically outside the law has also led to practices in contravention of Commission rules.

There is nothing in the law which would prevent a railroad from acquiring stock in another railroad so long as such acquisition does not amount to control, nor does the law prevent the acquisition of stock in companies not engaged in interstate commerce. A railroad may purchase any property it wishes unless new securities are issued, new obligations assumed, or intercarrier control effected. What this means is that railroads have been quite free to engage in many outside enterprises, such as warehousing and real estate ventures, and may make practically any inter-railroad investments not resulting in control. These activities outside the law have been pointed out by the Commission to be largely responsible for the failure of the New Haven in 1935.[2]

To meet some of these loopholes, more strict financial control has been proposed. Power to require "correct" answers to questions and power to reach the actual owners of railroads were enacted in 1940. To stop railroads from making outside investments which are not really investments but are made for the purpose of strategic traffic advantage, the Commission has asked that it be given greater supervisory power. On the whole, it believes that railroad funds should be kept in the business of transportation and the development of a railroad's own system. When funds are invested in outside enter-

[1] See 51st *Ann. Rep. I.C.C.* (1937), pp. 10, 27–28, and *Investigation of Railroads, Holding Companies, and Affiliated Companies*, U.S. Sen., Com. on Interstate Commerce, pursuant to Sen. Res. 71, 74th Cong. (1937–40).

[2] *N.Y., N.H. and H. R.R. Co. Investigation*, 220 I.C.C. 505 (1937).

prises, the Commission believes that it should be given authority to supervise the terms of these transactions and to make a finding as to whether the investment is in the public interest.[1]

Extension of the field of financial control brings up the difficult problem of proper spheres for private managerial discretion and regulation. So long as private enterprise exists, a regulatory commission should not become the real manager of a business. On the other hand, the interest of the public in adequate and soundly financed transportation, as well as the fact that it is often called upon to aid a financially destitute road, makes irresponsible, inefficient, or fraudulent management intolerable. Where to draw the line between regulation and private management is one of the most important and delicate problems of government control, whether in the field of railroad finance or elsewhere.

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CHAPTER

10

MOTOR TRANSPORT

A RELATIVE newcomer to the fold of regulation is the motor-transport industry. Its development as an important carrier has also been comparatively recent. Not until 1920 and after did the passenger automobile constitute a serious threat to railroad passenger business. The meteoric rise of the motor-truck industry took place during the 1920's. Stimulated by constant improvement in the vehicles themselves, by a marked increase in the number and quality of public highways, and by the growing recognition of the advantages of such transport, the highway carrier of freight had become a formidable competitor of the railroads by 1930.

Regulation of highway transport has presented an interesting case of searching for regulatory policies and methods in a newly developed transport industry. The multiplicity of carriers, the economic characteristics so variant from those of railroads, the diversity of types of carriage, the wide flexibility of routes and movements, the mixture of public and private financing, and the relationship of these new carriers to the long-established railroads, made regulatory policy difficult to outline and control arduous to effect. These troublesome features, combined with the originally local nature of the transport, led to a heterogeneous mass of state regulations. With their wide variation, the rapid development of long-distance hauling, and the creation of a "no man's land" of interstate carriage where state authority was found to be inadequate, the motor-transport field was in a serious state of demoralization by 1930.

Although federal control was suggested by the United States Chamber of Commerce as early as 1923,[1] systematic federal regulation was not forthcoming until the passage of the Motor Carrier Act in 1935. This legislation has not brought complete order to the chaos of the motor-transport industry, but it does represent the opening wedge for strong control, an opening which the future may see widened considerably.

[1] U.S. Ch. of Comm., *Relation of Highways and Motor Transport to Other Transportation Agencies* (1923), p. 37.

A. NATURE OF MOTOR TRANSPORT

An understanding of the main characteristics of the motor-transport industry is essential for an appreciation of the regulatory problem involved. Because much of the business is other than common carriage, and because even common carriage differs in certain essentials from the railroad business, the accepted reasons for public interest in railroad regulation are not all applicable to a like degree to the motor-carrier industry. The problem is also complicated by the existence of private pleasure operations, a kind virtually unknown in the railroad field.

Although it is not always easy to distinguish between pleasure and commercial motor-carrier operation, the primary emphasis in this chapter will be on highway transport for commercial purposes. The individual owner of a pleasure car is not at all exempt from various regulations prescribing speed, financial responsibility, accident reporting, and other measures applied to commercial carriage. Although the individual owning a pleasure car is a competitor with the commercial transport agencies, and should be viewed in this light, to date regulatory policy has not done so. Since the basic purpose of this book is to present government control of business, the pleasure-car operator will be overlooked.

1. Types of Carriers. Highway carriers fall into three general classifications: common carriers, contract carriers, and private carriers. Both common and contract carriers operate a for-hire business, carrying goods of others. The private carrier handles goods for the owner only. Farmers, oil companies, manufacturers, and commercial businesses owning vehicles for the purpose of carrying goods owned by the operating carrier are among the most important members of this class.

The common carrier is a carrier which holds itself out to serve all comers. Whether operating over a regular route, or on an "anywhere" basis, this has come to be the legal test for determining common carriage. Because common carriers have been traditionally regulated as to rates and service requirements, the common law having held that they were not private in nature, but quasi-public, their status is exceedingly important from a regulatory point of view.

With the exception of a few lines, such as lumbering railroads, all railroads are common carriers. This situation is practically reversed in the highway-transport field. A rather small proportion of highway business is done by common carriers, by far the larger part being carried by contract and private carriers. The contract carrier limits its service to particular shippers and contracts for definite carriage over a definite period of time, and restricts itself to the handling of goods specifically contracted for. The private carrier makes no contract or offering to serve others, limiting its business to the commodities of the owner.

As can easily be ascertained, the distinction between common and contract

carriage is often hard to make. Any carrier handling another's goods makes an explicit or implied contract. Carriers really common, in the sense that they offer their service to all shippers, have claimed to be contract carriers by virtue of making individual contracts for carriage. But the making of a contract is not enough. A regulatory commission must look to the essence of the business relationship and decide whether there has been a general "holding out" to serve, or a practice of dealing with certain individuals under a contract extending over a period of time.

As one transportation authority has noted, there is a tendency to regard the for-hire vehicle operator as using public highways for profit and to feel that the highways are for privately operated vehicles.[1] On this basis, regulation and taxation provisions often discriminate against the carrier transporting for hire. A moment's reflection will show that most operations of owned vehicles are for commercial purposes, in the sense that the transportation is being done for monetary profit. The use of the highway for commercial purposes is no different whether a cargo of freight is transported by a common carrier, a contract carrier, or a private carrier.

Although not a carrier, the broker of highway-transport service is placed under many regulations dealing with motor-carrier control. He is an intermediary who undertakes to bring users and carriers together. While not too important in other transport fields, the broker in the highway-carrier service has often had control over a large share of business in certain areas.

2. Economic Characteristics. As contrasted to the railroad business, the motor-transport business is an interesting hybrid. The public furnishes the road for pleasure as well as for commercial purposes. The motor-carrier agency furnishes only the operating equipment and sometimes terminal and station structures. This fact has marked economic effects. In the first place, regulation of motor carriers is not actually regulation of supply. Granting a certificate of convenience and necessity is merely the giving of permission to operate over a line already there. Building of highways is often justified on other than commercial transport grounds. Permission to build a highway has not been required yet by any regulatory authority. Once the highway is built, a transportation facility exists. To refuse to allow its use would hardly be economical. Whether certificates allowing entry into the field are granted or not affects mainly the number of operators using the highways, and has but a minor influence on the actual supply of transportation.

The hybrid nature of highway transportation also makes the determination of costs extremely difficult, if not impossible. Sound transportation regulation would seem to require that transport agencies bear the full cost of carrying goods and persons. But when the road facilities are used for both commercial and pleasure purposes, and are built also for cultural and military reasons,

[1] Locklin, D. P., *Economics of Transportation* (Chicago: Business Publications, Inc., rev. ed. 1938), pp. 757–58.

costs can hardly be allocated accurately to commercial traffic. This is a cause for inaccuracy in any cost study, and a reason for question as to the feasibility of co-ordinating transport business on an economic basis.

The fact that each carrier need not furnish his road and the fact that carrier units do not require a very large capital outlay have their effects in the economics of size in the motor-transportation business. The relatively small capital investment required for way means that the small owner may be just as efficient as the operator of a large fleet of trucks or buses. A few costs, especially for terminal and station facilities and repair staffs, may tend to decrease with the larger scale of business. Even these may be made unimportant through co-operative use of terminals and stations and by contracting for them and for repair services. Though a larger-scale business may have some cost advantages, they are not great, and the most efficient size is certainly much smaller than the economical scale for rail- or water-line operations.

The relative insignificance of investment costs and the small operating unit also make fixed costs much less important than in the case of railroads. Their proportion to total costs is relatively low, and they remain fixed over a much smaller volume of traffic than is the case with railroads. The result is that there is not nearly so great a tendency toward rate discrimination, nor is there as much inflexibility of facilities when traffic demand changes.

The smallness of the efficient operating unit and the fact that a carrier may not be limited to a single track or way give rise to certain peculiar service characteristics of the motor carrier. It can usually give a speedy service because it is not hampered by terminal delays, yard classification operations, switching, and interchange of traffic. The ability to operate over almost any road and to send units with fairly small cargoes at almost any time not only adds to the speed but also makes for a flexible service. With convenient pick-up of passenger or freight and convenient delivery, often door to door, the motor carrier's service is more complete than any other transport service. Less handling and the use of vehicles causing fewer jars and jerks make packing requirements of less importance, with consequent lower overall shipping costs. On the other hand, the very smallness of motor-carrier companies has served to make many of doubtful financial responsibility. This fact and the reliance upon the public highways have often served to make motor transport less reliable than rail carriage.

3. Basis of Public Interest in Motor Transport. The question has sometimes been raised as to whether commercial motor carriers should be specially controlled, apart from general regulations applicable to all carriers for the protection of the highways. The existence of so many operators and the fact that large-scale operation has no particular economic advantage has made the motor-carrier business anything but monopolistic. Because of the existence of competition, those opposing public regulation have pointed to competitive forces as being effective guardians of the public interest.

Admitting that the motor carriers have not become monopolies, and have no very strong economic incentives in that direction, there is some basis for a more than ordinary public interest in this field. Transportation by whatever form is in a peculiarly important position with relation to the public. It is essential for the efficient functioning of the economic machine, and the latter demands that transport facilities be reliable, adequate, furnished at the lowest possible cost, and offered without discrimination.

The existence of unhampered competition in any part of the transportation field is not usually in the public interest. Too much rate competition may lead to general financial instability not consistent with good service. Competition also gives rise to discriminatory rate practices, and this is of great interest to the shipper, even though the stimulus for such discrimination may not be as great as with the railroads. Not only does competition need to be regulated in order to keep rates high enough for equal service, but there is ground for regulating them so that they may not become too high for some shippers. A large shipper may be able to resort to private or contract carriage to avoid high rates, but this alternative is not always open to the small shipper.

A financially responsible and dependable service is eminently in the public interest. Without regulation, these requirements can hardly be obtained. Nor do the ease with which individuals can enter the motor-carrier field in the absence of regulation and the great number of operators make for such service.

A regulatory program half slave and half free is inconsistent within itself and is not conducive to a healthy transportation system. The motor carrier has been a strong competitor of the railroads. This is particularly so in the passenger business. In the freight business also the force of motor competition has been felt. Less-than-carload merchandise freight and other high-grade traffic, long carried at highly remunerative rates, have been taken over to a great degree from the railroads. The loss of traffic volume, coupled with forced reduction of railroad rates, has consequently had great effect on railroad revenues. If railroad regulation seems to be in the public interest, common fairness and desirability of equality of opportunity in the transport field would appear to make that of motor carriers also wise public policy.

Co-ordination of transport facilities would probably have to be accompanied by regulation, if not compelled by it. To attempt this co-ordination without subjecting all carriers to equal regulation is bound to meet with failure. Since economical co-ordination seems to be in the public interest, regulation of highway carriers would seem also to be.

Safe and efficient use of the public highways makes regulation of motor-vehicle carriers of public importance; all users of the highways should be subject to it. However, special attention should perhaps be paid to commercial highway users. In the first place, the public is providing a way for transportation *as a business*, and should certainly have something to say as to the conduct of that business. Secondly, the operation of commercial vehicles of

such size, weight, number, and operating characteristics as have recently developed makes public regulation imperative for safe and economical use of the highways.

B. THE PROBLEM OF HIGHWAY TAXATION

The problem of taxation for highway use differs materially from that applying to railroads or to business generally. Because the public furnishes a way, highway-transport businesses must be called on to contribute to the expense of furnishing and maintaining this road, in addition to paying taxes for general governmental support. Hence, in comparing taxation of commercial motor carriers with the railroad levies, an allowance should be made for this fact. Unless motor-vehicle levies exceed the fair cost of furnishing highway facilities, they can hardly be regarded as true taxes contributing to general governmental support.

1. Basis of Highway Taxes. The tendency in recent years to levy taxes for highway support on a user basis is undoubtedly sound. While highway construction increases real-estate values, has military importance, and improves cultural relations, by far the greatest benefit accrues to the individual user, whether use is for pleasure or for profit. This is especially true of state highways, and to a very great extent of local roads and city streets. Local roads, or land-use highways, benefit the farmer in moving his products to market. City streets are decidedly beneficial to long-distance commercial vehicles as terminal facilities; extensive commercial use is also made of city streets for local distribution purposes.

The question of allocation of highway costs between users and the general public is extremely difficult to solve equitably. Even more difficult is the problem of levying taxes as between commercial and non-commercial users, and as between individual carriers and vehicles in each class. Motor-vehicle manufacturers would limit allocation of costs to users to long-distance state highways. The railroads, on the other hand, would ask users to defray the cost of all highways and a part of that of city streets, particularly arterial routes. Many experts have agreed on the principle that users should finance all state highways, local highways of general use, and through routes in cities.[1] Land-use roads and general city streets should be financed by charges to property-owners and special agricultural and urban groups, and by general tax revenues.

The extensive study of public aids in transportation undertaken by the Federal Co-ordinator of Transportation adopted the user principle in allocating cost of highways between the operators of motor vehicles as a class, the

[1] This point of view is in general supported by Moulton, H. G., *American Transportation Problem*, pp. 556–57; Locklin, D. P., *Economics of Transportation*, p. 755; and Joint Committee of Railroad and Highway Users, *Regulation and Taxation of Highway Transportation* (1933), pp. 15–18.

landowners, and the general public. The findings of the co-ordinator were that in 1933–37 motor-vehicle users should have borne 83 per cent of the annual cost of state highways, 34 per cent of that of county and local roads, and 30 per cent of that of city streets.[1] These percentages are based upon estimates of (1) the added costs incurred for the benefit of motor-vehicle users, (2) the proportion of local or land-service use made of roads, as compared to motor-vehicle uses, and (3) the extent to which roads serve community and social needs, such as recreation, fire protection, policing service, and communication.[2]

As for allocation of costs between commercial and non-commercial users, acceptable principles are not easily deduced. The former ordinarily make more use of the highways per vehicle than do the latter, and recognition should be given to this fact. Moreover, additional highways or the higher costs of highways necessitated by commercial users should be charged completely to the commercial operator. Wider, stronger, and heavier highways and better bridges are generally necessary for most such operation. The tendency of the commercial truck or bus to be larger and heavier than the non-commercial passenger car has undoubtedly increased highway expense. To the extent, then, that the commercial user has increased the cost of highway construction, these entire additional costs should be charged against him.

Non-commercial vehicles, mostly the private passenger automobile, tend to be fairly uniform in size, weight, and operating characteristics. Some differences do exist, and these can easily be accounted for by taxation. Commercial carriers, on the other hand, vary from half-ton vehicles of normal width and length to eighty-five-foot-long combinations with capacities running from thirty to fifty tons. Other variants of interest to the public include speed, kind of tires, whether solid or pneumatic, and number of wheels. Not only should certain standards be established in the interest of safety and preservation of the highways, but taxation should vary with size and weight, as well as use.

Perhaps the soundest principle of taxation for these carriers would be to find out the extra costs attributable to each weight and size group, allocate these plus a share of general highway costs, and find a method of taxation whereby the total costs could be collected equitably. A gross ton-mile tax, while possibly administratively impracticable at present, would seem to be a sound method of taxation for highway use. In addition, multipliers might be applied for excessive width or length. A further levy should be made on the basis of total business, number of vehicles, or investment, to cover general tax contribution to the support of government.

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation* (1940), vol. I, p. 25; vol. IV, pp. 12–45.

[2] One might question the whole principle of separating local or "land-service" use of roads from use by motor vehicles. The transportation of persons and property from and to homes, farms, working establishments, and marketing places would seem to be chargeable to motor-vehicle users.

2. Sources of State Highway Funds. The sources of funds spent for state highways in 1937 are given in the following table:

Table II. State Funds for Highway Purposes, 1937 [1]

Source	Amount	Per Cent
State motor-vehicle taxes, fees, etc.	$276,840,000	23.4
Gasoline tax receipts allotted to highways	542,813,000	46.0
Other state taxes and funds	16,214,000	1.4
Federal funds	262,762,000	22.2
Bonds or notes	65,009,000	5.5
Miscellaneous	18,224,000	1.5

The revenue derived from state taxes on motor-vehicle operation has been tremendously increased since 1920. In that year registration fees amounted to $102,546,000, but by 1930 they totalled $355,705,000 and by 1938 they amounted to $405,246,000.[2] Revenues from gasoline taxes increased from $1,304,000 in 1920 to $493,865,000 in 1930, to $766,853,000 in 1938, and to $1,120,000,000 in 1940.[3] Special fees, such as levies on trucks and buses, were also large. At the same time, state and local governments had gone into debt on a large scale for highway construction; in 1936 this debt amounted to over $1,300,000,000.[4]

3. Do Highway Carriers Pay Their Way? Perhaps no more disputed question exists in the transport field than whether motor transport pays its fair share of highway costs in addition to an equitable amount of general taxes. Adequate data are lacking for an accurate study of this problem, and no acceptable basis of allocating costs to different groups of users has been found. It is impossible to say definitely not only whether all users pay their share, but whether commercial users pay more or less than their share.

The National Transportation Committee reported in 1933 that "our studies clearly indicate that in some states automotive vehicles do not bear their full burden of taxes." [5] The extent to which the commercial vehicles paid their share was not stated.

A study reported in 1939 by three eminent highway engineers, although subjected to the taint of being prepared for the Association of American Railroads, found that highway users were not paying their fair share of highway costs.[6] This study further indicated that the larger motor vehicles failed to pay their proportion of highway and street costs by a far greater amount than the passenger car or the small truck. During the period 1921–1932 motor vehicles as a whole enjoyed a total subsidy equal to about ten billion dollars. For the years

[1] Automobile Manufacturers Association, *Automobile Facts and Figures*, 1939 ed., pp. 86–87.

[2] *Ibid.*, p. 22.

[3] *Ibid.*, p. 22, and 3 *Automobile Facts*, No. 5, p. 7 (January, 1941).

[4] Trull, Edna, *Borrowing for Highways* (New York: Dun and Bradstreet, 1937), p. 31.

[5] Report included in Moulton, H. G., *op. cit.*, p. xxxiv.

[6] Breed, C. B., Older, C., and Downs, W. S., *Highway Costs* (submitted to Association of American Railroads, 1939).

after 1932 no detailed finding was made, but study indicated that these subsidies were continuing at a pace equal to increasing motor-vehicle payments. Examination of the report discloses that the data used are as authoritative as can be obtained. Question, of course, exists as to the bases upon which costs were allocated. In the absence of generally acceptable bases, no conclusive statement of the correctness of these allocations can be made. There is evidence, however, that these engineers made an attempt to approach the problem in a far more scientific light than their sponsorship would seem to imply.

By far the most extensive and disinterested study of the question of adequacy of highway-user payments was made by the Federal Co-ordinator of Transportation and published in four volumes in 1940.[1] Its results indicate that highway users as a group more than pay their way. Not including property taxes on vehicles or federal excise taxes on gasoline or vehicles, which were regarded as contributions to support of general government, total payments by highway users were calculated at $6,132,933,000 in the period 1921–1932 and $4,751,773,000 in the period 1933–1937. Against these payments, costs for the two periods amounted to $5,994,761,000 and $4,363,807,000.[2] Most individual groups of vehicles have paid or more than paid their way. In the case of school buses, farm trucks, small (one and one half tons or less) trucks, and trucks of five tons' capacity, the study concludes, payments made are less than the costs assigned.

The above study reaches conclusions which are so widely variant from the results of other reputable studies that one should note the principal reason for the differences. By far the greatest difference between the co-ordinator's report and that of the three highway engineers in 1939 lies in the allocation of total cost of highway facilities to highway users. Where the engineers' study allocates 90 per cent of costs to users of county and local roads, the co-ordinator's study charges only 34 per cent. Larger percentages are also allocated against users of state highways and city streets in the engineers' report than in the co-ordinator's report. The difference in these percentages amounts to approximately eight billion dollars for the period 1921–1937 and changes overpayments by users into large underpayments.[3] This difference arises from irreconcilable positions which could be held by reasonable people. The crux of the wide difference is the extent to which costs of county, local, and city highways and streets should be allocated to property-owners and the general public rather than vehicle users. If one takes the position that the vehicle users should pay a larger share of the costs than was calculated by the co-ordinator's report, then the highway users are not, as a group, paying their full costs.

Even if the co-ordinator's conclusions are correct, the question of whether commercial transport companies pay their way is not clearly answered.

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation* (Washington: Government Printing Office, 1940). Volume IV deals with the question of aid to highway users.

[2] *Ibid.*, vol. I, p. 26. [3] *Ibid.*, p. 28.

Granting that the co-ordinator gave some effect to taxes levied for general governmental purposes, it still is probably true that commercial carriers have not always paid for the cost of highway facilities *plus* a contribution to general governmental funds comparable to the payments made by railroads.

The tendency of many states to charge much more for common or contract carriage than for private carriage is an example of the misunderstanding of the real nature of the transportation business. Such higher levies have the effect of driving operators into the field of private operation. With public interest in transport what it is, such a result is of doubtful soundness.

If regulation is to proceed upon the basis of the relative economic merits of each kind of transportation agency, sound public policy demands that highway costs be allocated more accurately and impartially. The solution of this problem is fundamental to the working out of the transportation problem, and furnishes a challenge to students both of regulation and of public finance.

C. STATE REGULATION OF MOTOR TRANSPORT

The heterogeneous nature of state regulation of motor transport is well understood; with forty-eight states and the District of Columbia exercising control over motor-vehicle operation, such a maze of regulation is not surprising. In the last few years, however, there has been a noticeable tendency toward more uniformity. The co-operation of regulatory officials of the various states has had effect in the enactment of more uniform laws. The passage of the federal Motor Carrier Act of 1935, by setting up an example of interstate carriage, has done much to bring some order into the variations of state laws.

Some of the difficulty in adequate state regulation lies in the problem of distinguishing between interstate and intrastate operation. Further difficulty has come from the amazing development of the motor-carrier business and the inability of state laws to keep pace with this growth. Common carriers of persons and property have been quite generally regulated by all the states except one; contract carriers have been regulated in varying degrees by most states, but private carriers have been subjected to relatively little regulation.

In the following summary of state regulation, no attempt will be made to distinguish between the variety of such regulations now in effect. Enough will be accomplished here if a few of the problems and general results of state regulation can be ferreted out of the mass of regulatory experience.

1. The Problem of Jurisdiction. In their enforcement of motor-carrier laws, the states have come across two vexing questions of jurisdiction. Especially before the enactment of the federal law of 1935, they were hampered in determining what carriers operating within their borders were properly to be regarded as intrastate; even if they were not entirely intrastate, the question was posed as to how much state control affecting interstate operation was permissible. The second large problem of jurisdiction involved the character of

control which could constitutionally be exerted over contract and private carriers, these not being recognized as falling within the classification of common carriage.

In 1925 the United States Supreme Court held that a state motor-carrier law could not operate so as to interfere with or obstruct interstate commerce.[1] This case arose from an attempt of the state of Washington to require a certificate of convenience and necessity from an interstate carrier. Finding that the regulation was not for safety or highway conservation, but for prohibition of competition, the Supreme Court held that such attempts to regulate interstate commerce, even before Congress had acted, obstructed it. Thus the field of state regulation was limited to measures which would primarily promote safety or conserve the highways. Because of the impracticability of discriminating too much against intrastate carriage by state regulation, the prohibition of state regulatory action of an economic character against interstate carriers greatly curtailed the scope and efficacy of state control before the federal government entered the field in 1935.

An even greater problem of jurisdiction was faced in the attempt to regulate contract carriers. The existence of state power to control rates and services of common carriers was not disputed, this power being the same in principle as that applied to railroads in the nineteenth century; but the common carrier could easily change to a contract-carrier status and so escape regulation. Because contract carriage was early recognized as an important part of for-hire motor transport, the state attempted to bring it under the fold of regulation. Legal provisions relating to safe operation by any carrier have long been accepted as within the police power of a state. But economic regulation dealing with entry into service, service requirements, and rates has not until very recently been so considered, unless the business is found to be one "affected with a public interest." [2]

The Michigan legislature attempted to bring the contract carrier under economic regulation by declaring all persons engaged in transportation for hire upon public highways to be common carriers. The Supreme Court of the United States found this law to be unconstitutional as a taking of property for public use without just compensation.[3] The Court held that the legislature did not have the power to make a carrier in private business a common carrier or to subject any but genuine common carriers to the "duties and burdens of that calling."

The California legislature enacted a statute which did not declare contract carriers to be common carriers, but which did subject them to the same system of regulation as that imposed on common carriers. The law proposed to enforce this by not allowing contract carriers to use the public highways, a privi-

[1] *Buck v. Kuykendall*, 267 U.S. 307 (1925).
[2] See *infra*, pp. 278 ff.
[3] *Michigan P.U. Com. v. Duke*, 266 U.S. 570 (1925).

lege it was claimed the legislature might grant or withhold, unless motor companies submitted to common-carrier regulation. This law was found unconstitutional by the Supreme Court as aiming to do the same thing as was found unlawful in the Michigan case.[1]

The ingenious scheme of regulation passed by the Texas legislature finally brought a measure of economic control over the contract carrier in a way which the United States Supreme Court found to be constitutional.[2] The Texas statute established a different kind of regulation for contract carriers from that applied to common carriers. The regulation of contract carriers, including requirement of "permits" for operation, control over minimum rates, and other matters, was justified by the law as being necessary for the protection of the highways and the traffic thereon from the competition of uncontrolled carriers. The Supreme Court found this regulation to be a reasonable exercise of the state power to conserve and regulate the use of highways.

The question of whether the contract carrier is "affected with the public interest" has not been passed on in any case before the Supreme Court. Common carriers are not the only kind of businesses so affected with the public interest as to admit of economic regulation. Other businesses, from grain warehouses to electric companies, have been found to be in this category.[3] Future constitutional law may well recognize that the conduct of "for-hire," or even private commercial, transport business on the public highways makes a carrier "affected with the public interest." [4]

2. REGULATION OF SERVICE AND SAFETY. Safety regulations have been applied by the states to all kinds of motor transport. General regulations include speed restrictions, size and weight laws, licensing of operators, and requirements of certain equipment standards, such as adequate brakes, stop lights, et cetera. In a few states compulsory assumption of financial responsibility, by insurance or otherwise, has been required in the interests of responsible and safe operation.

In addition, all states exercise special safety regulations over common carriers; many states apply them to contract carriers, and some to private carriers. These regulations include such requirements as maximum hours of service and safety devices on equipment.

Service regulation is for the most part limited to common carriers. Control of entry into service is generally provided for common carriers, and an increasing number of states are requiring permits from contract carriers. Observance of schedules is required by nearly all states for common carriers and by a few states for contract carriers. Prohibition of discrimination in service

[1] *Frost v. R.R. Com. of California*, 271 U.S. 583 (1926).

[2] *Stephenson v. Binford*, 287 U.S. 251 (1932).

[3] See below, Chapter 13, for a discussion of the concept of affectation with a public interest.

[4] Note that the Supreme Court of the state of Washington found contract carriage to fall in the category of businesses "affected with the public interest." See *Prater v. Dept. of Public Service*, 60 Pac. (2d) 238 (1936).

is also provided in most laws, but is applicable to common carriers only. Both common and contract carriers are required by most states to file evidence of financial responsibility in case of accident and to file accident reports. Insurance of cargo from loss and regulation of bills of lading or contracts are demanded by a majority of states for common carriers and by a large number of states for contract carriers.

Few general conclusions can be drawn concerning service and safety regulation. The public interest in highway safety appears to be widely recognized by the state laws. There seems to be a tendency in service requirements, so far as for-hire carriers are concerned, to design state laws after the rigid regulation of service long applied to the railroads.

3. RATES. Regulation of charges made by common carriers is usually included in state laws. Commissions are given the power in nearly every state to fix reasonable rates. Power to fix maximum rates is usually found, and minimum-rate authority is common. Most states make unjust discrimination unlawful and require publication of rates, as well as adherence to published schedules.

Rate regulation of contract carriers is not uncommon, but relatively few states attempt it, and of course no rate regulation of private carriers is provided for in any state. Following the successful plan of Texas, whereby minimum-rate-fixing of contract carriers is authorized for the purpose of protecting common carriage and the highways, several states have placed contract carriers under regulations respecting minimum rates; in addition, several states require contract carriers to file their contracts and their minimum-rate schedules. The relatively scant regulation of contract-carrier rates is based upon the belief that such a business is essentially private in nature. Should future developments establish the contract carrier to be in a business "affected with a public interest," the more complete regulation now applied to the common carrier may become effective for the contract carrier.

4. FINANCE. Because of the need for accurate financial records, nearly all states prescribe a uniform system of accounting for motor common carriers and a large majority of states do the same for contract carriers. While prescribed accounting and the requirement of periodical reports have decided regulatory effects, their primary purpose is to enable the state commissions to obtain reliable and comparable information upon which to base the other aspects of regulation.

Control of security issues of common-carrier companies has been provided for in about half the states. A like number have given their commissions authority to approve or disapprove consolidations and acquisitions of control. Similar regulation has been applied to contract carriers by a few states.

5. EFFECTIVENESS OF STATE REGULATION. State regulation has changed so much in recent years, and certain states are so far advanced in legislation and administrative practice over others, that generalizations as to its effectiveness

are difficult to make. State regulation of passenger transportation has been comparatively successful. Whether common carrier or otherwise, the nature of the passenger business is such that regulation is relatively simple; moreover, states have had more experience with this field of motor regulation and have placed much more emphasis on its control. Until federal regulation was applied in 1935, the most serious problem the states faced with passenger transport was the uncontrolled status of the interstate carrier.

Regulation of carriers of property has been far less successful and faced with far more difficult problems. Perhaps the greatest single problem in this field arises from regulating common carriers and at the same time exerting little or no control over contract carriers. It has generally been recognized that effective motor-carrier regulation cannot be had if the contract carrier is not included within the sphere of control.[1] Evasion of common-carrier regulation by resort to numerous individual contracts or a single contract with a forwarding or storage company has been practiced by many spurious "contract" carriers. Not only does this make enforcement extremely difficult, but the common carrier is discriminated against. Hence this class must bear extra burdens of regulation, and many state tax laws place higher tax levies on it.

State regulation has often been difficult to enforce, even where adequate authority may be found on the statute books. The tremendous number of motor-carrier operators and motor vehicles makes the job of enforcement exceedingly difficult. This fact, the lack of funds of state commissions for enforcement, and apathetic co-operation of local officials have served to make many state laws ineffective. When these factors are considered along with the wide variety of such laws, one is surprised that state motor-vehicle regulation has been as effective as it has.

D. FEDERAL REGULATION: THE MOTOR CARRIER ACT OF 1935 AND AMENDMENTS

In cases decided in 1925 the Supreme Court held that states could not place a direct burden on interstate commerce by regulating the business of interstate motor carriage.[2] This created a situation similar to that in 1886 when the Supreme Court held that states could not place burdensome regulation on interstate railroad transportation. In each session of Congress from 1925 to 1935 bills proposing federal motor-carrier regulation were presented. During this decade, the difficulty of framing an acceptable law for this complex industry and the opposition of certain interested groups kept Congress from passing any federal law, despite the increasing need for such control. In 1928 and 1932, the Interstate Commerce Commission made detailed investigations of

[1] See *Regulation of Transportation Agencies*, Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934), p. 193.

[2] *Buck v. Kuykendall*, *supra*, and *Buck v. Maloy*, 267 U.S. 317 (1925).

the problem and suggested programs of regulation.[1] The Federal Co-ordinator of Transportation likewise made a study of proposed federal regulation and recommended measures.[2]

Opposition to federal regulation came from some parts of the motor-carrier industry, especially from the contract carriers, although many of the larger and better established motor carriers felt that federal regulation would protect them from the "irresponsible" carrier. Farmers, fearing that federal control would hinder their trucking operations to the large markets, rather generally opposed the bill. Motor-vehicle manufacturers also registered some opposition, for they feared that the fast-growing motor-carrier business might be restricted by being placed in a straitjacket of regulation.

After thorough study of the many problems involved, and after the chaotic condition of the motor-carrier industry, resulting from the limitation of state control, had been widely recognized as needing regulation, the Motor Carrier Act was passed in 1935. By this law, regulation of interstate motor carriers was placed under the Interstate Commerce Commission, where nearly all federal carrier regulation has been assigned.

1. POLICY OF THE LAW. The purpose of Congress in enacting the Motor Carrier Act of 1935 was shown in section 202, which provided as follows:

> It is hereby declared to be the policy of Congress to regulate transportation by motor carriers in such manner as to recognize and preserve the inherent advantages of, and foster sound economic conditions in, such transportation and among such carriers in the public interest; promote adequate, economical, and efficient service by motor carriers, and reasonable charges therefore, without unjust discriminations, undue preferences or advantages, and unfair or destructive competitive practices; improve the relations between, and coordinate transportation by and regulation of, motor carriers and other carriers; develop and preserve a highway transportation system properly adapted to the needs of the commerce of the United States and of the national defense; and cooperate with the several states and the duly authorized officials thereof and with any organization of motor carriers in the administration and enforcement of this part.

This statement of policy is interesting because it represents a modern approach to regulation. It indicates a seeing of the problem as a whole. Railroad regulation has been evolved by trial and error over a period of years. When motor-carrier regulation was authorized in 1935, the forty-eight years of experience with railroad regulation made it possible for Congress to draw up a comprehensive law, based on long-developed principles. Not only is this apparent from the statement of policy, but it can also be seen in the provisions of the law. This does not mean that the Motor Carrier Act is a model piece of transportation legislation. As early as 1938, amendments were made which were mainly procedural and for the purpose of expediting and facilitating ad-

[1] See *Motor Bus and Motor Truck Operation*, 140 I.C.C. 685 (1928), and *Co-ordination of Motor Transportation*, 182 I.C.C. 263 (1932).

[2] *Regulation of Transportation Agencies*, Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934).

ministrative action. By the Transportation Act of 1940, further amendments were enacted for the purpose of clarifying the meaning of the law, especially in regard to classes of carriers, exemptions, rates, and accounts.

The Transportation Act of 1940 also repealed the statement of policy which headed the Motor Carrier Act. But a statement of policy, drawn along similar lines, was placed at the head of the entire Interstate Commerce Act to serve as the broad policy for the Interstate Commerce Commission to follow in regulating all rail, water, and motor carriers under its jurisdiction. Although this admirable policy has become the congressional mandate to the Commission for treatment of all carriers under its control, the statutes applicable to the various carriers are still almost as individual as they were before 1940.

In contrast to the results of development of railroad regulation, Congress intimated in the original statement of motor-carrier policy, and directs in the Motor Carrier Act's provisions, that the federal government is not to crowd state regulation from the field.[1] Co-operation with state officials is required, and later in the act the Interstate Commerce Commission is plainly told that it has no power to regulate intrastate rates as a part of the control over interstate rates.

2. Carriers Covered by the Law. The Motor Carrier Act is, of course, limited to motor-vehicle carriers engaged in interstate and foreign commerce. As the concept of interstate commerce has been broadened, particularly in recent years, this grant of jurisdiction involves a power of uncertain magnitude. If the apparent policy of Congress to keep state regulation predominant in local carriage is maintained, the obstruction-to-interstate-commerce doctrine may not become the basis for almost exclusive federal control of motor-carrier operations. However, except for regulation of intrastate rates and a few minor provisions, there is in the law no specific restriction against federal control of intrastate operations affecting interstate commerce.

While certain carriers operating in the general field of interstate commerce are exempt from a part of the law, no such carrier is exempted from the provisions which authorize the Interstate Commerce Commission to fix safety standards of employees, operation, or equipment. Exempted from provisions other than safety regulation are: (1) motor vehicles operated by farmers for transportation of farm produce and supplies; (2) motor vehicles used exclusively for carrying livestock, fish, or agricultural products, but not including articles manufactured from these products; (3) motor vehicles owned or controlled by agricultural co-operatives; (4) trucks handling newspapers exclusively; (5) vehicles used exclusively in connection with aircraft operations;

[1] In par. 202c of the Motor Carrier Act of 1935 (*Laws of U.S.*, 1934 ed., supp. IV, 1934–1938, Title 49, ch. 8, par. 302c), it is provided that "nothing in this chapter shall be construed to affect the powers of taxation of the several states or to authorize a motor carrier to do an intrastate business on the highways of any State or to interfere with the exclusive exercise by each State of the power of regulation of intrastate commerce by motor carriers on the highways thereof."

(6) local carriers, such as school buses, taxicabs, trolley buses, hotel buses; and (7) vehicles used by the Department of the Interior in the national parks.

Except for safety regulation, the Commission is further empowered, to the extent it deems wise, to exempt: (1) interstate operations within a municipal area; and (2) casual, occasional, or reciprocal transportation for compensation by any person not engaged in motor transportation as a regular occupation or business. The municipal area may be a single municipality, a group of contiguous municipalities, or a zone adjacent to and commercially a part of such municipality or municipalities.[1] The first conditional exemption is for the purpose of allowing local control of primarily local traffic, although the transportation might actually be interstate. The second exemption is to allow the Commission to overlook insignificant cases of transportation for hire.

Private carriers are not subject to the law except for regulations regarding qualifications and hours of service of employees, standards of equipment, and safety of operation. In this respect the economic regulations of the act are limited to for-hire carriers, with primary emphasis on the common carrier. Even in regulations affecting contract carriers, the law is based on the principle that they be regulated only to the extent necessary to prevent undue interference with common carriage.

Usually the determination of the status of private carrier is not difficult. But the mere fact that the carrier owns the shipment is not always enough. In some cases the Interstate Commerce Commission has found that the carrier purchases the load, transports it, and sells it at cost plus a charge for carriage. In such cases the Commission has held that the primary function is transportation, that the transport business is not incidental to some other business, and that such a carrier cannot claim exemption on the ground that this is private carriage.[2]

The Commission has followed certain well-defined principles, already noted in defining the various classes of carriage, in determining whether a carrier is a common or a contract carrier. It has defined the contract carrier as follows:

> All contract carriers of property by motor vehicle... shall transport under contracts or agreements which shall be in writing, which shall provide for transportation for a particular shipper or shippers, which shall be bilateral and impose specific obligations upon both carrier and shipper or shippers, which shall cover

[1] In fixing the exempt area of the St. Louis commercial zone, the Commission said: "The commercial zone of a municipality and contiguous municipalities cannot be found to include all of the territory coming within the commercial influence of the municipalities. The commercial zone includes only those areas which are 'commercially a part' of the municipalities and are adjacent thereto. By restricting the commercial zones to areas which are adjacent to the municipalities and contiguous municipalities, it is presumed that Congress intended to restrict such zones to those areas in which transportation by motor vehicle is in the nature of an intraterminal movement." *St. Louis, Mo. — East St. Louis, Ill., Commercial Zone*, 1 M.C.C. 656, 661 (1937).

[2] See *Carpenter Common Carrier Application*, 2 M.C.C. 85, 86–87 (1937); *McBroom Contract Carrier Application*, 1 M.C.C. 425, 427 (1937); and *Monninger Common Carrier Application*, 2 M.C.C. 501, 502 (1937).

> a series of shipments during a stated period of time in contrast to contracts of carriage governing individual shipments.[1]

As for common carriers, the Commission has held that "the essential consideration is the general character of his business and of his holding out to shippers." [2]

3. SAFETY REGULATIONS. As has already been noted, the Interstate Commerce Commission's authority over safety is the broadest of all powers granted to it, and extends to all interstate and foreign commercial transportation of person or property. Even where exemptions have been granted the Commission has reserved the power to prescribe and enforce safety measures. This authority extends to hours and qualifications of employees, safety of equipment, and safety of operation. In the actual definition of safety measures, the widest sort of discretion is left to the Commission.

The Interstate Commerce Commission has put these measures into effect by promulgating various sets of rules from time to time. In 1936, safety regulations were published prescribing qualifications for drivers, certain rules for safe driving, parts and accessories necessary for safe operation, and the reporting of accidents.[3] These were made applicable to common and contract carriers only, the private carrier regulations not being promulgated until 1940. In 1937 rules governing hours of service of common and contract motor-carrier employees were formulated.[4] Made effective late in 1938, these rules prescribe a maximum work week for drivers of sixty hours and require at least eight hours of rest after ten successive hours of driving.

For financial protection of the public the Interstate Commerce Commission has also required carriers and brokers to file certificates of insurance of certain minimum amounts.[5] These certificates are approved by the Commission if adequate insurance is carried in an acceptable private insurance company or if the carrier files a surety bond, or proves to the Commission its ability to insure itself. Most carriers have filed evidence of insurance with private companies. A few have filed applications for self-insurance, and of these a very small number have been approved. In 1940 the Commission reported that it had allowed only twenty-three carriers to insure themselves, because most carriers could not establish to the Commission's satisfaction that they could carry self-insurance without endangering the public interest or the stability of their operations.[6]

During the first years of operation of the Motor Carrier Act, the Interstate Commerce Commission has been forced to prescribe regulations without com-

[1] *Contracts of Contract Carriers*, 1 M.C.C. 628, 632 (1937).
[2] *Slagle Contract Carrier Application*, 2 M.C.C. 127, 134 (1937).
[3] *Motor Carrier Safety Regulations*, 1 M.C.C. 1 (1936).
[4] *Maximum Hours of Service of Motor Carrier Employees*, 3 M.C.C. 665 (1937).
[5] *Motor Carrier Insurance for Protection of the Public*, 1 M.C.C. 45 (1936).
[6] 54th *Ann. Rep. I.C.C.* (1940), p. 111.

plete study. But it has been engaging in extensive research on problems of safety and is planning to modify or enlarge the present basic safety requirements. In this research it has been hampered somewhat by a lack of funds. The enforcement of safety regulations where so many operators, employees, and vehicles are concerned is an unusually difficult task. The Commission has not been able to do a very thorough job, for funds for an adequate field staff have not been appropriated. It has had to rely largely upon the co-operation of motor-vehicle associations and state officials.

One of the most encouraging aspects of federal safety regulation has been the tendency of the states to remold their laws to fit federal requirements. This has had a beneficial effect toward uniformity and has served to make state co-operation in enforcement more effective.

4. ENTRY INTO SERVICE. The Motor Carrier Act adopts the Texas plan of requiring authorization from carriers before entry into service. It does not require such authority from private carriers, nor from carriers in the exempted classes mentioned. But common carriers must receive "certificates of convenience and necessity," and contract carriers must receive "permits" to operate. To meet the problem presented by the fact that thousands of carriers were already in the field, the law gave "grandfather" rights to these carriers. For carriers operating on and since June 1, 1935 as *bona-fide* common carriers, the law directed the Commission to grant certificates of convenience and necessity without question if application was made within one hundred and twenty days after October 1, 1935. For contract carriers, a permit would also be forthcoming automatically on the same basis, except that they must have operated on and since July 1, 1935.

For carriers which could not qualify under the grandfather clauses, certain requirements were set up by the law upon which a permit or certificate should be granted. The act provided that certificates may be issued to common carriers if (1) "the applicant is fit, willing, and able properly to perform the service proposed and to conform to" the provisions of the law and rules of the Commission; (2) the Commission finds the "proposed service . . . is or will be required by future convenience and necessity." Permits are to be given to contract carriers if the Commission finds (1) the applicant to be "fit, willing, and able"; and (2) the proposed operation to be "consistent with the public interest and the policy" of Congress in formulating the law. Thus, the only difference between the requirement for a certificate and a permit lies in the service of a common carrier being required for public convenience and necessity and the service of a contract carrier being consistent with the general policy of the law. The contract carrier apparently need not make as strict a showing of the necessity of service as the common carrier, though it should be remembered that the law contemplates a healthy growth of motor transport and co-ordination of motor and other forms of carriage.

In the first few months of operation of the law, the Interstate Commerce

Commission received 82,477 grandfather applications and 6448 more were filed later.[1] By the end of 1940 an additional 15,760 applications had been filed asking authority to institute new operations, bringing the total applications for permits and certificates to 104,685. At the same time the Commission reported that it had approved 26,891 applications, that there had been denied, dismissed, or withdrawn 66,931 applications, and that a total of 10,863 remained to be approved.[2] The immensity of this task is evident from the number of applications, each requiring investigation both in the field and by an office check of the forms required, and many requiring formal hearings.

The bestowal of grandfather rights by the Motor Carrier Act robs the Interstate Commerce Commission of much of its power to control the character and the supply of motor transportation service. If uneconomic duplication of motor facilities or facilities of all transport agencies existed in June or July, 1935, or if a number of economically inefficient operators were in business at that time, the regulatory commission is fairly powerless to do anything about it. Even so, by setting up high standards of performance, some uneconomic motor carriage can be eliminated. Furthermore, the economic law of the survival of the fittest, coupled with Commission control over new operations, may serve to reduce uneconomic motor transport and make for more efficient units of motor-carrier business. Nevertheless, the economic result of this provision is to postpone effective control over the supply of transportation service.

To the extent that all new applications for service must be approved by the Interstate Commerce Commission, that body does have some control over the supply of transportation facilities. The Commission has taken the position that competition is desirable, whether motor carriers are considered alone or with other transport agencies.[3] At the same time it has recognized that excessive competition may result in poorer service and unstable transport businesses. Where the Commission has evidence that the existing carrier, whether rail or highway, is adequately and efficiently serving the territory in question, and that the traffic would not support another carrier, applications for operation have been denied. Because motor vehicles often give a service different, or superior in some respects, as compared to rail service, the Commission has found cause to allow much motor-vehicle competition with railroads.[4] A similar attitude is taken where a contract motor carrier desires to enter a field already served by a common carrier. While the Commission has found protection of common carriage from destructive competition to be in the public interest, it has freely allowed contract-carrier operations where the carrier can prove cost or service advantages.

[1] 54th *Ann. Rep. I.C.C.* (1940), p. 108. [2] *Ibid.*

[3] *Pan-American Bus Lines Operation*, 1 M.C.C. 190, 208 (1936).

[4] In *Transamerican Frt. Lines, Inc. — Purchase — Gorman*, 5 M.C.C. 712 (1938), at p. 713, the Commission noted that "there is nothing inconsistent with the public interest in providing the public with improved service, even if it should have an unfavorable effect on the revenue of protestants."

5. SERVICE REQUIREMENTS. In addition to safety regulations and provisions for entry into service, the motor-carrier law imposes some further restrictions. Common carriers are required to provide adequate service, equipment, and facilities for transportation of persons or property. The Commission may also require them to establish through routes with other common motor carriers in respect to passengers, and with motor, rail, or water where property transport is concerned. Common carriers are also forbidden to discriminate in service against any person, port, gateway, or description of traffic.

These service regulations have not as yet received much attention from the Commission. However, since they are drawn so closely to those applicable to railroads, the same principles are expected to be applied in their administration by the Commission.

6. RATES. The federal law places practically the same rate restrictions on common carriers by highway as by rail. All rates must be reasonable and non-discriminatory. The Commission is empowered to fix both maximum and minimum rates of common carriers. Making, giving, or causing any undue or unreasonable preference or advantage to persons, places, or traffic is forbidden, although discrimination against traffic of carriers other than by motor is excepted. The Commission may require and regulate the making of joint rates and control the divisions thereof. As is the case with railroads, common carriers by highway are required to post their rates and to adhere to them. Notice must be filed for changes in rates, and the Commission is allowed to suspend rates pending investigation into their lawfulness.

The rule of rate-making formulated in the law directs the Interstate Commerce Commission to take into account in fixing the rate level for common motor carriers substantially the same factors as is required for railroad rate regulation. It must consider (1) the inherent advantages of transportation by common carriers by motor vehicle; (2) the effect of rates upon the movement of traffic by such carriers; (3) the need, in the public interest, of adequate and efficient transportation service by such carriers at the lowest cost consistent with such service; and (4) the need of revenues sufficient to enable such carriers, under honest, economical, and efficient management, to provide such service. In practically all respects rate regulation of motor common carriers parallels the railroad rate law. However, there is no long- and short-haul clause in the motor-carrier law and the Commission is expressly denied authority to regulate rates for intrastate transportation for any purpose whatever. An interesting feature of motor-carrier regulation, not found in the law respecting railroads, is the specification that good-will, earning power, and the value of a certificate are not to be included as elements of value for determining rates.

Much less control over the rates of contract carriers is included in the law. The Commission may require them to file their schedules or contracts showing

minimum charges. To the extent necessary for regulation in accordance with the stated policy of Congress, it may prescribe the minimum charges of contract carriers. Collecting less than the filed minimum rate is forbidden, and reduction of the minimum requires notice to the Commission, which has the usual authority to suspend reductions in charges pending investigation.

Restricting rate control to minimum rates is consistent with the general principle that the contract carrier should be regulated only to the extent necessary for the protection of common carriers and for the development of a healthy motor-transport service. Hence, rate regulation of contract carriers is highly incomplete.

In the general field of rate regulation, there is reason to believe that the Interstate Commerce Commission will follow the well-defined principles developed in a half-century of railroad rate regulation. Because of lack of pressure of high fixed costs, the problem of rate discrimination will probably never be as serious as with the railroads. On the other hand, the pressure of competition has been enough to force many carriers to grant rebates or concessions. In its annual report of 1938, the Commission mentioned that it was giving attention to this evil.[1]

If one is to judge from the cases, the primary problem of rate regulation has had to do with the establishment of minimum rates, both for common and contract carriage. Competitive rate-cutting by motor carriers has long been one of the most troublesome features of this industry. In order to bring stability to the motor-carrier business, the Commission has fixed minimum class and commodity rates in many large operating areas. In fixing these minimums it has established rates above out-of-pocket costs wherever rail or water competition permits.

7. FINANCE. The Interstate Commerce Commission is given authority to require annual, periodical, or special reports from common and contract carriers, to prescribe the manner and form in which such reports shall be made, and to prescribe the accounts of these carriers. A limited control over the issuance of securities by common and contract carriers is also included. If the par value [2] of securities issued and to be issued exceeds $500,000, the issuance falls under the same provisions as those applicable to railroads.[3] In 1938 the security issue regulation was amended so that issuance of short-term notes of two years or less and not aggregating more than $100,000, including all such notes previously issued, is exempt from the law. This exemption is made applicable regardless of the percentage which such notes bear to total outstanding securities.

Consolidations, mergers, and acquisitions of control of contract and common

[1] 52d *Ann. Rep. I.C.C.* (1938), p. 83.

[2] The law states that where no par-value securities are used, the fair market value as of date of issue is to be taken as par value.

[3] See *supra*, pp. 178–80.

carriers are also placed under the supervision of the Commission. The provisions in this respect are similar to those applying to railroads. All kinds of combination are included; whether the combination is effected by merger, consolidation, lease, contract to operate, control of stock, or other device, approval must be obtained from the Commission. Persons not motor carriers come under the jurisdiction of the act if they gain control of any common or contract motor carrier. While these provisions are similar to those of railroad regulation, there are a few significant differences. In the first place, the law does not apply to carriers with twenty or less vehicles so long as the combination is one between motor carriers. Second, no special hindrance exists for combination of motor carriers with other carriers, as is found in the restriction of railroad control of water carriers.

The Interstate Commerce Commission has shown a tendency to follow the principles developed in financial regulation of the railroads, making allowances here and there for the different economic characteristics of highway carriers. In regulation of security issuance, special attention has been given to the avoidance of overcapitalization. The actual investment made in physical property has been controlling evidence of asset values for security issuance, and intangible values have generally been ruled out.[1] Combinations involving motor carriers have been approved rather freely, but where carriers other than by highway desire to combine with motor carriers, the Commission has required that the public interest be "promoted" by such consolidation or acquisition of control.[2]

8. The Broker. Where the broker of motor-carrier services arranges for interstate transportation, he is brought within federal regulation. Under the law, brokers must obtain licenses from the Interstate Commerce Commission. Such licenses may be issued if the applicant is found fit, willing, and able to perform the service of a broker, and if the proposed service is or will be consistent with the public interest and with the declared policy of Congress. In granting these licenses or allowing them to remain in force, the Commission must be satisfied that the bond or other security furnished insures adequate financial responsibility.

Brokers are further subject to accounting regulations and other reasonable rules prescribed by the Commission for the protection of travelers and shippers by motor vehicle. The purpose of regulating brokers is to insure adequate, responsible, and supervised service by this middleman of highway transport.

9. Joint Boards. In addition to reserving the field of intrastate highway operation to the states, the federal law provides a means of co-operation between the Interstate Commerce Commission and state regulatory agencies. Where operations of carriers or brokers are primarily local in nature and do not involve more than three states, the Commission must refer applications and

[1] See, for example, *Union Bus Lines, Inc. — Purchase — Amberson*, 5 M.C.C. 201, 206 (1938).

[2] See *Pennsylvania Truck Lines, Inc. — Control — Barker*, 1 M.C.C. 101 (1936).

complaints to a joint board of representatives of each state concerned. Where such matters involve more than three states, it may if it wishes refer the applications or complaints to such boards. These joint boards are selected by the Commission from nominees approved by the state regulatory agency or governor, and are given the same powers as members of the Commission. Their decisions are final unless exceptions are filed within twenty days after their reports; in the latter case their orders are reviewed by the Commission.

Matters referable to joint boards include applications for certificates, permits, or licenses; applications for approval of combinations; complaints as to violations of the requirements established with respect to service, accounts, reports, hours of employees, safety operation, and financial responsibility; and complaints as to rates or practices of brokers. In addition, the Commission may refer any other matter arising under the law and may ask the board to undertake specific investigations.

The use of joint boards to engage in much of the work of the Interstate Commerce Commission is an interesting administrative device. The magnitude of motor-carrier operations and the great number of operators, as well as the local character of much highway transport, make this device a noteworthy addition to current administrative practice. It makes possible the inclusion of a broad field under a single commission, but at the same time distributes and decentralizes the task of regulation. The great number of joint boards, two hundred and twenty-six in 1937,[1] may make regulation too complex to be effective, especially if the Commission finds that it must review many of the cases decided by the boards. On the other hand, should the method be found successful, its extension to other fields of federal control seems probable.

E. HIGHWAY REGULATION

Regulation of motor carriers is still in a developmental stage. The federal government has only recently entered the field, in spite of the recognized need of such control for a full decade or more before the Motor Carrier Act was passed. In contrast to other fields of transport, motor carriage is primarily local, and state regulation will probably remain the most important part of government control, at least from a quantitative point of view. On the other hand, federal regulation of interstate and foreign carriers, limited as it is, has had and will continue to have a beneficial effect on state motor-vehicle laws.

Moreover, even though the federal law limits the Interstate Commerce Commission to operations which are clearly interstate, the widening scope of such operations may mean that federal control will extend much further into the industry than the framers of the law realized. It is not likely, however, that it will supersede state regulation nearly to the extent prevalent in the railroad field, for as the law is now constituted, discriminations against interstate

[1] I.C.C., *Interstate Commerce Commission Activities, 1887–1937*, p. 222.

rates caused by intrastate rate-making cannot be used as a basis for controlling intrastate charges.

From the point of view of safety regulation, both state and federal control seem adequate. To be sure, state laws are far from uniform, but the interest of the public in highway safety and the influence of federal regulations will tend to remove this deficiency. The shortcomings of highway regulation lie more in the sphere of economic regulation. In the first place, there is no clear regulatory or taxation policy developed which takes into account the hybrid character of public ownership of way and private ownership of equipment. The complete escape from economic regulation of private motor carriers and the relatively incomplete control over contract carriers are gaps of great significance to transport regulation. Most of the business of motor carriage is done by the private and contract carrier. Regulation of entry into service, rates, financial practices, and service requirements other than safety are clearly inadequate to the development of a consistent and fair transport-control policy by which the public interest will be served.

Regulation of highway carriers bids fair to be one of the most complicated tasks undertaken by government. The large number of operators, the variance in operating conditions and service requirements, the difference in types of carriers, the split between federal and state jurisdictions, and the small size of operating units make the enforcement of any kind of government control exceedingly difficult.

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CHAPTER

11

WATER, PIPE-LINE, AND AIR TRANSPORT

A. WATER CARRIERS

THE field of water carriage displays many economic and regulatory characteristics similar to those noted in highway transport. The waterway is furnished and maintained by the federal government, while private enterprise customarily owns and operates the carrying equipment. Even in respect to equipment the government has entered the field as a carrier by its ownership and operation of the Inland Waterways Corporation,[1] which conducts a business on the Mississippi and Warrior Rivers. In contrast to highway carriage, there is little attempt to make privately owned water carriers pay their way on the governmentally furnished waterways, either by tolls or taxes. The water carriers also differ from highway transport in that most operations are interstate or foreign rather than local.

As with the highways, water transport is handled by common, contract, and private carriers. The importance of the last two is evident from data reported by the Federal Co-ordinator of Transportation in 1934. He found that only 31 per cent of the traffic in 1932 on the Mississippi River was transported by common carriers, less than 4 per cent on the Ohio and Monongahela Rivers, and 5 per cent on the Great Lakes.[2] On the other hand, except for tanker traffic, 90 per cent of the intercoastal trade was handled by common carriers, but 95 per cent of the tanker business was by private carriers.[3]

Water carriers are usually classified for regulatory purposes according to their field of operation. The inland water carriers include those operating on inland rivers, canals, connecting channels, and lakes; often a separation is made between carriage on the Great Lakes and other inland water transport. The intercoastal water carriers are those operating through the Panama

[1] See *infra*, Chapter 30.

[2] *Regulation of Transportation Agencies*, Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934), p. 7.

[3] *Ibid.*, pp. 7–8.

Canal between the Atlantic and Pacific coasts. Intracoastal or coastwise transport includes carriage along the various coasts of the United States, but not through the Panama Canal. A further classification is the foreign or ocean-going carrier, operating between ports of the United States and foreign countries.

Some indication of the relative importance of these classes is given by Table III.

TABLE III. INTERSTATE AND FOREIGN WATER TRAFFIC, 1937

Tonnage handled — tons of 2000 lbs.

Rivers, canals, connecting channels	313,287,000
Great Lakes	161,095,000
Intercoastal	7,525,000*
Coastwise	153,461,000
Imports and exports in foreign trade (United States ships)	21,813,000*

* Data for 1936.

Source: U.S. Army, *Report of Chief of Engineers* (1938), pt. 2, pp. 4, 14; U.S. Dept. of Commerce, *Statistical Abstract of the United States* (1938), pp. 420, 421.

The data there presented, however, do not give an accurate picture of the actual volume of traffic handled, since the length of carriage is not shown. Revenue ton-mile data for all carriers by water are not available, but estimates of total freight traffic in the United States show the relative importance of inland water carriers with other inland carriers (Table IV). One should

TABLE IV. COMMERCIAL FREIGHT TRAFFIC IN THE UNITED STATES, 1937 *

(Millions of revenue ton-miles)

Agency of transport	Ton-miles	Per Cent to total
Steam railways	362,815	64.6
Intercity trucks	43,380	7.7
Great Lakes	93,244	16.6
Other inland waterways	16,883	3.0
Pipe lines	44,793	8.0
Electric railways	697	.1
Airways	2	
Total	561,814	100.0

* Does not include purely local commercial traffic.

Source: Report of Committee of Six to the President of U.S., December 23, 1938, pp. 66–67.

realize that even these figures do not take into account differences in rates, and hence gross revenue, attributed to traffic carried by the particular carriers; nor do they make any allowance for circuitous hauls.

Water carriers are ordinarily fairly large-scale businesses as compared to highway operators, though much smaller than the more important railway companies. In some rivers and harbors a number of small operators furnish water-transport service, but the water-carriage industry is generally characterized by relatively few operators. Fixed costs are somewhat more important with water carriers than with highway carriers, but not nearly so much so as in

the rail-transport field, where the carrier furnishes its own way. A motive for discrimination exists in the water-carrier business, to the extent that its fixed costs are important. Owing to a surplus of transport facilities on most waterways, as well as to competition with other carrying agencies, competition has been rather keen. This has caused rates to be very unstable and operations to be none too profitable.

1. WATERWAY PROMOTIONAL POLICY. Both federal and state governments have contributed liberally to the development of waterways. Whether natural waterways have been improved or maintained or artificial ones have been constructed such projects have been vigorously pushed at tremendous expense. Accurate data for these expenditures are not available. The federal government has recorded outlays of well over two billion dollars for investment and maintenance of navigation facilities to 1937.[1] As of 1931, Moulton conservatively estimated expenditures on waterways by states as about $530,000,000.[2] These figures do not include the Panama Canal. Except for the Panama Canal, tolls are not charged for the use of any of these facilities.

a. Reasons for government development of waterways. Modern waterway promotion dates from the opening of the present century. Canal construction of the nineteenth century had been superseded by the railroad years before. In the early part of the twentieth century, however, came a revival of interest in water transportation which has been a cause of governmental outlay for facilities of questionable economic value. There were several reasons for this revival of interest. Many contended that water transportation was cheaper than rail carriage and that the government should stimulate cheap transportation, with its beneficial effects on costs and prices. The popular notion that conservation of natural resources demanded increasing utilization of waterways also had a profound effect in encouraging government expenditures. A third reason was the belief that water competition would be the best regulatory device for railroad rates. The argument was also advanced that the railroads could not handle all the traffic, especially that of bulky and heavy commodities, which water carriers could handle so well. Of importance also was the pressure brought on legislatures by interested communities and others expecting to gain by waterway expenditures.

As Moulton points out, these arguments are not valid reasons for public expenditure of funds on the scale which has actually been undertaken and has been planned for the future.[3] When railroads can be regulated by an administrative commission at a much lower cost, expenditures for waterways for this reason are indefensible. The social welfare is not promoted by any policy guided by selfish interests alone. Natural resources are not conserved in an

[1] See Locklin, D. P., *Economics of Transportation*, pp. 698–99. See also Federal Co-ordinator of Transportation, *Public Aids to Transportation*, vol. III, pp. 11–15. The Co-ordinator estimated annual costs in 1935 for national and local governments to be $145,000,000. *Ibid.*, vol. I, p. 22.

[2] Moulton, H. G., and others, *American Transportation Problem*, pp. 433–34, 440.

[3] Moulton, H. G., and others, *op. cit.*, pp. 434 ff.

economic way if the cost of constructing and maintaining devices to utilize them exceeds that of furnishing transport services by other means.

b. Economics of waterway expenditures.[1] In some fields of waterway development, expenditures are economically defensible. Where natural ways are available, such as on the Great Lakes and the oceans, governmental expenditures for dredging, navigation aids, and port facilities may be justifiable. But altogether too many projects have been economically unsound.[2] Moulton found that the all-inclusive cost of transportation on the New York Barge Canal system was nearly double that on railroads for similar traffic; that the Ohio River costs were three times railroad costs; that the Missouri River improvements cost taxpayers $1720 per ton of traffic handled; and that expenditures for Mississippi River improvements were the equivalent of 33 mills' subsidy per ton-mile on the upper river and 3 mills on the lower river.[3] As sometimes suggested, the government could have obtained cheaper transportation by allowing would-be water shippers to ship by rail at government expense.

In spite of the many occasions when economists have discredited the waterway development program, the code of the "pork barrel" and the tenacious belief that water transportation is cheap transportation have served to keep the program not only alive but downright thriving. Commercial users of the waterways naturally find it cheap, since their expenses are limited to the cost of operating their boats. Military authorities find it valuable for defense purposes. Then, too, once a government has embarked upon a waterway program and vast expenditures have been made, it is not an easy matter to drop these facilities, or to require tolls which would restrict their use. Understanding of the merits of the program is also obscured by the tendency to tie up these projects with flood and soil-erosion control and hydro-electric developments.

Not only have the expenditures for waterways been subject to serious question as to their social and economic validity, but there has been practically no attempt to levy tolls for their use. Taxation of water carriers has not been designed to cover their costs. The admitted subsidy of such carriers is interesting as a part of the government promotional policy toward business. To a student of transport regulation, however, the subsidy element is important as bearing on the general problem of effecting transport co-ordination, by regulation or otherwise.

In the sphere of foreign commerce, shipping subsidies have been allowed by the federal government for ships themselves and for harbor and navigation facilities. In some respects these are not as open to question as are subsidies for

[1] For a thorough discussion of waterway promotional policy, see the report of the Federal Co-ordinator of Transportation, *Public Aids to Transportation*, vol. III.

[2] For a discussion of the projects see Moulton, H. G., and others, *op. cit.*, chap. XXIII; Miller, S. L., *Inland Transportation* (New York: McGraw-Hill Book Company, Inc., 1933), chaps. XXXV and XXXVI; Daggett, Stuart, *Principles of Inland Transportation* (New York: Harper and Brothers, 3d ed., 1941), chaps. III and XXV.

[3] Moulton, H. G., and others, *op. cit.*, chap. XXIII.

carriers of domestic commerce. Ocean vessels do not compete with other means of transportation; subsidizing them may not complicate the problem of regulation and transport co-ordination. But the economic basis of such subsidies may not necessarily be sound; if foreign ships can carry commerce much more cheaply than American ships, the economic law of comparative advantage would seem to operate in favor of the former. Even though questionable from an economic point of view, the policy of subsidizing the merchant marine has some value from the standpoint of national defense; indeed, this has been the main justification for it. A recent study of the problem, however, has indicated that defense value has been grossly overrated.[1]

2. General Characteristics of Water-Carrier Regulation. Regulation of water carriers has been piecemeal in character, confusing as to division of authority, and generally inadequate. Even where regulatory powers have existed, their enforcement has not always been effected. Because of the ease of entering water-carrier business, the large number of contract and private carriers, and competition of land carriers, the industry has been subject to the free play of competition. This fact has had much to do with the slowness with which regulation in economic matters has developed.

Regulation for safe service has been imposed on water carriers for many years by both state and federal governments. Navigation controls have dated from the ratification of the Constitution. Federal steamboat inspection was provided for fairly early in the nineteenth century. The Interstate Commerce Commission was given jurisdiction over water carriers engaged in water-rail operations by the original act of 1887, and this jurisdiction was enlarged by the Panama Canal Act of 1912, the Inland Waterways Corporation Act of 1924, and the Transportation Act of 1920. It should be noted, however, that these laws were largely drawn for the purpose of forcing rail-water co-operation and protecting the water carriers from railroad competition.

Regulation of water-carrier rates, finance, and service has been provided in many states for local commerce for some time. However, even the better state laws have often been limited to intrastate rates and rate practices, with occasional regulation of finance. These regulations have ordinarily applied only to common carriers, and the requirement of a certificate or permit to operate has been relatively rare. The Federal Co-ordinator of Transportation found in 1934 that "many of the states which have enacted comprehensive regulatory laws are doing little or nothing in the way of enforcement, doubtless because waterborne traffic is of relatively minor importance."[2]

Until 1940, federal regulation came from several pieces of legislation in addition to the special jurisdiction of the Interstate Commerce Commission over rail-water operations. The Shipping Act of 1916 established the United

[1] See Zeis, P. M., *American Shipping Policy* (Princeton, New Jersey: Princeton University Press, 1938), chap. XIV.

[2] *Regulation of Transportation Agencies*, Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934), p. 161.

States Shipping Board and charged it with supervision over rate discriminations and other discriminatory practices of common carriers; for interstate common carriers, the Board was given the power to fix maximum rates. The scope of the act was limited to carriage on the high seas, on the Great Lakes, and in interstate coastwise traffic. Thus, intercoastal and inland waterways other than on the Great Lakes, as well as contract and private carriers, were excluded. The Intercoastal Shipping Act of 1933 extended this regulation to the intercoastal service and included both common and contract carriage. The Merchant Marine Act of 1936 set up the United States Maritime Commission to take over all water regulation except that under the Interstate Commerce Commission. In 1938 an amendment was passed granting a minimum-rate power to the Maritime Commission in intercoastal and coastwise shipping.

The chaotic condition of water-carrier regulation before the passage of the Transportation Act of 1940 may be made somewhat clearer by pointing out the former jurisdictions of the Interstate Commerce Commission and the Maritime Commission. The former had jurisdiction only over interstate and foreign common carriers of persons or properties, partly by railroad and partly by water, when both were used under a common control, management, or arrangement for a continuous carriage or shipment. The Interstate Commerce Commission also had complete jurisdiction over any water carrier owned or controlled by a railroad to the same extent as it now has over railroads. The Maritime Commission had jurisdiction, except where the Interstate Commerce Commission already possessed it, over (1) interstate and foreign common carriers in oceanic ("by the high seas"), coastwise, intercoastal, and Great Lakes traffic; and (2) contract carriers in the intercoastal trade. This left unregulated by the federal government intrastate water carriers, interstate inland water carriers except on the Great Lakes, all private carriers, and all contract carriers except in the intercoastal trade.

The regulations applicable to types of carriers in each kind of service also varied to a great degree. The jurisdictions of the Interstate Commerce Commission and the Maritime Commission were confused and overlapping. Regulation under the Shipping Board and its successor, the Maritime Commission, was mixed in with the administration of the subsidy policies toward the merchant marine. Indeed, these two bodies were so busy with the problem of subsidy allocation that regulation was not very effective. Before 1933, according to a statement of a Shipping Board official, the Board did little in the way of regulation.[1]

3. Regulatory Changes of the Transportation Act of 1940. Perhaps the most important contribution to regulation made by the Transportation Act of 1940 was the revamping of water-carrier regulation and the introduction of federal control over inland water carriers. Except for safety regulation and control over common carriers in foreign commerce, all the control of

[1] Zeis, P. M., *op. cit.*, p. 168.

water carriers was placed entirely under the jurisdiction of the Interstate Commerce Commission. Thus for the first time interstate inland, intercoastal, and coastwise carriers were brought under the jurisdiction of one commission. Also new was the application of economic regulation to inland carriers.

Numerous exemptions are made from the 1940 law, however, and it can hardly be regarded as a complete regulation of water carriage. Local and small operations in interstate commerce are excepted. Contract carriers which do not compete "actually and substantially" with other types of transport agencies are placed outside the law. Private carriers, and even carriers transporting property solely of the person owning or controlling them, are exempted. The act goes so far as to exempt common carriers which transport goods in bulk in cargo space used for not more than three commodities, and common carriers of liquid cargoes in bulk in tank vessels. Although the act ostensibly applies to operations in interstate and foreign commerce, transportation to or from points outside the United States is not included, at least to the extent of the portion of the movement outside the United States. Furthermore, the act explicitly forbids the Interstate Commerce Commission to regulate the rates or services of any intrastate carrier, even where advisable to remove discriminations against interstate commerce.

These exemptions are worth noting. Bulk carriers predominate in the domestic water-carrier business; oil, grain, ore, coal, lumber, and other products, carried in large volume, are almost entirely transported by them. All these would be exempt under the law. An important part of the inland water commerce travels over such intrastate canals as the New York Barge Canal, and would thus seem to be effectively omitted from the law. Much water traffic is also handled by private carriers or by companies owned by, and transporting exclusively for, shippers of the freight. This traffic would be excluded. Although one cannot estimate accurately how much of the water-carrier business is exempted from regulation, the amount is considerable and represents traffic which competes with regulated carriers, particularly the railroads.

The regulation of the new law is fairly thorough for the carriers to which it applies. Rates, routes, and service of common carriers are regulated almost to the degree found in railroad control. Rates of contract carriers are regulated in much the same way as those of contract motor carriers. Common carriers must obtain certificates of convenience and necessity before entering into service, and contract carriers must obtain permits. Strict accounting regulation is also imposed. The long- and short-haul clause, long applicable to railroads, is extended to common carriers by water under the law. Combination of water carriers by pools, mergers, acquisitions of control, or other means is placed under the same general kind of control as is applied to railroads.

4. Safety Regulations. The Department of Commerce has wide supervisory powers over all interstate and foreign water carriers, whether common,

contract, or private, in matters connected with navigation, equipment, and safe operation. This power is broad enough to include any regulations or requirements in the interests of safety. As the result of some major disasters at sea, new safety regulations were passed in 1935 and 1936.[1] These increased the liability of shipowners in marine accidents, reorganized the administrative agencies charged with safety regulation, provided means for checking more accurately on the qualifications of crews, and required adoption of certain safety devices and practices.

The administration of safety regulation has been subject to more criticism than the content of the laws themselves. In 1936 the Bureau of Navigation of the Department of Commerce was widely criticized as allowing unsafe conditions and laxly enforcing safety laws. As a result, in addition to the wave of new legislation, measures were devised to insure stricter enforcement. Additional supervisory and traveling inspectors were hired. A technical staff was created to pass upon safety standards, and special boards of inquiry, outside the Department of Commerce, were empowered to investigate accidents. With these new regulations it was hoped that political influences would be reduced or eliminated and that safety regulation might reach the standard of effectiveness found in the railway field.

5. SERVICE REGULATION. Until 1940, water carriers were not required to obtain certificates of convenience and necessity or permits of any kind before entering service. A possible exception can be found in railroad ownership and control of water carriers, which has had to receive the approval of the Interstate Commerce Commission; but this did not mean that in the absence of such control or ownership a water carrier needed to receive any permission to operate. Water carriers have also had to be licensed by the Department of Commerce, but as an aid in enforcing safety requirements rather than for determining the public need for such service. The Inland Waterways Corporation Act had also authorized the Interstate Commerce Commission to grant certificates to common carriers on the Mississippi and Warrior Rivers. Such a certificate, however, was not a permit to operate, but merely certified that the water carrier had the legal right for establishment of joint water-rail service and rates.

Under the 1940 law, common carriers by water to which the legislation applies must obtain certificates of convenience and necessity. The Interstate Commerce Commission is directed to grant such certificates if it finds the applicant fit, willing, and able properly to perform the service proposed and to conform to rules and regulations, and if the service proposed is found to be required by the present or future public convenience and necessity. The Commission is empowered to attach such terms and conditions as are deemed necessary in the public interest, including limitations and extensions of routes, but not including any limitation on the expansion of equipment or any restriction on

[1] Zeis, P. M., *op. cit.*, pp. 176–85.

the use of new waterways authorized by Congress. Carriers operating in *bona-fide* service prior to January 1, 1940,[1] are automatically granted certificates of convenience and necessity under the act.

Contract carriers subject to the new law are required to obtain permits from the Interstate Commerce Commission. The Commission is authorized to grant them if it finds the applicant fit, willing, and able to perform the service and to conform with the law, and if such service will be consistent with the public interest and the national transportation policy of the Interstate Commerce Act. The conditions and terms which the Commission may attach to the permit are similar in nature to those which may be attached to common-carrier applications. Moreover, all contract carriers operating on January 1, 1940, are entitled to permits upon application.

Before 1940, the Interstate Commerce Commission had power to regulate joint rail-water service, and to require railroads to interchange joint traffic, establish through routes, and furnish facilities for interchange. This power was extended to interchange between water carriers in 1940, and now common carriers by water must make reasonable through routes and rates and afford reasonable, proper, and equal facilities for interchange of traffic with other water carriers and with railroads. Although the enforcement of interchange of traffic between railroads and water carriers seems to be fair, it must be admitted that the results have been largely favorable to water carriers, because much interchange forced on the railroads represents traffic that they could easily have handled by land.[2]

The law further forbids common carriers by water to make, give, or cause any undue or unreasonable preference or advantage to persons, places, or kinds of traffic. This provision obviously includes service discrimination as well as that in rates. Although the Maritime Commission had jurisdiction over service discrimination of many classes of water service before 1940, relatively little real regulation developed, because of reliance on the conference method of control, to be discussed presently, and the primary interest of the Commission in allocating shipping subsidies. Moreover, the existence of so much unregulated competition has made elimination of unreasonable discrimination a most difficult task.

6. Rate Regulation Before 1940. Before the law was clarified somewhat in 1940, regulation of water-carrier rates was subject to confusion and to rather inadequate administration. The more effective rate regulation was that applied by the Interstate Commerce Commission to water carriers under control of railroads and to joint rail-water traffic. The former were subject to practically the same rate regulation as was imposed on railroads. On joint rail-water traffic, the Commission had complete power over the railroad part

[1] Or, if engaged in seasonal service, operation during the preceding period is necessary.

[2] For discussion of the administration of this power, see Locklin, D. P., *op. cit.*, pp. 736–40, and Sharfman, I. L., *op. cit.*, vol. II, pp. 32–51.

of the rate and over the division of rail-water rates, but could fix only the maximum rates of the water part of any haul. Consequently, if water carriers chose to cut their portion of the rate below the maximum or to engage in discriminatory rate practices, the Commission was powerless to act. As a matter of fact, its chief function was to control the division of joint rates and to safeguard water carriers against the superior bargaining power of railroads.

The jurisdiction of the Maritime Commission was limited to the extent that the Interstate Commerce Commission found cause to regulate. As powers stood before 1940, the Maritime Commission had authority to fix maximum rates for all common carriers except those on inland waters outside of the Great Lakes. Maximum- and minimum-rate regulation of contract carriers in the intercoastal trade was provided. Power to fix minimum rates was also established in 1938 as to all common carriers under the Maritime Commission, except for those operating on the Great Lakes and in the foreign trade. Neither maximum- nor minimum-rate powers existed, or still exist, over carriers in the foreign, as contrasted to interstate field, but the Commission may pass upon rate reasonableness.

Regulation of discriminatory practices of interstate and foreign carriers extended to cases of unreasonable advantage or prejudice to persons, localities, and descriptions of traffic. Only deferred rebates,[1] however, were definitely prohibited, since they were thought to give the carrier too great control over shippers. Other rate discrimination, if found to be reasonable, was held to be valid. In 1933, for example, the United States Shipping Board approved as reasonable a rate involving goods in foreign commerce which made a lower charge to shippers agreeing to patronize members of a conference.[2]

An important part of the regulation of water carriers has been the imposition of self-regulation through agreements or conferences. The latter are simply agreements regarding such matters as rates, allotment of traffic, pooling of earnings, and methods to be employed to meet competition of non-conference members. Long practiced by American and foreign shipping lines, they were legalized by the Shipping Act of 1916 and were placed outside of the national anti-trust laws, if filed with and approved by the Shipping Board (since 1936 the Maritime Commission). Unlike railroad pooling agreements which might be approved by the Interstate Commerce Commission, the conferences could legally fix rates or the terms of special privileges and advantages.

Although the conferences have not been able to stabilize rates and other

[1] Deferred rebates have been defined in the law as "a return of any portion of the freight money by any carrier to any shipper as a consideration for the giving of all or any portion of his shipments to the same or any other carrier, or for any other purpose, the payment of which is deferred beyond the completion of the service for which it is paid, and is made only if, during both the period for which computed and the period of deferment, the shipper has complied with the terms of the rebate agreement or arrangement." See sec. 14, Shipping Act of 1916.

[2] *Rawleigh Co. v. Stoomvaart*, 1 U.S.S.B. 285 (1933). This practice was disallowed in a case concerning such rates in the intercoastal trade. See *Intercoastal Investigation*, 1 U.S.S.B.B. 400 (1935).

shipping practices, they have been somewhat successful in bringing competitive actions under control. They have played a conspicuous part in water-carrier regulation and will probably continue to do so, especially in the foreign trade, where American regulatory jurisdiction is limited. Reliance even by regulatory authorities upon self-regulation through conferences will probably not cease to be an integral part of water-transport control. In 1938 the Maritime Commission had 2227 approved agreements on file and an average of 100 new or modified agreements were being filed each month.[1]

7. RATE REGULATION UNDER THE TRANSPORTATION ACT OF 1940. For those carriers to which the law applies, the Transportation Act of 1940 provides for stricter regulation of rates than before, and places all such control under the Interstate Commerce Commission. Somewhat different control of common-carrier and contract-carrier rates is provided for, with much broader control over the former.

Rates of common carriers are required to be just and reasonable, as respects both the rate level and individual rates. The Interstate Commerce Commission is given the power to fix maximum or minimum rates, and to prescribe reasonable divisions of rates between connecting carriers. In establishing reasonable rates, the Commission is directed to give due consideration, among other factors, to their effect upon traffic moved by the carrier or carriers for which they are prescribed; to the need for adequate and efficient water service at the lowest possible cost; and to the need for revenues sufficient to enable water carriers to provide such service under honest, economical, and efficient management. The Commission is specifically charged not to consider as evidence of value such intangible items as good-will, earning power, or the certificate under which the carrier is operating.

In passing upon the division of rates between carriers, the Commission is directed to consider the efficiency of participating carriers; the amount of revenue necessary to pay operating expenses, taxes, and a fair return upon property used for transportation; the importance to the public of transportation service given by the carriers; and factors, such as the origination of traffic, which would entitle one carrier to a greater or lesser proportion of the division than other carriers.

Under the new law, common carriers by water are forbidden to make, give, or cause any unreasonable preference or advantage in rates to any person, place, or description of traffic, except traffic of other kinds of carriers. Long-haul rates lower than short-haul rates over the same line are prohibited, with the same possibility of relief as was the case with railroads.

The rates of contract carriers are subject only to the requirement of a reasonable minimum, and the Interstate Commerce Commission is given power to fix minimum rates only for this class of carrier. It must see that these rates

[1] **Eisenhart, J. H., Jr.**, "United States Maritime Commission's Regulatory Jurisdiction," 201 *Ann. Am. Acad.*, pp. 227–32, at p. 229 (January, 1939).

do not contravene the national transportation policy set up by the act. This policy declares, among other things, that Congress desires all forms of transportation to be regulated impartially, with recognition of the inherent advantages of each, and for the purpose of developing a sound and adequate national system of transportation. The solicitude of Congress for the common-carrier business and the desire to protect such carriers are exemplified in the provisions of the law by which the Commission is ordered to see that no approved minimum rate of contract carriers gives them an undue advantage over common carriers, unless such rate is justified fully by the cost of service.

The rates of common carriers and the minimum charges of contract carriers must be published and adhered to under the law. Changes in rates must be made by application to the Commission, and the latter has power to suspend rates, pending investigation, either upon its own motion or upon complaint.

8. Other Water-Carrier Regulations Under the Act of 1940. The Transportation Act of 1940 places common carriers by water under the same provisions as railroads in respect to pooling agreements, consolidations, and other kinds of unification, except that water carriers are not hampered by the more specific labor-displacement provisions. Although the Interstate Commerce Commission is asked to consider the interests of labor in a water-carrier combination, there are no provisions that labor harmed by combination must be cared for by an acceptable plan, and that it may not be put in a worse position with respect to employment for four years. These latter restrictions apply to railroad combination only. Control over acquisitions of stock and non-carrier holding companies follows the same provisions as those effective for railroads.

The Interstate Commerce Commission is also given complete control over the accounting of common and contract water carriers. It may require periodical and special reports, and is directed, as soon as practicable, to set up depreciation accounts. Adequate power to enforce its orders and to police the activities of carriers is also given to the Commission.

9. Water-Carrier Regulation: Conclusions. Much of the legislation enacting regulation of water carriers is so new that one can hardly draw conclusions as to its adequacy or effectiveness. Water-carrier regulation has largely developed in the last ten years, in spite of fairly complete early control over safety and some scattered examples of economic regulation. Until 1940 it was piecemeal and inadequate, and lax enforcement of such laws as did exist created a situation approaching the chaotic. Some carriers were regulated by the Interstate Commerce Commission, some by the Maritime Commission, and some (those having joint rail-water as well as port-to-port traffic) by both commissions. Private carriers were, and still are, exempt from all regulations except those pertaining to safety. Contract carriers were regulated in only a small part of the field. Even inland interstate common carriers were unregulated, except for safety, unless they operated on the Great Lakes.

At the same time, the water-carrier industry has been demoralized and financially unstable. Competition within it and with other carriers has lowered rates and reduced earnings. Despite the belief that low rates are beneficial to shippers, the broader public interest would seem to demand a more stable industry capable of handling water-transport needs with efficiency and responsibility. The long-run costs of destructive competition are well known. Unstable transport rates are disruptive to commerce and industry. Furthermore, the co-ordination of various transport agencies cannot be brought about if regulation of any class of carriers remains inadequate.

The need for regulatory reform of the water-carrier industry has been long recognized, and the Transportation Act of 1940, as well as other laws passed since 1933, has done much to meet that need. The result is that water carriers have at last been brought under the jurisdiction of a single commission, and one which, unlike the Maritime Commission, is not charged with promotional activities. The new legislation has subjected such water carriers as come under the law to control which is nearly as complete as is found in the case of railroads.

To be sure, there are many gaps, even in the new law. As was noted in discussing the exemptions under the 1940 act, a great many water carriers which are transporting goods for business purposes and which are competitive with other transport agencies are outside the law. Furthermore, several important provisions applicable to railroads are not imposed on water carriers. One finds no such complete control of equipment and its use. No special regulation of issuance of securities is included in the law. Moreover, water carriers are not subject to the impediments placed in the way of railroad combination by restrictive labor safeguards.

Within the limits of the law, we may expect to see much more thorough and effective regulation of water carriers under the Interstate Commerce Commission. Although water carriage should be neither favored nor hampered, the industry should be dealt with in line with a policy looking for an efficient and economical national system of transportation.

B. PIPE LINES

The pipe line is one of the oldest methods of transportation, having had its beginnings in the water aqueducts of antiquity. In 1865 an oil pipe line four miles long was successfully put into operation in the western Pennsylvania field. In 1870 a wooden pipe line was built to carry natural gas a distance of twenty-five miles in northern New York State. In more recent years pipe lines have been laid for the transportation of gasoline, and experiments have been made for using crude oil pipe lines for the transportation of both crude oil and refined products. Experiments have also indicated the possibility of carrying such products as alcohol, wheat, and pulverized coal by pipe line.

There were approximately 115,000 miles of oil pipe lines and 6500 miles of gasoline pipe lines in the United States in 1938.[1] Of the oil pipe lines, slightly less than half are trunk lines, the remainder being feeders. The lines extend from southern Texas and Wyoming to Chicago, to the Great Lakes, and to the Atlantic seacoast. Gasoline pipe lines are not nearly so extensive, but pipes run from Texas to Chicago and from St. Louis and Toledo to the Atlantic. Transportation of natural gas by pipe lines accounts for well over fifty thousand miles of trunk lines and many additional miles of feeder and distributor lines.[2] Natural gas transport operations are nearly as extensive as oil pipe lines. Water pipe lines are of little commercial importance, being used almost entirely as feeders from relatively near supply sources to city distribution systems.

The importance of commercial pipe-line traffic is shown above,[3] the ton-mileage being 8 per cent of the total commercial traffic of the United States. Of the 190,000,000 tons of crude and refined petroleum transported in the United States in 1937, over 70 per cent moved by pipe line.[4] All natural gas moves thus. By far the greater part of crude petroleum is so transported, and an increasing, but relatively small proportion of petroleum products is being carried by pipe.

1. Economic Characteristics of Pipe-Line Transportation. The pipe line is a highly specialized mode of transport. While it has been extended to several different commodities, these are very few in number. Moreover, any given pipe line is fitted only for a certain commodity, or at best a few related ones. This means that the pipe line makes no such wide contact with the public as do other carriers. Public interest in it has usually sprung from the desire to see competition in the industry whose goods are carried, as with oil, or to regulate the companies distributing the product, as with natural gas.

The specialized nature of pipe-line transport has also tended to make it one where control or ownership is vested in the industry whose product the line handles. The pipe line is looked on as a necessary facility for conducting an oil or gas business. Because of the investment required to build a long pipe line from producing fields to the consuming market, this ownership has usually rested in the hands of the larger oil or gas producers and sellers. This characteristic of ownership and the cost of construction have served to make the pipe line a field of transport in which the smaller business man is at a particular disadvantage.

Pipe lines have been constructed almost entirely with private capital, there being only negligible land grants such as contributed somewhat to railroad

[1] *Investigation of Concentration of Economic Power* (Hearings before the Temporary National Economic Committee, 76th Cong., 2d Sess.) Pt. 14A, pp. 7722–29 (1940).

[2] Federal Trade Commission, *Utility Corporations*, Sen. Doc. No. 92, 70th Cong., 1st Sess. Pt. 84–A (1936), p. 27.

[3] See p. 225.

[4] *Report of Committee of Six to the President of U.S.* (December 23, 1938), p. 74.

building.[1] This is in marked contrast to the public expenditures for highways, waterways, and airways. Although most states grant rights of eminent domain to pipe lines, companies have not used this power extensively to obtain right of way, this right often being purchased as a completely private business transaction.

The pipe-line business has been very profitable, return on recorded investment ranging from 18 per cent in 1929 to 14 per cent in 1937 and 10 per cent in 1939.[2] To be sure, these profits are in a sense paper profits; most of the oil pipe-line business, for example, is done for owning companies which have little interest in the rate paid, since profits return to these companies. At the same time, costs of transportation are low by pipe line as compared to other carriers. Excluding capital costs, the Federal Co-ordinator of Transportation found that pipe-line operating cost was 3.2 mills per ton-mile, as compared to 8.3 mills for rail carriers, 6 mills for water carlot carriers, and 1.25 mills for water cargo carriers.[3] Pipe-line rates for crude petroleum have been found to average a little less than half of railroad rates.[4] Hence, where pipe-line competition is available the railroads have almost no opportunity of receiving crude oil traffic. In transportation of oil products, the pipe-line charges are more nearly equal to railroad charges. The water carrier, where it can be used, has a decided rate advantage over both pipe lines and railroads.

Pipe-line costs are predominantly fixed, making full utilization of the line especially desirable. This would seem to make rate-cutting and discrimination a probable result, but the tendency for large producers to build lines for their own use has reduced this threat.

2. Basis of Pipe-Line Regulation. From a regulatory point of view, the pipe line has been relatively unimportant. State governments regulate pipe lines, the Interstate Commerce Commission has had jurisdiction over interstate petroleum lines since 1906, and the Federal Power Commission was given power to regulate interstate gas lines in 1938. Except for the rare requirement of certificates of convenience and necessity, these laws are practically as broad as those applicable to other carriers. The record of enforcement, however, is meager. Serving very few shippers, handling usually a single commodity, and often owned by the chief customers, the pipe line does not need much control to protect the public interest.

The basis for public interest in oil pipe lines is found mostly in the necessity for protecting small producers and refiners from the large companies owning pipe lines. Control over a pipe line can be used by a large oil company as a means for curbing the independent company. By setting high rates for transport or high minimum tender requirements, the company owning its line can

[1] The Federal Co-ordinator of Transportation found (*Public Aids to Transportation*, vol. I, p. 34) that public lands valued at $77,000 had been given to pipe lines for rights of way over public domain.

[2] See I.C.C., *Statistics of Railways* for years mentioned.

[3] *Freight Traffic Report* (1935), vol. I, p. 79. [4] *Ibid.*, vol. II, p. 104.

place the independent at a decided economic disadvantage, forcing it to sell its oil at the pipe-line gateway at whatever price the large company wishes to pay.

Another reason for public interest in oil pipe lines lies in the fact that they compete with regulated carriers, particularly the railroads. To develop fair and economical transportation competition, some regulation of pipe lines would appear to be in the public interest.

Gas pipe lines do not compete directly with any other carrier. Indirectly they compete with the railroads, for the increasing use of gas for industrial purposes has meant a decline in the demand for coal, with a resultant effect on railroad coal traffic. In many cases before the Interstate Commerce Commission, the effect of this competition on railroad rates has played a part in fixing railroad charges.[1]

Ownership of gas pipe lines by public-utility gas systems has also been a basis for regulation. The absence of "arm's length bargaining" between pipe line and distributor, plus the inability of states effectively to reach the interstate pipe line, had much to do with the placing of these lines under federal control in 1938. Through its interest in gas rates and service, the public has found a reason for regulating the gas pipe line.

3. Extent of Regulatory Authority. Every state in which the principal pipe-line operations of oil and gas carriers are found has placed them under regulation. Most states have declared all pipe lines to be common carriers. They are given the right of eminent domain in obtaining their way. Ordinarily placed under a railroad or public-utilities commission, these operators are required to file rates, make reports, and keep uniform accounts. Most state commissions have powers to fix rates and to prohibit discriminatory practices. As already noted, state laws do not generally require permits for entry into business. Since most large-scale pipe-line operations are interstate, the restricted area of jurisdiction has made control by states rather difficult. On the other hand, through their conservation powers the states have had a material effect on pipe-line operations by fixing oil and gas production quotas.

Oil pipe lines were placed under the jurisdiction of the Interstate Commerce Commission in 1906. Following disclosures showing rebates and discriminations in favor of large oil companies (usually having an ownership interest) against the smaller companies, pipe lines were included as carriers under the Interstate Commerce Act. By this inclusion, practically all the regulation applicable to railroads became effective for oil pipe lines. A few special regulatory provisions, especially the commodities clause, did not. Gas and water pipe lines were also specifically exempted from federal regulation.

In 1938 natural gas pipe lines were placed under the Federal Power Commission. By the Natural Gas Act, all persons owning or operating any gas-transportation facilities in interstate commerce are subject to regulation. Certificates of convenience and necessity must be obtained where a gas com-

[1] See, for example, *Coal from Illinois, Indiana, and Kentucky*, 215 I.C.C. 593 (1936).

pany contemplates extending its lines into a territory already being served by a natural gas company. Gas pipe lines under the Commission must file reports and rates and keep uniform accounts. Upon its own motion, or the request of any state commission, the Commission may investigate the cost of transporting and producing natural gas, and may fix a rate for interstate carriage. The transport provisions of this act are tied in with regulations of the price of the gas itself, and are designed to aid in more effective regulation of local gas utilities by state public-service commissions. Strictly speaking, the Natural Gas Act is primarily a federal regulation of gas rates, rather than carrier control. This is a reasonable regulatory approach, since gas pipe lines are usually in effect mere departments in the business of certain large gas utility systems.

4. The Problem of Common Carriage. Experience with commission regulation of pipe lines is very limited. Gas pipe-line regulation is too new to provide any basis for judging regulatory policy. Oil pipe-line regulation has taken very little of the Interstate Commerce Commission's time. In spite of a vast reservoir of power over pipe lines, the Commission has done very little with them. It has prescribed accounts, had rates filed, and required reports. Yet in thirty-one years of regulation the Commission had before it only three cases dealing with pipe lines.[1] By far the most important of these cases had to do with the question of whether pipe-line companies which owned oil transported by them could be classed as common carriers under the law.[2] Another fixed minimum tender requirements,[3] and the third was an investigation of rates, rules, and practices of many important companies.[4]

In the common-carrier case, the question of jurisdiction was presented. Most oil pipe lines admittedly did not hold themselves out as being willing to transport oil of all comers. The current practice was to purchase all oil not previously produced by the line owner before transporting it. Unless used in the pipe-line owner's refinery, it was sold after transportation. Under these circumstances the pipe-line operators claimed to be private carriers of oil.

The Interstate Commerce Commission took the position that in spite of ownership of oil by the carriers, they were actually in the business of common carriage as contemplated by the law. The law of 1906 had not defined common carriage as for-hire transportation, but had included all pipe lines which "shall be considered and held to be common carriers within the meaning and purpose" of the act. After considering the legislative purpose of the law, as well as the fact that pipe-line regulation would be virtually meaningless with any other construction, the Commission applied its common-carrier regulation to all interstate pipe lines purchasing or selling any oil or, of course, transporting it for hire.

[1] I.C.C., *Interstate Commerce Commission Activities, 1887–1937* (1938), p. 234.

[2] *In the Matter of Pipe Lines*, 24 I.C.C. 1 (1912).

[3] *Brundred Bros. v. Prairie Pipe Line Co.*, 68 I.C.C. 458 (1922).

[4] This investigation, known as Docket 26570, was still being undertaken in 1940.

The pipe lines attacked this decision as taking property without due process of law, claiming that the Commission was impressing obligations of common carriage on a private carrier business. The United States Supreme Court upheld the Commission, however. It held that these carriers were in substance common carriers, for "they carry everybody's oil to a market, although they compel outsiders to sell it before taking it into their pipes." [1]

5. OTHER REGULATION. In the second case, the Interstate Commerce Commission ordered a pipe-line company to reduce its tender requirements from a 100,000-barrel minimum to 10,000 barrels. An independent producer had complained that the pipe-line rates were excessive and the minimum tender requirements so high as to discriminate against the smaller producers. The Commission found the rates reasonable as compared to those of other pipe lines, though it made no finding as to reasonableness of the individual rate against which the complaint was made. On this point, it held that it could not pass on the reasonableness of all rates of the pipe line on the basis of the record in the case. The Commission did find the tender requirement too high. Recognizing that the pipe lines are essentially a "bulk business" and cannot be operated on a "driblet basis," the Commission found that the 100,000-barrel tender was higher than the economics of operation required.[2]

The conclusions from investigation into pipe-line rates and practices will be awaited eagerly by those interested in this form of transportation. The reluctance of the Interstate Commerce Commission to investigate these rates and practices decades ago is not easily explained. To be sure, few complaints have been filed, and the other phases of the Commission's regulatory jurisdiction have kept it busy. Watkins has suggested that the paucity of complaints may be due to the fear by small producing customers of discriminating reprisals by large oil companies owning pipe lines.[3] The pipe lines may be filing rates which, even though uniform and reasonable by comparison, are too high as judged by cost. If they are, the independent producer or refiner is being subjected to discrimination, for these rates have only paper significance to the owner of a pipe line who transports the oil he produces.

6. SEPARATION OF OIL PRODUCTION AND TRANSPORTATION. One of the proposals for regulating the pipe lines which has been actively discussed since 1906 is the divorcement of oil transportation from other oil business. As may be remembered, the railroads are not permitted to own companies whose products they carry. This provision, the "commodities clause" of the Interstate Commerce Act, was designed to remove the railroads from control of coal mining. Application of the commodities clause has been suggested for the pipe lines.

Effective regulation of transportation in the public interest is usually best

[1] *The Pipe Line Cases*, 234 U.S. 548, 561 (1914).

[2] *Brundred Bros. v. Prairie Pipe Line Co.*, *supra*, p. 466.

[3] Watkins, M. W., *Oil: Stabilization or Conservation?* (New York: Harper and Brothers, 1937), p. 56.

obtained by requiring transport companies to limit themselves to the business of carriage. Enforcement of such policy is certain to eliminate many of the reasons for discriminatory practices. On the other hand, the oil pipe line is not a carrier serving a wide public. Its interest and those of producers and refiners are closely identified. More so than any other carrier, the oil pipe line is an auxiliary of a particular industry. If regulatory measures can be adopted and enforced which will protect the independent producer and maintain competition in the sale of petroleum products, there would appear to be no pressing need for applying the commodities clause to these carriers.

C. AIR CARRIERS

Youngest of transport agencies, the air carriers have a short history of commercial use and regulation. Although the Wright brothers lifted their flying machine off the ground at Kitty Hawk in 1903, and the military significance of the airplane was recognized during the World War, commercial flying dates from the middle 1920's. Even then business other than mail was of minor importance. As compared to other transport agencies, air carriers are still relatively insignificant. In 1939, airways handled only 1.7 per cent of the commercial passenger traffic in the United States, as measured by revenue passenger-miles, and around 0.002 per cent of total freight ton-miles.[1] Yet the progress of commercial aeronautics has been remarkable for the relatively short experience with such carriage. Table V shows the development of the

TABLE V. DEVELOPMENT OF COMMERCIAL AIR TRANSPORT IN THE UNITED STATES, 1928–1939

Domestic Commerce of Scheduled Operations

Year	Total Miles Flown (000's omitted)	Passengers Carried (000's omitted)	Passenger Miles (000's omitted)	Mail Carried (pounds) (000's omitted)	Express and Freight Carried (pounds) (000's omitted)
1928	10,400	47.8	——	3,545.5	210.4
1929	22,380	159.8	——	7,099.6	249.6
1930	31,993	374.9	84,015	7,985.0	359.5
1931	42,755	470.0	106,442	9,097.4	788.1
1932	45,606	474.3	127,039	7,393.3	1034.0
1933	48,772	493.1	173,492	7,362.2	1510.2
1934	40,955	461.7	187,859	7,411.0	2133.2
1935	55,380	746.9	313,906	13,268.7	3822.4
1936	63,777	1020.9	435,740	17,706.2	6958.8
1937	66,072	1102.7	476,603	——	7127.4
1938	69,669	1343.4	557,719	——	7336.0
1939	82,572	1876.1	749,787	——	9514.3

Source: U.S. Dept. of Commerce, 9 *Air Commerce Bulletin*, pp. 276–77 (May 15, 1938), and 1 *Civil Aeronautics Journal*, p. 455 (October 15, 1940).

[1] 54th *Ann. Rep. I.C.C.* (1940), p. 23.

domestic air-line business of scheduled operations. This takes no account of the large volume of air carriage, both for hire and for pleasure, which does not travel over scheduled routes. This flying was estimated to be 142,788,000 plane-miles in 1939, or nearly twice as much as scheduled operations.[1]

Perhaps the expansion of the air-carrier business is even better portrayed by the declining importance of air-mail revenues in total air revenues. Since air-mail revenues have been meant to subsidize air carriage, the fact that they declined from 91.6 per cent of revenues of air-mail carriers in 1931 to 36.6 per cent in 1938 is evidence of the commercial importance of this agency of transportation. The changing character of total revenues of those lines carrying mail is shown in Table VI.

TABLE VI. TOTAL REVENUES OF AIR TRANSPORT COMPANIES CARRYING MAIL

Year Ending June 30	Air-Mail Revenues	Per Cent of Total	Express Revenues	Per Cent of Total	Passenger Revenues	Per Cent of Total
1931	$16,943,606	91.6	$ 23,910	.1	$ 1,536,583	8.3
1932	19,938,123	80.0	83,354	.3	4,900,770	19.7
1933	19,400,265	74.6	202,567	.8	6,407,748	24.6
1934	12,129,960	56.6	382,865	1.8	8,906,656	41.6
1935	8,814,296	40.8	507,625	2.4	12,275,006	56.8
1936	12,104,797	39.9	796,171	2.6	17,413,260	57.5
1937	12,938,577	36.2	1,198,387	3.4	21,508,325	60.4
1938	14,182,244	36.6	1,218,250	3.1	23,371,376	60.3

Source: Postmaster General, *Annual Report* (1938), pp. 131, 134, 135.

Airways have likewise increased. From a few airways in 1920 there has developed a system of over 36,000 miles, on 31,000 miles of which navigation aids may be found.[2] Airports are also found in large numbers, there being 788 municipal and 496 commercial ones in the United States by 1941.[3] Even these data do not show the increasing expenditures made for airways and airports to take care of larger planes and more freight operations on a safer and more expeditious basis. Safe operation has also been improved. From a rate of one passenger fatality in 4,000,000 passenger-miles of operation in 1930, the degree of hazard was reduced to one fatality in 83,000,000 passenger-miles in 1939.[4] A record of no passenger fatalities was made for the period between March 26, 1939, and August 31, 1940.[5]

1. ECONOMIC CHARACTERISTICS OF AIR TRANSPORT. To understand some

[1] 1st *Ann. Rep. Civil Aeronautics Authority* (1939), p. 55.
[2] 1 *Civil Aeronautics Journal*, p. 455 (October 15, 1940), and vol. 2, p. 3 (January 1, 1941).
[3] *Ibid.*, vol. 2, p. 31 (January 15, 1941). [4] *Ibid.*, vol. 1, p. 454 (October 15, 1940).
[5] *New York Times*, September 1, 1940, p. 1.

of the problems of government control of air lines, a few underlying economic characteristics should be noted. In the first place, air transport has been widely subsidized. These subsidies consist of advantageous air-mail contracts, airway facilities, airports, and research projects undertaken at government expense. All airway facilities, such as radio beams, lights, emergency landing fields, and weather information, have been furnished at government expense. A large part of the airport facilities has also been furnished by the government, although an increasing proportion of expenditures has been made by the commercial air carriers themselves.

In the second place, air transport is fairly competitive. A number of companies operate between certain large cities in the United States, although competition at smaller stations is limited. One reason for competitive conditions in this industry lies in the economic character of air-line costs. As compared to railroads, the proportion of fixed costs is relatively low, since most of the cost incurred is for operation itself. Fixed costs on account of airways are not incurred, and units of operation are fairly small. Even so, there exists a fairly large group of fixed costs. The cost of ground crews and facilities and maintenance and depreciation costs of planes are fairly constant. With the tendency toward larger and more expensive equipment and more expenditures for research, fixed costs have increased.

As fixed costs have become more important in air-carrier operation, the most economical size of the business unit has become larger. With investment costs increasing with larger equipment and wider operations, the air-line business has become one with greater monopolistic tendencies than in the past. The fact, too, that air transport is a business of more than ordinary risk has made the larger companies those best able to withstand the shock of loss. The business is intensely dynamic, and losses from obsolescence are considerable as new techniques and devices are developed.

Another economic characteristic of importance to regulatory policy is the type of traffic carried. Offering a high-speed and fairly expensive service, air carriage appeals primarily to passengers willing to pay well for the service and to mail and freight, for which this service has high value. Moreover, the traffic is largely long-distance carriage as compared with most other commercial transport.

The industry is also complicated by the large volume of non-commercial traffic and operations not over scheduled routes. Many for-hire fliers operating as common carriers make no attempt to restrict transport to certain routes Contract carriage is fairly large and scattered over numerous operating units, both large and small. The private carrier, for business or for pleasure, is also coming to operate on an increasingly extensive basis.

2. Basis for Public Interest. Safety of operation has long been recognized as a reason for governmental intervention in air transport. Compared to other agencies, the airplane is still a highly hazardous mode of transportation. In

order to protect life and property, government has entered widely into this field.

Public interest in adequate, safe, and continuous service of common carriers at reasonable rates has been fundamental in the placing of the various transportation agencies under governmental control. With the current belief that common carriers should be protected from other carriers, and that those in all transport fields should be co-ordinated, regulation of air carriage has become important as a part of the whole public policy toward transportation.

Having promoted air-carrier operation by subsidies of one sort or another, the government should naturally regulate the receivers of these benefits. The public does not ordinarily grant favors, whether certain legal rights, free facilities, or outright subsidies, without laying down requirements or levying regulatory measures in return. From this point of view alone, an adequate basis for public control of aviation can be found.

As a practical matter, too, regulation is necessary to allot and rule the use of air space. After some legal acrobatics with the ancient maxim that who owns the soil owns also the sky above,[1] the courts have finally come to agree that the right of private property does not extend to the air above.[2] Common ownership of air space means that government is the only agency capable of exercising any control over its use.

3. Promotion of Air Transport. In analyzing the relations of government to air transport, one finds a close connection between promotional and regulatory activities. Both are customarily placed under the same administrative agency and are dealt with as a single phase of a single program — the development of air transportation. This is probably due to the fact that the air-carriage business did not develop as rapidly under private enterprise as seemed desirable. The military value of the airplane had much to do with making the public anxious for rapid air progress; but some of this promotion has come from the appeal of this mode of travel to the public imagination. War abroad has shown the great military value of aviation. Because this value cannot be measured, nor can government aid be allocated between commercial and non-commercial transport, one should take care not to gain the impression that total amounts spent, or projects undertaken, are an outright subsidy to commercial transport.

a. State aid. Promotion of aerial navigation has received some impetus by the states, though most of the promotional activities are financed by the federal government. By far the greatest part of state aid has come from municipal expenditures for airports. The majority of airports now in use have been constructed by municipalities.[3] In many cases, particularly in recent years, these

[1] *Cuius est solum eius est usque ad coelum.*

[2] See *Swetland v. Curtiss Airports Corp.*, 55 F. (2d) 201 (1932); *Thrasher v. City of Atlanta*, 173 S.E. 817 (1934); *Hinman v. United Air Lines*, 84 F. (2d) 755 (1936).

[3] As of 1938, there were 784 municipal airports in operation. These represented an investment of more than $200,000,000. See *Public Aids to Transportation*, vol. I, p. 153.

local projects have been aided by appropriations from the federal Works Progress Administration. In some cases the municipalities require air carriers to pay a fee for the use of airports, especially hangars, though many local airports are furnished free of charge.

State aid has also been given by way of auxiliary landing fields for emergency use. In addition, many states and the federal government have appropriated funds to be used for the study of aeronautics in public schools and universities.

b. Federal aid: facilities. By the Air Commerce Act of 1926, the Secretary of Commerce was directed to provide aids for air navigation, including airway facilities, meteorological information from the Department of Agriculture, research and developmental work, and accident investigation. As early as 1915, Congress provided for a National Advisory Committee for Aeronautics which would co-operate with the various scientific agencies of the government for aviation research. But the real promotional program of the federal government began with the Act of 1926. To administer this program an Aeronautics Branch was established in the Department of Commerce. In 1934 this agency was changed to the Bureau of Air Commerce, and in 1938 these functions were included as a part of the duties of the Civil Aeronautics Authority.

Prior to 1926, the Post Office Department constructed over two thousand miles of lighted airways for the air-mail service. In ten years the Department of Commerce opened more than twenty thousand additional miles. These airways have been built with emergency landing fields at fifty- to one hundred-mile intervals, beacon lights every fifteen miles, radio range beacons, and radio informational services along the route. The emergency fields are equipped with night lighting facilities, radio beacons, and transmitters for weather broadcasts.

Additional federal aid has come from the works program of the government. Through loans and grants to municipalities under the Public Works Administration and the Works Progress Administration, the federal government has contributed handsomely toward the construction of airports and other facilities. Furthermore, assistance of an incalculable nature has been rendered to air transport by the research activities of the army and navy air corps.

Exclusive of most expenditures of the works program,[1] and exclusive of any aid under air-mail contracts, the direct expenditures of the federal government for aid to aeronautics are shown in Table VII. Not all the aids so indicated can be charged to commercial transport. In the first place, approximately $8,500,000 of the amount expended for administrative personnel should be charged to regulatory work. In the second place, both private and commercial aviation have benefited from the expenditures, and the amount appropri-

[1] Some expenditures by works administrations and relief agencies were made by allotments to the Department of Commerce and the Weather Bureau, although these were relatively small as compared to allotments to municipalities.

ately chargeable to commercial aviation with scheduled services has been estimated as equal to about $34,000,000 of the total expenditures of about $92,000,000.[1]

c. Federal aids: air mail. The principal form of subsidy to commercial aviation has come through air-mail contracts of the federal government. So important have these contracts been that commercial flying could hardly have advanced to its present status without them, and an air line carrying no mail has had little chance for financial success. The extent of this subsidy can hardly be told. Even an excess of payments for air-mail service over air-mail revenues does not measure the subsidy. As Locklin has pointed out, this excess may prove only that air *mail* is subsidized, and not that the business of air *transportation* is subsidized.[2] Not all classes of postal service pay their way; yet this is only ground for saying that some postal services pay their way and others do not, rather than a sound basis for finding that certain carriers are subsidized.

Payments to air-mail contractors and other expenditures for air-mail service exceeded the receipts from air postage by large amounts over the years from 1926 to 1933, and by much smaller amounts since 1934. This is shown by Table VIII. These excess payments are not necessarily subsidies to air transportation. A better way of determining the extent of subsidy is to compare the cost of carrying the mail with the payments for this service. David made such a study in 1934, apportioning costs on the basis of weight of mail, passengers, and express.[3] In the years 1931 and 1933 he estimated this subsidy as 15.4 cents per passenger-mile. In 1935, the Interstate Commerce Commission found average revenue per hundredweight-mile to be 2.4 cents for passenger; 3.3 cents for excess baggage; 3.6 cents for express; and 14.2 cents for mail.[4] This would indicate a substantially higher revenue, and possibly a subsidy, for air mail.

The weakness of attempting to find the extent of subsidy by allocating cost on a weight basis is that these costs are jointly incurred. For the most part, the total cost of transportation per mile would not be different if no mail were carried. If only mail were carried, the total cost would be reduced somewhat, but not in proportion to the reduction in weight transported. Because most costs are joint, a faultless allocation cannot be made.

No one doubts that Congress meant to help commercial aviation by legislation fixing methods of payment for air-mail contracts. Under the Air Mail Act

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation*, vol. I, p. 152. This allocation has been made on the basis of plane-miles flown. It probably underestimates the aid to commercial aviation, since it includes only scheduled air operations, and since the plane-mile basis of allocation does not reflect the greater importance of airways to the larger planes and more continuous operation of commercial air lines.

[2] Locklin, D. P., *op. cit.*, p. 827.

[3] David, P. T., *Economics of Air Mail Transportation* (Washington: Brookings Institution, 1934), pp. 93–99.

[4] *Air Mail Compensation*, 206 I.C.C. 675, 720 (1935).

TABLE VII. FEDERAL GOVERNMENT AIDS FOR AERIAL NAVIGATION, 1926–1938

Fiscal Year Ending June 30	Administrative Personnel	Maintenance and Operation	Miscellaneous Expenses [1]	Teletype Circuits (Rentals)	Expenditures by Weather Bureau	Total Maintenance and Operation	Investment	Total Expenditures (Investment, Maintenance, and Operation)
1926	$ 25,000	$ 100,000	——	——	——	$ 125,000	$ 542,000	$ 667,000
1927	46,332	333,861	$ 1,613	——	$ 70,480	452,286	269,533	721,819
1928	513,026	1,128,428	21,300	——	118,637	1,781,391	1,481,610	3,263,001
1929	902,952	2,074,803	95,300	——	252,126	3,325,181	1,740,000	5,065,181
1930	1,503,505	2,934,921	217,615	$ 241,500	667,880	5,565,421	1,521,000	7,086,421
1931	2,094,098	3,967,274	229,542	601,820	1,120,756	8,013,490	2,121,600	10,135,090
1932	2,760,185	4,973,356	306,579	855,379	1,382,522	10,278,021	1,471,500	11,749,521
1933	2,537,209	4,220,233	262,032	643,097	1,200,477	8,863,048	75,210	8,938,258
1934	1,992,230	3,025,611	115,766	457,710	869,480	6,460,797	279,917	6,740,714
1935	1,509,466	3,372,113	762,035	361,080	840,321	6,845,015	1,530,453	8,375,468
1936	1,278,108	3,515,920	446,607	374,448	1,207,483	6,822,566	774,810	7,597,376
1937	1,326,548	4,079,755	138,693	394,862	1,484,556	7,424,414	878,613	8,303,027
1938	2,061,341	5,099,505	124,287	890,246	2,153,664	10,329,043	2,844,381	13,173,424
Totals	$18,550,000	$38,825,780	$2,721,369	$4,820,142	$11,368,382	$76,285,673	$15,530,627	$91,816,300

[1] Includes expenditures for distribution of Weather Bureau reports, airport consultation and rating, research and experimental work, and airway mapping.
Source: Federal Co-ordinator of Transportation, *Public Aids to Transportation*, vol. I, p. 151 (1940).

TABLE VIII. DOMESTIC AIR-MAIL REVENUES AND PAYMENTS, 1926–1940

Fiscal Year Ending June 30	Revenues from Air-Mail Postage	Payments to Contract Carriers	Other ‡ Expenditures	Total Expenditures	Excess of Expenditures over Revenues
1926	$ 118,407 *	$ 89,754	—†	$ 89,754	$ — 28,653
1927	1,500,000 *	1,363,228	—†	1,363,228	— 136,772
1928	3,640,000 *	4,042,777	—†	4,042,777	402,777
1929	4,250,547 *	11,169,015	—†	11,169,015	6,918,468
1930	5,272,616	14,618,232	$ 500,547	15,168,779	9,896,162
1931	6,210,345	16,943,606	649,804	17,593,410	11,383,065
1932	6,016,280	19,938,123	3,833,244	23,771,367	17,755,087
1933	6,116,442	19,400,265	3,633,891	23,033,856	16,917,415
1934	5,737,536	12,129,960	3,160,073	15,290,033	9,552,497
1935	6,589,534	8,814,296	3,770,532	12,584,828	5,995,294
1936	9,702,676	12,104,797	4,774,552	16,879,349	7,176,673
1937	12,439,579	12,938,577	6,238,552	19,177,129	6,737,550
1938	15,301,210	14,182,244	7,608,015	21,790,259	6,489,049
1939	16,326,358	16,767,935	8,293,357	25,061,292	8,734,934
1940	19,122,906	18,678,921	9,360,329	28,039,250	8,916,344

* Source: David, P. T., *Economics of Air Mail Transportation* (Washington: Brookings Institution, 1934), p. 159.

† Not available.

‡ Cost of handling mail, transporting to and from air fields.

Source: Annual Reports of the Postmaster General.

of 1925 Congress provided that all lines be paid on the basis of pounds of mail carried. For a short time this law provided that payments could not exceed mail revenue for air service. This restriction was removed in 1926, and in 1930 Congress embarked on a frank program of subsidy. By the Watres Act of 1930, the Postmaster General was authorized to contract for space on airplanes regardless of volume of mail carried. Officials admitted that this method was designed to keep air lines solvent and that the Post Office Department purchased space on this basis rather than on the amount actually needed.[1]

Some change of policy came through the Air Mail Acts of 1934 and 1935. Under these laws, fixing of mail compensation was placed in the hands of the Interstate Commerce Commission. The Commission was empowered to fix maximum reasonable rates for air mail, but the Postmaster General, in awarding the contract, could set a lower rate. By the Civil Aeronautics Act of 1938 this jurisdiction was transferred from the Interstate Commerce Commission to the Civil Aeronautics Authority and, in 1940, to the Civil Aeronautics Board.

4. STATE REGULATION OF AIR TRANSPORT. Air-carrier regulation is still in a developmental stage. Operating usually over long distances, the air carrier has naturally fallen under the jurisdiction of the federal government. While

[1] David, P. T., *op. cit.*, pp. 93–96.

much intrastate air traffic still exists, the bulk of commercial transportation is interstate. Since both commercial and non-commercial, and interstate and intrastate, air carriers use many of the same facilities, uniformity in certain regulations is imperative for safety. Even where safety is not a primary consideration, as in rate regulation, the character of the industry makes uniform regulation advisable.

In spite of the tendency for the federal government to control air transport, the states still play a part. Practically every state has laws dealing with aviation. Aircraft and airmen are licensed by states for intrastate flying. In recent years most of these requirements have been made the same as federal rules. States have authority to issue air-traffic regulations, though they have been forced to make these coincide with the rules of the federal government.

Much of state regulation deals with airports. Licensing of the airport, providing rules for its operation, and granting of eminent domain to obtain land have been included in state laws. Few states regulate the public transportation of persons or property for hire, other than as regards safety of operation. In some states air transportation for hire is classed as common carriage and is regulated under laws applying to other common carriers. These regulations include the requirement of certificates of convenience and necessity, rate-fixing, prescription of accounts and reports, and establishment of service standards. Even where air carriers are placed under public-utility or transportation commissions along with other carriers, it does not appear that much regulation has actually been effected.

The federal government will almost certainly continue to gain more jurisdiction over the whole field of aviation. This dominance follows from the nature of the industry. As compared to railroads, where state authority has largely been superseded, federal regulation of air carriers seems even more desirable. Unlike the motor carrier, aviation is not a local problem, but is definitely national in scope.

5. Federal Regulations: Development and Nature. As noted above, federal regulation has been closely related to the encouragement of the development of the air-transport industry. Before 1926 the United States had no definite program for regulating aviation. The Post Office Department, through its mail operations, made some attempt after 1920 to put into effect recommendations of the National Advisory Committee for Aeronautics, created by Congress in 1915. When the futility of state regulation and the advisability of federal regulation came to be recognized, the Air Commerce Act was passed in 1926.

The regulatory portions of the Air Commerce Act were limited to safety measures, including registration and licensing of aircraft and pilots, and establishment of air-traffic rules. No economic regulations were provided whereby transportation for hire was brought under control.

Under the various air-mail acts, some regulation was applied to air carriers.

As early as 1925, when the Postmaster General was given power to grant air-mail contracts to private companies, the giving or withholding of these contracts had regulatory force. It was the Watres Act of 1930, however, that gave the Postmaster General a wide range of authority over mail carriers; he could make extensions or consolidations of routes, and select routes for mail transport; he could stipulate the character of passenger services to be performed by mail planes; he was empowered to prescribe accounts and make requirements respecting air-line personnel and equipment. Through these powers, as well as the more subtle authority usually found where a person has something to give away, the Postmaster General has had a material influence on airway operation. To be sure, he could only reach air-mail carriers; but these carriers have been the ones of commercial importance.

Transfer of authority to fix reasonable maximum rates for air-mail contracts to the Interstate Commerce Commission in 1934 gave that body a limited regulatory jurisdiction over air transport. In 1934, also, Congress established a Federal Aviation Commission to study the whole field of federal aid and regulation of civil and military aviation. This commission recommended a broader program of regulation, as did the Federal Co-ordinator of Transportation and the Interstate Commerce Commission. The result of these recommendations and of general recognition of the increasing importance of air commerce was the Civil Aeronautics Act of 1938.

The Civil Aeronautics Act of 1938 is interesting in several respects. The Civil Aeronautics Authority, a commission, is designed to be a quasi-judicial administrative body similar to the Interstate Commerce Commission. Until 1940, within the organization of the Authority were two agencies responsible to the President, and removable by him at will. These were the Administrator and the Air Safety Board. The primary task of the Administrator was to oversee the promotional features of the Authority's jurisdiction. This left regulatory aspects, as well as general supervision, to the Authority itself. The Air Safety Board was charged with accident investigation and power to recommend changes in rules or other requirements to the Authority. The purpose in establishing a separate board to investigate accidents was to separate the board of inquiry from the commission administering air regulation and promotion. Past experience had led Congress to believe that if accident investigations were handled by the same persons responsible for airway facilities and navigation rules, an unbiased report could not be had.

The President of the United States made some changes in the administrative organization of the Civil Aeronautics Authority in 1940 under powers granted by the Reorganization Act of 1939. The Authority was placed under the general supervision, but not control, of the Secretary of Commerce. The Air Safety Board was abolished and its functions transferred to the Authority, to be known thereafter as the Civil Aeronautics Board. The Administrator of Civil Aeronautics was made responsible, in addition to his promotional functions, for

issuance and amendment of airman, aircraft, and air-carrier certificates, the registration of aircraft, and the enforcement of air safety rules. The five-man Civil Aeronautics Board retained the quasi-judicial and quasi-legislative functions of prescribing and holding hearings upon economic regulations and safety rules. The change was inaugurated in the interests of administrative efficiency, although the removal of the Civil Aeronautics Authority to the general supervision of the Department of Commerce and the abolition of the Air Safety Board have been seriously questioned.

An interesting feature of the present air-regulation law is that the Civil Aeronautics Board may exempt any carrier from most of the economic regulation, if such regulation is found to bear too heavily on the carrier. The act also provides for the establishment of a joint board, consisting of members of the Civil Aeronautics Board and the Interstate Commerce Commission, to administer matters having to do with through or joint services of carriers under the two commissions.

6. Federal Regulation: Safety. Air transport is probably more closely regulated in matters of safety than any other agency of transportation. Supervision by the federal government has dated from 1926. Since that date detailed rules and regulations have been developed. The main fields of safety regulation administered by the federal government include: (1) registration of aircraft; (2) rating of aircraft as to their air worthiness and periodical re-examination of them; (3) examination and rating of airmen as to their qualifications for flight service; (4) examination and rating of air-navigation facilities; (5) establishment of air-traffic rules; (6) issuance and revocation of licenses for aircraft and certificates of competency for airmen and mechanics.

All aircraft are registered with the federal government and bear a number assigned to them. But certificates of air worthiness and ratings are required only of interstate and foreign carriers. These craft are checked by federal inspectors and rated according to class of operation, for example, as "air-line carrier (goods)," "air-line carrier (passengers)," "visual contact flying," "day flying," or "no passengers." Periodical rechecking of the craft by certified mechanics is required.

Airmen must take examinations and are rated on the results of these, plus experience qualifications, in grades from student pilots to air-line pilots. The requirements for air-line pilots are very rigorous. In addition to a minimum of twelve hundred hours solo flying and experience as a commercial pilot, the applicant must pass examinations in engine and plane mechanics, instrument flying, air navigation, and meteorology.

The air-traffic rules of the federal government apply to all carriers in the air. On the theory that disobedience to these rules, even in intrastate commerce, would hinder interstate commerce, the federal authorities have insisted upon universal compliance. The United States Supreme Court has not passed on this assertion of power. A lower federal court has upheld it,[1] and precedent

[1] *Neismonger v. Goodyear Tire and Rubber Co.*, 35 F. (2d) 761 (1929).

for approval of the power exists in an earlier case of the Supreme Court by which the requirement of safety devices on intrastate trains operating on interstate tracks was upheld.[1] This is the only sound construction of the law, for rules as to flight altitudes (even thousands of feet in one direction, odd thousands in the other), passing of planes, and landing and taking off in areas of congested traffic should be completely uniform.

7. FEDERAL REGULATION: SERVICE. Carriers for hire in interstate and foreign transportation must now obtain a certificate of convenience and necessity from the Civil Aeronautics Board. This has been required only since 1938. Carriers in operation from May 14 to August 22, 1938, the date when the new law became effective, were automatically granted certificates under the grandfather clause of the act.

Carriers must furnish safe and adequate facilities and service. Air-mail carriers must furnish special facilities and service as required by the Postmaster General. Undue preference or advantage in service is prohibited. Abandonment of routes is unlawful except upon approval by the Civil Aeronautics Board.

8. FEDERAL REGULATION: RATES. Determination of reasonable maximum compensation for air-mail service is now a part of the jurisdiction of the Civil Aeronautics Board. The Board may also prescribe rates, both maximum and minimum, and reasonable or unjust rates are prohibited, as is undue or unreasonable preference or advantage therein. Air carriers operating for hire must file rates and fares with the Board and publish them for public inspection. Departure from published rates is prohibited. Proposed rate changes must be given thirty days' notice, and the Board may suspend changes of rates for one hundred and eighty days pending investigation.

The rule of rate-making found in the act of 1938 is similar to the rules provided by law to guide the Interstate Commerce Commission in regulating the level of railroad and motor-carrier rates. One notable feature is the direction of Congress to the Board to take into account the standards respecting character and quality of service prescribed by the law. Because the interests of safety demand that these be exceptionally high, Congress has deemed it appropriate to call attention to their cost.

Some time will elapse before a critical judgment can be made of the adequacy of these rate provisions and the character of their administration. The power effectively to regulate air-carrier rates seems to be included, but the provisions are far less explicit than those found in railroad regulation. Moreover, being under a separate commission, one cannot be sure that this rate regulation will be co-ordinated with that of other carriers.

9. FEDERAL REGULATION: FINANCE AND COMBINATION. The Civil Aeronautics Board is empowered to require reports from air carriers and to prescribe a uniform system of accounts. Strangely enough, however, no regula-

[1] *Southern R.R. Co. v. U.S.*, 222 U.S. 20 (1911).

tion of securities is included, such regulation as exists being that applying to businesses in general under the Securities and Exchange Commission.

Consolidations or acquisitions of control of any kind must be approved by the Board. Interlocking relationships of any kind are prohibited unless approved by it. They include relations between air carriers, those between air carriers and common carriers of other transport agencies, and those between air carriers and other branches of the aviation industry. Prohibiting interlocking relationships between carriers is understandable as a part of the general policy of competition in transportation and the removal of motives for unfair discrimination. Forbidding those with other parts of the industry grew out of the belief that equipment manufacturers, with a close relationship to carriers, had siphoned off funds in excessive profits. As a matter of fact, this separation was required of air-mail contractors by the Air Mail Act of 1934.

Further control over combination devices is given by the requirement that all pooling or other like agreements between air carriers be filed with, and approved by, the Civil Aeronautics Board.

10. FEDERAL REGULATION: CONCLUSIONS. One distinct advantage is apparent in federal regulation of air transportation. Through air-mail contract regulations and the control over for-hire carriers under the 1938 law, the federal government has entered the field rather early in the development of commercial air transportation. Unlike railroad and motor-carrier regulation, this control comes as the industry is far from maturity. The deadwood of railroad capitalization existing before effective federal control and the chaotic condition of the motor-carrier business prevailing in 1935 are strikingly dissimilar from the condition of the aviation industry in 1938. Regulation, especially of economic aspects, has not come too early, but it has come early enough for wise and effective government control. The Civil Aeronautics Board and the Administrator have the opportunity to devise administrative control which will not restrict air-transport growth in a mass of bureaucratic red tape, but which will allow for a healthy development of an industry in which the public has so great an interest.

Air carriers are still regulated apart from the whole field of transportation. This is not conducive to transport co-ordination or to effectuating a national transportation policy.

A few gaps still appear in federal regulation. In the first place, the federal law does not take so affirmative a step as seems desirable in controlling all air transport. Aerial navigation is a sphere of business where federal control should be as exclusive as possible. Through power over interstate commerce and matters which affect this commerce, the government could assert an extremely broad control over aviation. The trend is in that direction, but the centralization of control is still far from complete.

Regulation of air-carrier securities should be undertaken while there is still opportunity to head off practices which lead to overcapitalization. Experience

may indicate also that more definite rate-regulation provisions may be advisable.

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CHAPTER

12

NATIONAL TRANSPORTATION POLICY

OF ALL businesses so affected with a public interest as to admit of widespread economic regulation, transportation has been most consistently subject to it over the years. The business of common carriage is one of the few in which common-law regulation has survived the period of *laissez-faire*. The common carrier, professing to serve others at a price, has long been required to serve adequately, safely, and at reasonable rates.

It has been a short step from the common-law obligations of common carriers to their statutory regulation by federal and state commissions. The former have been defined in increasingly greater detail by statutes; and additional regulations, well beyond those conceived in the common law, have been imposed to protect public interest. Regulation of the economic practices of the contract carrier has become a necessary concomitant, and greater government intervention in private carriage may not be far away.

Why all this public interest in how operators in the transport field conduct their business? Doubtless it may be traced in part to the legal history of control and the survival of common-law principles from the days when all business had certain customary obligations to the public. In more recent years, public interest has found an exceptional basis in the granting of public aid to carriers. Whether this aid has taken the form of legal rights of eminent domain, land grants, or furnishing of way at public expense, the public has properly felt that it has a more than ordinary interest in the business practices of those whom it has helped.

Above all, however, public interest in transportation has grown out of the recognition that it is an essential function of economic life. No other business touches upon economic activity so broadly, or has so much effect on the cost of producing so many products. Through defining the economic size of a market, the transportation business effects the sale of production and the extent of division of labor. In the same way, not only does it have much to do with how goods are produced, but also where they are produced.

Because of this close relationship of transportation to economic welfare, it follows that a regulatory policy should be one which makes for efficient transportation. In formulating a criticism of past policy or a program for reform, this simple fact should be a guidepost. Although discussion of a policy of control implies the maintenance of private enterprise, what may be said here about a national transportation policy may apply almost as well in case of government ownership. Public enterprise might obscure the elements of cost and profits, but these factors are nonetheless essential to social-economic welfare.

A. THE TRANSPORTATION INDUSTRY

The character and extent of the transportation industry have been commented upon in previous chapters, and certain economic features have been pointed out. If total costs are considered, transportation is a business in which fixed costs generally predominate. Consequently, the industry would tend to be highly monopolistic if all costs were incurred by each carrier. Owing to government ownership of ways for all carriers except railroads and pipe lines, and to the force of regulation, this tendency has been modified and the industry has become extremely competitive.

The nature of the transport field is also confused by the existence of carriers which are not common carriers. Practically all railroads are common carriers. Most of the volume of commercial air transport is done by common carriers. Pipe lines, while generally held to be common carriers, have in fact operated more nearly as private carriers. Water and motor carriage are spread among all classes of operation, with the common carrier generally less important than the contract or private carrier.

Regulation, as has been noted, has proceeded unevenly, at different times for different agencies, in different degrees for different kinds of carriers, and with variance between federal and state provisions. Whether this regulation has been effective depends upon what it should do. One can be sure only that it has not been faultless, that reform measures can be offered with ease, and that a wholly satisfactory policy and program will probably never exist.

Too often what is referred to as a "railroad problem" is in reality a transport problem embracing all carrier agencies. The trend toward railroad bankruptcies since 1929 has stood out in bold relief because of the size of the companies, as well as their number, and the longstanding reliance of private and institutional investors on railroad securities; the railroads have been a victim of depressed revenues and increased expenses; their bankruptcies have never been higher. But they are not alone: the whole transport industry, with the exception of the pipe lines, has not been very prosperous.

Available evidence indicates that the business of transportation generally has been one in which total costs, including return to capital, have not been covered in recent years. Table IX shows the high ratio of operating ex-

TABLE IX. REVENUES AND EXPENSES OF COMMERCIAL TRANSPORTATION AGENCIES IN THE UNITED STATES, 1936

Carrier	Transportation Revenues of Common and Contract Carriers (Millions of dollars)	Operating Expenses, Depreciation and Taxes (Millions of dollars)	Per Cent Expenses to Revenues
Steam railroads	$4,103	$3,237	78.9
Highway motor trucks	742	667	89.9
Highway motor buses	168	146	86.9
Waterway carriers	667	639	95.8
Air carriers	36	35	97.2
Pipe lines	216	125	57.9

Source: Immediate Relief for Railroads, House Doc. No. 583, 75th Cong., 3d Sess. (1938), pp. 9–10.

penses to revenues of common and contract carriers in all fields of transport in 1936. With the exception of pipe lines, these ratios are signs of poor financial health. While the data for 1939 and 1940 would show a slight improvement, the picture would not be changed materially. Even though capital costs are relatively low for highway, waterway, and air carriers, and a high operating ratio is expected, the ratios shown indicate an inadequacy of return available for capital.

Other sources of information point to the same conclusion. The Federal Co-ordinator of Transportation found that, with the exception of pipe lines, carriers were not operating at a point where an adequate investment return was afforded on facilities furnished by private enterprise.[1] Like conclusions can be drawn from recent railroad rate cases in which the Interstate Commerce Commission canvassed the profitability of water and highway, as well as railroad, operations.[2]

It should not be inferred that the generally unprofitable status of the transportation industry is due entirely to regulation or lack of it; the causative factors are many and complex. It is clear, however, that the whole policy of the government toward transport is open to suspicion. If any features of regulation or promotion have contributed to the unhealthful state of the industry, they should be sought out and corrected.

B. WHAT SHOULD GOVERNMENT DO?

The aim of government regulatory or promotional policy does not seem to be difficult to formulate. Transportation is primarily an economic machine.

[1] See *Freight Traffic Report* (1935), vol. 1, p. 16; *Regulation of Transportation Agencies,* Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934), pp. 14 ff.; pp. 49–51.

[2] See especially *Fifteen Per Cent Case, 1937–1938,* 226 I.C.C. 41, 50–74 (1938). See also 52d *Ann. Rep. I.C.C.* (1938), pp. 1 ff., and 53d *Ann. Rep. I.C.C.* (1939), pp. 5 ff.

The ideal transportation is that by which adequate service is furnished at the lowest cost to society. Both adequacy of service and reasonableness of cost are highly dynamic matters; they are interdependent, for the quality and adequacy of service demanded depend in large part on its cost. Given certain standards of service, the interest of society lies in getting it at the lowest cost as measured by expenditure of human effort and natural resources. Upon this basis, cost covers expenditures by private enterprise and outlays by the public as well. The aim of the government, whether in regulatory or promotional policy, should be, then, to obtain the highest standard of service at the lowest cost.

Control over transportation facilities, whether in public or private hands, involves such great power over general economic welfare that government must curtail abuses of it. Shippers may be placed at disadvantages not consistent with economic welfare. Investors may be caused to suffer loss from unwise or dishonest use of this power. Laborers may be exploited or be subjected to undue dangers. Different carriers may be discriminated against in ways not for the social good. The consuming public may be made poorer by abuse of the power over transportation facilities.

So long as the principal reliance is placed on private enterprise to operate transport facilities, an equality of opportunity to conduct business efficiently should be afforded by government policy. Subsidizing the inefficient or placing unequal restrictions on classes and types of carriers is not only poor economic policy but is unsound treatment of private enterprise. However, if private enterprise cannot be as efficient as the government, a strong presumption exists in favor of public ownership.

To be sure, even an ideal policy toward transportation would take into account social needs which are not economic; the military and cultural features of transportation also cannot be overlooked. Yet its main task is an economic one.

C. FUNDAMENTAL WEAKNESSES IN TRANSPORTATION REGULATION

As each agency of transportation has been studied, criticism of regulatory and promotional policies has been made. In some cases the weaknesses emphasized are peculiar to the field of transport regulation concerned. Often they lie in the statutory basis of control. Sometimes they may be attributed to its administration.

1. INADEQUATE CONTROL OVER SUPPLY. In viewing the whole sphere of government and transportation, certain weaknesses appear which seem fundamental. In the first place, control of the supply of transportation facilities is inadequate. Were competition allowed to rule, maladjustment in supply would be solved by the hard principle of survival of the fittest; some such ad-

justment is going on irrespective of government control. As a general matter, however, the public by regulating transportation has necessarily taken on the task of control of supply. To some extent supply is regulated by government. Railroads have had to obtain certificates from the federal government to enter or abandon service since 1920. Highway carriers have had to obtain certificates to enter new service since 1935. Certain air carriers have had to get such permission since 1938 and certain water carriers since 1940.

Experience with government control of supply leaves much to be desired. In every field where certificates or permits have been required, except perhaps with air carriers, the control has come after extensive development of the industry. Even now in the railroad field, control extends only to the mileage of track to be operated and not to the volume of facilities using the track. In the highway and airway industries, regulatory jurisdiction does not apply to the supply of road facilities or vehicles, but only, at best, to the *number* of contract carriers and the *number* and *routes* of common carriers. Noteworthy regulation of the supply of water carriers has just commenced. The supply of private carriage in any field is not limited by regulation.

One very important gap in control of supply has arisen from the determination of promotional policy. The economic need for new highways, waterways, or airways for a national transportation system has played too minor a part in the decision as to their being built. This situation is made even more serious by the fact that once these facilities are built they might as well be used, irrespective of the effect on the total supply of transportation. With the lack of regulatory control over supply and the fact that promotional policy has not been made consistent with economic need for transportation service, there is little wonder at the oversupply of transport facilities in many places and the demoralization of the industry.

2. Insistence Upon Competition. A further cause of chaotic conditions in the industry and uneconomic duplication of services may be found in government insistence upon competition between carriers of the same kind, and carriers of the different transport agencies. Ever since the passing of the Interstate Commerce Act of 1887 and the Sherman Anti-Trust Act of 1890, the federal government, as well as the states, has maintained a fundamental policy of enforcing competition. Even though this policy has been relaxed to allow approved consolidations and co-ordinations, the law has generally made as a condition for approval that competition be not unduly lessened.

At first, this policy was based upon reasonable grounds. In the late nineteenth century the railroads had a virtual monopoly of transportation. Regulation was in its infancy and adequate regulatory devices were not developed. To curtail the railroads, maintenance of competition seemed necessary. The scene has shifted, however. The basis for sound and effective regulation has been laid. If only it were extended to all carriers, there would appear to be little need for the competition which is now so prevalent. Competition has

led to wasteful duplication of transport services. It has also accounted for much of the need for regulation. To it the demoralized transportation rate structure and the depressed condition of the industry may be attributed to a large degree.

A policy leading to some kind of monopoly in transportation would seem to have many advantages. Wastes of competition could be eliminated. With monopoly of all transport in a particular area, co-ordination of facilities according to their economic advantage would be a normal business move. Certain other economies might be effected through large-scale operation and fuller utilization of facilities. Regulation would be somewhat simplified, since practices arising from competition would no longer need regulatory attention. The government commission would have one or very few companies to supervise, and this would probably more than make up for the increased vigilance necessary.

The economics of government promotion of transport might be brought into clearer light. Perhaps the greatest political force back of the uneconomic expenditures in waterways has been the railroad-fearing agricultural bloc, bent on encouraging competition. If competition were replaced by properly regulated regional monopolies, much of this pressure would be eliminated.

Regulatory policy in the transportation field has been somewhat inconsistent. On one hand, competition is encouraged and enforced. On the other hand, carriers, especially some groups, are kept from competing by application of the same rate and service regulations found in the regulated monopoly field. If competition is to be the policy, then restraints not found in competitive "private" business should be removed; if carriers are to be regulated monopolies, then encouragement should be given to monopoly. Study of the transport field indicates that the economic features, character of public interest, and other factors make the monopoly policy a better one to pursue.

3. Inconsistency Between Regulation and Promotion. Promotional activities of the federal government have been spread over numerous agencies. For example, in 1937 seven federal agencies had a part in highway development, eight aided air commerce in some way, and fourteen had promotional duties in connection with water carriage.[1] Appropriations have been made for specific projects, but most of these have been in no wise related to the picture of transportation as a whole. The federal promotional program has not been evaluated in terms of the relative merits of spending for one type of facility over another, and there is no evidence that the effect of new facilities upon present operations has been considered seriously.[2]

At the same time regulation has been developing along more paternalistic lines; the government has been assuming more positive responsibility for the

[1] See *Investigation of Executive Agencies of the Government*, Report to Select Committee of U.S. Senate, 75th Cong., 1st Sess. (1937), Pt. 12, pp. 78–79. (Prepared by Brookings Institution.)

[2] *Ibid.*, pp. 82 ff.

development and maintenance of economical transport service. The statements of policy in the Motor Carrier Act of 1935 and the Civil Aeronautics Act of 1938 instruct commissions to regulate so as to "foster" sound economic conditions in the field of transport. Such a policy was, of course, a part of the Transportation Act of 1920, applying to railroads and oil pipe lines; and it was rewritten to apply uniformly to all carriers by the Transportation Act of 1940.

If regulation is to foster economic transportation development, the independent, unco-ordinated, and uneconomic program of promotional expenditures must be changed. The present policy leads to the government's furnishing facilities without regard to their effect on a plan of regulation. Promotional activities have been designed to develop individual forms of transport rather than a unified system. If regulatory policy is to become one by which transport agencies may be co-ordinated along economical lines, the policy of promotion should be made consistent with it.

4. Divisions in the Field of Regulation. Effective and sound regulation is definitely thwarted by the way in which this field is split. The federal system of government in the United States means that there are fifty governments to deal with the problem of transportation: the federal government, the forty-eight states, and the District of Columbia. The federal government has gained the dominant position. Nevertheless, the vexing problem of distinguishing between federal and state jurisdiction remains. Some carriers are in interstate commerce and some in intrastate commerce. In the railroad field, the federal government has been permitted to extend its jurisdiction over intrastate carriers where they have much effect upon, or are in the flow of, interstate commerce. In the motor-carrier and water-carrier industries, the federal law expresses the desire to keep the scope of federal control limited. What does this mean? It means that a unified program of regulation is not possible except by co-operation between governments — a device of questionable effectiveness.

Within the several state governments, and especially within the federal government, regulation of carriers is divided between different commissions. Under these regulation is further applied with varying force. Some carrying agencies are subject to more regulation than are others, and of a different kind. Statutory provisions and their administration have differed markedly as between railroads, water carriers, and air carriers in particular. Some kinds of carriers within each of these fields are regulated in different ways from others. Common carriers are ordinarily under much more rigorous regulation than contract carriers; private carriers are subject to no economic regulation at all.

With such variance in the scope and nature of regulation, one can hardly wonder at the condition of the transportation industry and the problem of government policy. A unified and consistent national policy should embrace all commercial carriage, especially intercity as contrasted to intraterminal, whether across state lines or within the states.

5. Legislation by Group Interest. A fundamental weakness in transportation regulation, as perhaps in all regulation, is that legislation is the result of pressure by interested groups. This is equally true of promotional legislation. If the farmers wish relief, they get a resolution passed asking the Interstate Commerce Commission to reduce railroad rates on agricultural products, or press for free waterways at government expense. Labor finds it profitable to get a basic eight-hour day made law, a full-crew bill enacted, or a provision passed to limit lay-offs in co-ordination and consolidation projects. Chambers of commerce and local politicians in cities situated on waterways find that they "get something" by pressing for harbor improvements, canals, and dredging at government expense. Shippers believe it to be to their interest to keep laws enforcing competition on the statute books, for lower rates are believed to result. This may mean that shippers will have to put up with higher rates or poorer service in the future, but the future is far beyond the horizon. Management groups often fight regulation, good or bad, unless such legislation seems to give them a competitive advantage over certain other carriers.

Study of the genesis of transportation legislation would disclose many more examples of lawmaking by interested groups. In a sense, if groups are equally powerful and if they represent wide enough interests, the laws thus made may really be to the public interest. But this is not the case. At various times certain groups have been so powerful as to get pretty much what they want. Moreover, the consuming public, as a highly interested group, is seldom represented in the councils of lawmakers.

Transportation regulation has almost never been viewed as a whole. The relationship of one policy to another has seldom been recognized; long-run effects are usually sacrificed to short-run needs. The result has been a fairly unco-ordinated patchwork.

D. PROPOSALS FOR REFORM

Examination of the literature on transportation, including investigations of Congress, will disclose the not too surprising fact that drastic reform of regulation has been intermittently proposed over the years. Before the depression of 1929, this was usually aimed at solution of the "railroad" problem; since 1929, proposals for reform have been concerned with the whole sphere of transportation. The extraordinary depression in the railroad business has dramatized the need for reform. At the same time, the unsatisfactory status of government control in other fields has brought all transport into the agenda of reform.

So many studies of the problem have been made since 1929 that it would be impossible to summarize them all here, or to discuss the measures for changes in legislative or commission administration which have been recommended. Only a few can be mentioned.

1. NATIONAL TRANSPORTATION COMMITTEE REPORT, 1933. At the invitation of sixty-five insurance companies, banking and business associations, and other large institutional investors, five eminent business men and statesmen undertook to survey the transportation problem and recommend legislation for a sound national transportation policy.[1] After a detailed investigation by the Brookings Institution, the committee reported in 1933.

The findings as respects regulatory and promotional policy may be summarized briefly.[2] As a general principle, the committee came out strongly for the encouragement of combinations. It found no need for the government to foster competition, believing regulation to be a sufficient means of safeguarding public interest. The committee also recommended that "government policies should be freed of any purpose either to favor or to handicap any form of transportation with relation to any other form." Extension of regulatory jurisdiction to the whole national transportation system was recommended, but the committee declared that regulation should only be "applied to the extent necessary for public protection."

Among the concrete suggestions were the encouragement or enforcement of regional railroad consolidations, and allowing railroads to own and operate competing carriers. The committee recommended that waterway users should bear the cost of furnishing facilities, and that, while air transport might be aided in its developmental stage, ultimately air carriers should pay their way. Suggestion was also made that motor transportation be put under regulation to the degree necessary for public protection, and that motor carriers pay a tax on the basis of public expenditures made on their behalf plus a fair share of the general tax load.

2. FEDERAL CO-ORDINATOR'S REPORT, 1934. The Federal Co-ordinator of Transportation made a study of needed changes in transportation regulation. This study was published in 1934 and had a measurable effect on legislation proposed after that date.[3]

The co-ordinator came out mildly in favor of public ownership of railroads. He held that "theoretically and logically public ownership and operation meets the known ills of the present situation better than any other remedy," since "when an industry becomes so public in character that such intimate regulation of its affairs becomes necessary, in strict logic it would seem that it should cease to masquerade as a private industry and the government should assume complete responsibility, financial and otherwise." [4]

[1] The report and conclusions of the committee are found in Moulton, H. G., and others, *American Transportation Problem* (Washington: Brookings Institution, 1933). The members of the committee were Calvin Coolidge, Alfred E. Smith, Bernard M. Baruch, Clark Howell, and Alexander Legge.

[2] For the conclusions of the committee, see *ibid.*, pp. xv–lxv.

[3] The study and recommendation were published in two parts: *Regulation of Railroads*, Sen. Doc. No. 119, 73d Cong., 2d Sess. (1934); *Regulation of Transportation Agencies*, Sen. Doc. No. 152, 73d Cong., 2d Sess. (1934).

[4] *Regulation of Railroads*, p. 30.

Nevertheless, the co-ordinator did not recommend government ownership of railroads, because he believed that the time was not propitious for such action. Instead, he proposed for railroads extension of the co-ordination program, a measure of enforced consolidation, and reduction of fixed charges. Outside the railroad field, he suggested full regulation by the Interstate Commerce Commission of water and motor carriers under federal jurisdiction.

The co-ordination program recommended was similar to that provided by the Transportation Act of 1933 and continued until 1936. The co-ordinator suggested that all agencies of transportation should be included, and that his office should not dominate the industry but act as an adviser showing methods for making transportation more efficient. He believed that primary action should come from the industry itself, and that compulsion should not be employed except as a last resort. The outright restriction on effecting co-ordinations which caused unemployment should be eliminated, although a reasonable charge might be made against savings to compensate displaced employees.

The co-ordinator further recommended that consolidation of railroads should be enforced by the Interstate Commerce Commission, where he initiated proceedings of that kind. Programs of co-ordination and of consolidation were to work somewhat in harmony. Where consolidation seemed economically justified, especially after a trial by some co-ordination project, it should be ordered, if necessary, and supervised by the Commission.

Whether in consolidations and reorganizations, or by future regulation of securities by the Commission, reduction of railroad fixed charges was recommended. In the meanwhile, as a temporary expedient, the co-ordinator favored government credit aid to those railroads which the Commission found not to need financial reorganization.

The co-ordinator's recommended regulation of motor carriers was substantially the Motor Carrier Act of 1935; this has been discussed in an earlier chapter. In the field of water transport, the co-ordinator suggested regulation of all such carriers under a uniform law which would follow the principles of the motor-carrier provisions and would provide different treatment of common, contract, and private carriers.

The proposals of the co-ordinator were made as parts of a purposively conceived national transportation policy. There seem to underlie them several principles applicable to transport generally. In the first place, the recommendations recognize the need for fairly uniform regulation of all carriers by a single government commission. Secondly, they appear to favor extension of monopoly by co-ordination or consolidation.

Some of the co-ordinator's proposals became law, although many changes were made in the details of the statutes. The Motor Carrier Act of 1935 followed his suggestion. Regulation of water carriers was increased in 1936, 1938, and 1940, but its extent and administration remained somewhat below the level envisioned by the co-ordinator. Increased control over railroad

bankruptcies by the Interstate Commerce Commission followed in 1935 when the special act of 1933 was amended. Enforced consolidation and extension of the office of Federal Co-ordinator have been denied by Congress.

3. REPORT OF THE SPLAWN COMMITTEE, 1938. Early in 1938 President Roosevelt asked three members of the Interstate Commerce Commission (Commissioners W. M. W. Splawn, J. B. Eastman, and C. D. Mahaffie) to make specific recommendations for legislation to relieve the railroads. While aiming primarily at railroad legislation, the report made does not limit its scope to that alone.[1] The recommendations, divided between means of immediate relief and a long-term program, were in general approved by the entire Interstate Commerce Commission.

The immediate relief measures are not particularly significant, for they were not proposals for much real reform. The committee did recommend that government funds be used for purchase of railroad equipment for lease to carriers, that government might use its credit to support needed financial reorganization, that certain details of bankruptcy law be changed, and that statutes requiring railroads who were recipients of land grants to give the government reduced rates be repealed.

The long-term program is far more important. The main proposals had to do with creating a Federal Transportation Authority and with the placing of equal and impartial regulation of all forms of transportation in a single government commission. The Transportation Authority suggested was patterned after the office of Federal Co-ordinator; it was to plan, encourage, and promote co-ordinations and consolidations which would reduce waste caused by transport competition. It was not to be given power to compel consolidations, but the Interstate Commerce Commission was to be authorized to require co-ordinations recommended by it. Where consolidation of railroads seemed wise, the Transportation Authority was to report the facts through the Commission to the President and submit a draft of appropriate legislation.

As conceived by the committee, the Authority was to be an advisory and research organization, not only to encourage co-ordinations and consolidations but to recommend action with respect to government policy in the use of funds to promote transportation. All regulatory functions were to be retained by the Interstate Commerce Commission. As a "logical conclusion," the committee felt that the sphere of the Transportation Authority might be broadened to include all promotional activities of the government and that it might become a new government department.

The regulatory program recommended was essentially that of the Federal Co-ordinator of Transportation. Believing that successful co-ordination depended upon impartial control over all carriers, and that a unified national program was necessary, the committee suggested accordingly. To administer

[1] The report is printed as *Immediate Relief for Railroads*, House Doc. No. 583, 75th Cong., 3d Sess. (1938).

such regulation effectively, it declared, these activities should be concentrated in a single agency. The committee noted that this had been done with rail, motor, and pipe-line carriers, and should be done with respect to water and air carriers.

4. Report of the Committee of Six, 1938. Late in 1938 President Roosevelt asked three representatives each for railroad labor and railroad management (the "Committee of Six") to prepare a program of recommended legislation. This report was made in December of that year.[1] Here again, the primary concern was for the railroads, although many aspects of a national transportation program were suggested. The report follows closely the recommendations of the Splawn Committee. A Transportation Board was to be established, but its primary function was to be research into the relative economy of carriers for certain kinds of service and into the extent and desirability of government aid. With conclusions from these studies, the Board was to recommend proper legislation to Congress for the attainment of efficient national transport.

The committee strongly recommended uniform regulation, "similar in character and scope," for all modes of transportation. Like other reform measures, most of these powers were to be lodged in the Interstate Commerce Commission. However, to facilitate regulation the committee made the novel proposal to place under the Commission only regulations affecting rates, service, valuation, accounting, and investigations. The Transportation Board was to exercise control over entry into service and abandonments, security issuance, and combinations of all kinds.

Further recommendations of the committee included collection of tolls for commercial use of inland waters, federal legislation to relieve the railroads of certain "unjust" tax burdens, repeal of land-grant rates, placing of railroad reorganizations in the exclusive jurisdiction of a single federal court, a more liberal lending policy by government agencies, and more complete power of the federal government over state rate-making wherever intrastate rates affect interstate rates.

Of interest, too, is the recommendation in respect to consolidations. Believing that co-ordinations often consolidate competing traffic without removing the reasons for competition, the committee attached greater importance to consolidations as a means of effecting economies. It did not offer compulsory consolidations as a solution, placing reliance upon voluntary ones initiated by the carriers. In this connection repeal of the consolidation plan was advised and approval of proposed combinations by the Transportation Board suggested.

5. Legislative Reform by the Act of 1940. The first real attempt to write a new transportation program into legislation was the Transportation Act of 1940. By extending control over water carriers and placing them under

[1] *Report of Committee of Six to the President of the U.S.* (1938).

the Interstate Commerce Commission, the federal government has placed regulation of railroad, water, and motor carriers under the same regulatory commission for the first time. The new law has also initiated a broad policy for commission action in stating that

> It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; to promote safe, adequate, economical, and efficient service and foster sound economic conditions in transportation and among the several carriers; to encourage the establishment and maintenance of reasonable charges for transportation services, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; to co-operate with the several states and the duly authorized officials thereof; and to encourage fair wages and equitable working conditions; — all to the end of developing, co-ordinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of commerce of the United States, of the Postal Service, and of the national defense. All of the provisions of this Act shall be administered and enforced with a view to carrying out the above declaration of policy.

This grand statement of policy, placed at the head of the present Transportation Act, is the first in which Congress has definitely demanded a comprehensive approach to the regulation of transportation. It is as refreshing as it is admirable; it inspires the hope that Congress may at last be willing to see and treat the transportation problem as a whole. Many of the provisions of the new act bear out the statement of policy. But the good intentions of the policy are somewhat belied by omissions in the act itself. It does not touch upon subsidies to water and other carriers, and leaves a large part of the water-carrier business unregulated. Private carriers in both motor and water transport are still left virtually uncontrolled. The law bolsters earlier provisions forbidding the Interstate Commerce Commission to regulate intrastate motor-vehicle business, even where that business affects interstate transport, and extends this restriction to the administration of water-carrier regulation. As is well known, the Commission found long ago that effective regulation of interstate railroad transportation required control over intrastate operations which burdened interstate commerce.

The new law does not completely equalize regulation of carriers. Air carriage is still outside the Interstate Commerce Commission. In the provisions amending the law regarding the setting of rates and the removal of discriminations, the act seems definitely to order the Commission to act in the interests of a given type of transport. In spite of the wise and broad statement of policy, no regulatory commission administering such a law can be expected to do its utmost so that co-ordination will be fostered or the most efficient and adequate transportation system developed.

One of the most hopeful aspects of the new law is the section creating a board

to investigate certain economic aspects of the various modes of transportation. This board, composed of three members appointed by the President, is directed to investigate the following: (1) the relative economy and fitness of carriers by rail, highway, or water to carry each type of traffic, and the methods by which each type should be developed so as to obtain a sound national transportation system; (2) the extent to which right-of-way or other transportation facilities have been and are being financed from public funds; (3) the extent to which taxes are imposed upon such carriers by the various taxing authorities of the nation; and (4) any other matter which the board deems to be important for the improvement of transportation conditions. The board is directed to report the results of its studies to Congress and the President from time to time and to make recommendations. Although it is created for a period of two years, the President is granted the power to extend its life for two more years.

The board may represent the beginning of serious and expert study of transportation problems by a special agency charged with no other duty than to investigate, report upon, and recommend needed legislation for a sound transportation system. It may become a body to carry on and augment the excellent research done by the Federal Co-ordinator of Transportation; or it may become merely another agency which will study needs of transportation policy and make recommendations, only to have them fall upon deaf congressional ears. It is too early to say whether the high purposes of the board will be transformed into legislative action designed to improve policies of governmental control in transportation. What one can say, at least, is that its creation represents a disposition on the part of Congress to continue to study legislative needs of transportation.

E. TOWARD A SOUND NATIONAL POLICY

The present status of government relations to business in the transportation field is not satisfactory. The transportation industry is not in a sound financial condition. Looked upon as a social-economic instrument, it is not giving the maximum of service at the minimum of cost. Since government has embarked upon a program of control and promotion, some of these shortcomings must be laid at its doorstep. The problem is too complex for anyone to map *the* policy which will make the industry most serviceable and least costly to the public. Nevertheless, in the opinion of this writer, there are measures which can be undertaken to develop a more sound and economical transport system. Some of these are within the power of government.

1. CONTROL OF SUPPLY. If government regulation of transportation is to be successful, complete control over the supply of carrying facilities should be effected; otherwise it is probably futile to control competitive rates or service. Adequate control of supply extends further than to the mere requirement that certificates or permits be required. It should cover the field of promotional

activities in which roadways, waterways, airways, or other facilities are built without consideration of their effect on the total quantity of transportation service. It also goes further than the mere supervision of entry or abandonment of service by for-hire carriers; the private carrier, especially in highway and water transport, can hardly be overlooked.

As matters now stand, the supply of transport facilities is woefully unregulated. Gaps have been pointed out in previous discussions. Practical difficulties may stand in the way of filling all these gaps. But a national board or commission could be given authority to approve most increases in the supply of ways, number of operators, and routes. With the widened concept of interstate commerce and with a high degree of co-operation between federal and state governments, much could be done in this direction.

Because of their effect on for-hire transportation and because of public interest in transportation generally, operation of private carriers might even be brought within the scope of this control. If excessive competition occurs over certain routes, by reason of increase in operating equipment by authorized operators, some degree of power over the quantity of such equipment might be wise. Such power should be used carefully, however, for once ways are constructed, full economic utilization of them must be given consideration.

2. A Sound Policy of Promotion. The government has been generous in its expenditures for transportation facilities. This program of promotion is subject to several criticisms, however. Facilities have been constructed without determining the social need for them. Costs have been incurred without determining whether or not other means of expending funds would bring a better grade or higher volume of service at lower expense. The government has furnished facilities without trying to levy adequate fees for their use, and in so doing has laid some of the burden for transportation on the general taxpayer, rather than upon the user of transportation service. This might be justifiable as a social policy if needed service could not otherwise be obtained. Aid to aviation during its early development, for example, is probably justified. But where the government subsidizes transportation at the expense of more efficient privately owned agencies, the policy is hardly wise.

Government promotional policy ought to be reconsidered. Some independent agency should be empowered to approve public expenditures as being necessary for a national transportation system developed along sound economic lines. This would seem to be not only good public finance but wise social planning. If regulation of private enterprise is to succeed, it should not be hampered by government subsidies which are economically unjustified and which do not consider transportation needs generally.

Government-financed facilities should ordinarily be self-supporting. Those using them should be required to pay tolls or special fees to defray their expense. An exception probably must be made for existing projects. As large a fee as practicable should be charged; however, since facilities already exist,

such fees should not be so high as to hinder economic utilization. But if users cannot pay the cost of maintaining and operating present facilities, it would not seem unwise to discontinue them, despite loss of a large government investment. As for enlargement of old projects or expenditures for new ones, government funds ought not be spent unless levies for use promise to be adequate to cover costs.

A further exception to these principles is conceivable. If a certain transportation facility has such great military or social importance as to outweigh economic considerations, government expenditure for it might be made. Clearly, the determination of whether a case is exceptional opens the way for pork-barrel politics; this is dangerous. The best that can be hoped for is that such determination may rest in an independent advisory agency as separate as possible from the pressure of interested groups hoping to "get something."

Where subsidies are contemplated, another test might be made. Can the same results be obtained in ways less expensive to government and less disruptive to private industry? If waterway-building is projected for purpose of curbing other transportation agencies, the question should be faced as to whether the same results, assuming they are desirable, might not be obtained by regulation. Where credit aids to railroads are considered, the government might investigate instead the possibilities of changing the regulation or promotion of other carriers so that such aid might not be necessary. The popularity of giving government loans to carriers in recent years has been increasing. This is clearly government subsidy; it is likewise an easy way to meet a troublesome situation. Nevertheless, the problem should be faced as to whether better results might not be secured by other means.

3. Separation of Regulation and Promotion. Individuals charged with promotional work are almost sure to become champions of the things promoted. It is only natural that a commission charged with developing facilities for water carriers or air carriers should be prejudiced in favor of them. Regulation, especially if it is to consider the relative merits of different carrying agencies, requires a quasi-judicial approach.

A clear line should be drawn between the functions of promotion and those of regulation. In one case there is administration and fostering of business; in the other there should be deliberate and unbiased consideration of points of view that are usually opposing.

As has been pointed out, the scattering of promotional functions and the mixture of promotional and regulatory activities have been characteristic of government intervention in the transportation field. These two functions should not only be separated; they should be concentrated. If all promotional activities were placed in one government agency, the chance for economical and co-ordinated development of a national system of transportation would seem to be vastly improved. Similarly, if all regulatory functions were placed in a single commission, a co-ordinated policy of control would appear to be much more possible.

4. Redefining the Field of Regulation. The gaps and conflicts in the scope of regulation have been referred to repeatedly. Different regulations exist as to modes of transportation, as to kinds of carriers in each industry, and as to carriage within political boundary lines. A unified and consistent national transportation policy can hardly develop as long as these conditions exist.

Laws providing impartial and uniform regulation of all modes of transportation should be enacted. Enough experience has been gained by a half-century of regulation to know what sort of controls and what principles of regulation ought to be applied. Transportation experts seem to be agreed that sound regulation cannot be secured without extending the field to cover all agencies of transportation. Consistent treatment along economically sound lines can probably be had only by placing this uniform control in a single governmental body.

The field of regulation should not be confined to common carriers alone. All contract carriers should be placed under enough regulation to insure that they will not undermine efficient operation of common carriers. To leave private carriers practically unregulated is likewise dangerous; to the extent necessary to protect for-hire carriers, they should be brought under control. Such a move would probably be lawful. With public interest in commercial transport what it is, and with the close economic relationship of for-hire transport and private transport, federal government power to regulate interstate commerce or state government power to legislate in the public welfare would seem to be broad enough to encompass all commercial carriage.

A little more difficult to deal with is the split in jurisdiction between the state and federal governments. The main hope for a uniform transportation policy lies in the assumption of jurisdiction by the federal government. Under its power to regulate interstate commerce and those things affecting, or in the flow of, this commerce, the government has a basis for control the limits to which are difficult to conceive. It is certain that it has not asserted this power to the greatest extent possible. In the interest of a national transportation policy, broadening of the scope of federal control seems desirable. Where matters are clearly beyond it, and an amendment to the Constitution to place intercity transport under central control is not desired, the government could bend itself to greater efforts in effecting co-operation with the states.

5. Transport Co-ordination. Much has been heard in recent years about the benefits of co-ordinating transportation. As broadly defined, this means the assignment, by some means, of transportation tasks to those carrying agencies which can perform them most efficiently. Co-ordination may be achieved by private agreement among carriers, by outright monopoly, private or public, or by regulatory action. There are those who hold that it would result from the survival of the fittest if free competition were allowed to operate. Because of the difference in size, influence, and resources of operating companies, however, this might not come about.

Co-ordination obtained by agreements between carriers is subject to weaknesses. In the first place, the natural independence and great number of operators might make agreements difficult to form and to enforce. A second disadvantage is that agreements would tend to reflect relative powers of companies rather than economic superiority. Furthermore, public interest in transportation is such that these agreements would have to be carried out under government supervision. If this is necessary, then the regulatory agency might as well deal with all aspects of co-ordination.

Co-ordination through monopoly has much to commend it. If one company had a monopoly of all forms of commercial transport in a particular area, the quest for profits would tend to make it select the right mode of carriage for most efficient handling of traffic. The objection to the proposal is that managements have been accustomed to think of transportation in terms of a single agency. Whatever group gained the monopoly might well be biased in favor of utilizing a certain agency, and not taking full economic advantage of other forms. For example, if railroad management gained a monopoly control, the huge investment in rail facilities might mean that it would try to make full use of railroads and not develop other modes of carriage.

In the course of time, however, any bias by managers would tend to disappear. But greater drawbacks exist to accomplishing co-ordination by monopoly. Unless the government forced it or took over the transportation business itself, the process would be long and tedious, since so many companies exist and so many complexities are found in the procedure of combination. A further hindrance lies in the public attitude against monopoly and the popular support of competition.

Much can be said for encouraging monopoly as a means of developing an economically co-ordinated transport system. But if this method is not feasible for political or practical reasons, and if co-ordination is as desirable as it appears to be, the best way to accomplish it is by a policy of regulation. As an immediate program this is to be recommended.

To co-ordinate transport services in this way, regulatory provisions should be administered so that traffic would tend to fall to those carriers which can handle it most efficiently. This requires certain essential features. In the first place, some control must be exerted over the supply of transportation facilities; before new facilities are permitted, some authority should determine whether they are conducive to economical transport. Another essential is a unified system of regulation applying equally to all modes of transport and effectively to all carriers of each agency. These provisions should be under the administration of a single commission. A third basic requirement is the determination of relative efficiency on the basis of total costs, whether subsidies are given or not. If subsidies were eliminated except in rare cases of public need, computation of costs and operation of rates based on them would be much more easily accomplished.

Co-ordination by regulation would come principally from regulation of rates and service. If supply of transport facilities is controlled wisely, only economically necessary and sound service need be offered. Given an economically sound supply, a commission could base rates for particular services on costs. If the latter were fairly accurately computed,[1] traffic would tend to distribute itself to carriers able to handle it on the most economical basis.

6. ENCOURAGEMENT TO COMBINATION. The task of regulation of transportation would appear to be more simple and accomplishment of co-ordination more probable with a greater degree of combination. The wastes of competition have been referred to many times; many problems of regulation may be traced to an excessive amount of it. The present unsatisfactory financial condition of the transportation industry is in no small way attributable to this factor.

In spite of certain moves to encourage some combinations, the foregoing chapters bear much evidence that government policy is still in favor of competition between carriers. To a great extent, competition is the life blood of efficient and progressive business. But the public interest in an efficient national system of transportation and the fact that the public has seen fit to regulate economic policies of carriers make the need for competition in this field a secondary matter.

At the risk of removing spurs for efficiency and progress, it seems to the writer that the government should come out flatly in favor of combination of transportation businesses. Monopoly, or virtual monopoly, has great possibilities for lower costs in an industry like transportation, in which fixed costs are so high. It likewise has certain advantages from the point of view of regulation. This encouragement to combination need not result in a single nation-wide monopoly; perhaps regional monopolies would be large enough for efficient management. Regions for combinations could even be defined with this factor in view.

The past policy has been fundamentally inconsistent. With one hand the government has insisted upon and promoted competition; with the other it has placed upon carriers regulation assuming a near-monopoly situation. The regulation of rates, particularly rate levels, is a case at point. Publicly regulated enterprises are supposedly entitled to rates which will cover reasonable operating and capital costs. Yet the government can do little to see that such rates are collected in an industry where competition is so prevalent.

For those who dislike to give up competition, two factors may be pointed out. In the first place, regulation in transportation is developed to the point, and could be further expanded in places, where the public can be well protected from abuses of monopoly. A second consideration is the probable alter-

[1] The reader should recognize that this in itself is no easy task. With large overhead costs and unused capacity, a determination of costs is certain to include purely arbitrary allocations. An able discussion of the relationship of rates and costs is given in Locklin, D. P., "Transport Co-ordination and Rate Policy," 15 *Harvard Business Review*, p. 417 (1937).

native to encouragement of combination; if the transportation industry remains unsettled, both government and management may find public ownership and control to be wise. Should this come in any part of the industry, competition will probably not be preserved.

F. CONCLUSIONS

Enactment of a sound national policy toward regulation and promotion is beset with many difficulties, some of which may be practically insoluble. One of these is the need for disinterested study motivated only by a desire to see an economical transportation system developed which will protect and promote public interest. With group interests so well organized, this seems highly improbable of attainment. Moreover, business men and others who stand to be benefited by efficient transportation have not taken an active part in promoting a nationally sound system. Associations and conventions too often make nice-sounding recommendations about "preserving private enterprise" rather than definite proposals backed by consistent and well-reasoned principles.

Because transportation is such a mixture of interstate and intrastate operations, any program of government control or aid is bound to run afoul of the federal system of government, with its political divisions between state and national sovereignties. These divisions generally follow no economic lines, but that does not mean that they cannot complicate or nullify a uniform treatment of the transport problem.

Popular support of competition in principle is also one of the difficult factors in formulating a program of regulation. Even though individual farmers or business men or laborers may dislike the competition which hurts them and may try to have their legislatures pass bills to reduce it, they still believe in it as a "public" policy. Since transport is public in its contacts and background, popular reliance on competition is a hard fetish to combat.

Above all, any regulatory program must draw the questionable line between regulation and management. If private property in business is to endure, some of the function of managing an enterprise must be left in the hands of owners or their representatives. Yet regulation is sure to intrude upon this sphere of managerial discretion. Where a proper division is, no one knows. That there is a field of discretion belonging to private enterprise and that regulation should not usurp this field are facts admitted by all. The nice balance between the forces of private direction and public control, or the division between the two fields, is difficult to find, at least if long-run public welfare is considered.

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Part Three

CONTROL OF PUBLIC UTILITIES

CHAPTER

13

THE CONCEPT OF A PUBLIC UTILITY

STRICTLY speaking, transportation agencies are public utilities. This term applies to all those businesses which have become impressed with such peculiar public interest that the government subjects them to intensive regulation extending to practically every detail of their activities. Every business is affected with some measure of public interest. But as a general rule, entry into business is unrestricted by the government, except where certain qualifications demand licensing to protect the public interest. Usually, too, business men are free, so far as the government is concerned, to charge what prices they please and to extend service as they wish. In the public-utility field however, the public interest is so great that regulation includes control over business activities ordinarily regarded as private.

All businesses may be subject to a certain degree to regulations promoting the safety, health, or welfare of the public. But the public-utility businesses have been subject in addition to control of rates and services, as well as many matters ancillary to this control, which are often referred to as economic activities.[1]

Just what businesses are so affected is a question which the courts have been called upon to decide. In interpreting the meaning of the taking of property without due process of law, until recently the courts have held generally that economic regulation is perfectly valid if the business so regulated is one "affected with a public interest." This phrase, the legal development of which is to be discussed presently, is the practical equivalent of saying that a business is a public utility.

The courts have found many businesses to be in this category. Common carriers of persons and property have been included, as have been many auxiliary services such as warehouses, toll bridges, stockyards, grain elevators, messengers, terminal companies, ferries, refrigerator-car companies, sleeping-car companies, and dock companies; companies furnishing communication ser-

vices, such are those providing telephone, telegraph, and radio services; and electric, gas, water, steam, and sewage disposal companies. Several miscellaneous businesses have also been given this special legal status; they are hotels, grist mills, cotton gins, insurance companies, and milk dealers.

In recent years the courts have tended to uphold regulation of such matters as prices and services in businesses not in the generally accepted public-utility category. As will be noted in the development of cases discussed in the following pages, the United States Supreme Court has held that regulation of economic activities may be justified as an appropriate means for removing certain business evils. Whether this recent tendency represents a passing of the time-honored public-utility concept is difficult to say. It does apparently mean that businesses can no longer be divided systematically into "private" and "quasi-public," and that the complete controls experienced in the public-utility industries may be imposed upon other businesses.

There are several reasons for separating the discussion of government control of transport agencies from the regulation of other public utilities. One reason is that regulation of transport agencies has followed closely the established common-law precedents. Most other public utilities have come to be recognized as affected with a public interest by reason of their peculiar relation to the public, although the precedent of regulating common carriage has often been used to support government restrictions over other businesses, such as the communication utilities. In other cases these businesses have been found to be auxiliary to common carriage.

A second reason for discussing transport utilities separately from other utilities is that the principal regulation of the latter has come from the states. They are generally more local in nature than transportation businesses. Even though the federal government has been encroaching upon this part of the public-utility field, these utilities still represent the best case of state regulation of businesses affected with a public interest.

Additional ground for dividing the field is the economic character of most of these public utilities. They are usually highly monopolistic, particularly as compared to transportation agencies. While a measure of competition exists between telephone and radio, or gas and electricity, one seldom finds the same public utility in competition with another in the same locality. This gives a fairly good case study of regulated monopoly.

The following chapters will be devoted largely to regulation of communication, electric, gas, and water companies. Most of our regulatory experience has come from control over these companies. At the same time, the extent, principles, and problems of control might be applicable, to an almost equal degree, to all other businesses in the public-utility category. Moreover, particularly where local transportation companies are concerned, their regulation usually falls under the same controls as applied to the companies mentioned above.

The meaning of the concept of a public utility is extremely important. Any business found to be "affected with a public interest" may be subject to government control of its many economic activities. The traditional rights of private property are markedly circumscribed and constitutional defenses limited. To define the concept one must look to the decisions of the courts. Because need for regulation in the public interest changes with the times, the courts have refused to place this category within fixed limits. The only way to understand the legal meaning of this concept is to find what the courts have actually held to be public utilities and the reasoning employed in so holding.

A. LEGAL DEVELOPMENT OF THE CONCEPT

1. *Munn v. Illinois* (1877).[1] The legal basis for government control of public utilities is found in the decision of Munn *v.* Illinois, handed down by the United States Supreme Court in 1877. In this case the Court first met with the problem of state control of rates in a privately owned business.

Munn and Scott were owners of a grain warehouse in Chicago. In 1870, as the result of the Granger movement [2] the Illinois legislature passed a law prescribing maximum rates for grain storage, and required warehouse operators to obtain a license and post a bond to insure performance of their lawful duties as public warehousemen. Munn and Scott refused to obey the law on the ground that it was unconstitutional as a regulation of interstate commerce, as preference in regulation of one port over another, and as a deprivation of property without due process of law. The last contention was based on the belief that the business of Munn and Scott, being privately owned, was deprived of its property by virtue of the state regulations.

When taken to the Supreme Court, the case was decided in favor of state regulation. The Court disposed of all contentions without trouble, except the issue of confiscation of property. On the question of deprivation, the Court was faced with an entirely new situation. It seems that the attorney for Munn and Scott, being an erudite lawyer, found a reference to a treatise written by the Lord Chief Justice of England in 1676. In this essay the writer, Lord Hale, had distinguished between "public" and "private" wharves. He had held that a person might charge what he wanted for use of a wharf set up for his "private advantage," but that, if the wharf were one to which all persons must come for loading and unloading, the wharf had become "affected with a public interest" and the rates charged should be just and reasonable.[3] Munn and Scott's lawyer maintained that this doctrine proved that his clients' business was not one which was subject to such obligations under the common law, and that hence the Illinois statute was unconstitutional as taking property without

[1] 94 U.S. 113. [2] See *supra*, pp. 13–14.

[3] See Hamilton, W. H., "Affectation with Public Interest," 39 *Yale Law Journal*, pp. 1089–1112 (June, 1930); and McAllister, B. P., "Lord Hale and Businesses Affected with a Public Interest," 43 *Harv. Law Rev.*, pp. 759–91 (March, 1930).

due process of law. He had found references to regulation of carriers, wharfingers, and ferrymen, but he noted no precedent for control of grain elevators.

The majority of the Supreme Court made use of the reference to Lord Hale's treatise.[1] But they found in it a legal basis for holding the regulation of Munn and Scott's warehouse to be constitutional. The Court held that, as Lord Hale had indicated, when private property becomes "clothed with a public interest" and affects "the community at large," the owner of the property has in effect granted the public an interest in that use and "must submit to be controlled by the public for the common good."

The Court found grounds for believing these Chicago warehousemen to be in a business "clothed with a public interest." The facts had shown that warehouses on the Chicago waterfront were virtual "gateways of commerce" which took "toll from all who pass." The Court was clearly impressed by the fact that these operators were in a monopolistic position and were furnishing a service practically indispensable to the public.

The opinion of the majority is not nearly as convincing from legal logic as it is from the point of view of expediency. Resting the legal case on Lord Hale's essay, and then only by indirection, the logic of the Court is not very clear. But the need for regulation was apparent and the decision has the virtue of being good common sense.

Two members of the Court dissented from this decision. They declared that there was "no magic in the language," even of a state law, which made a private business public in nature. They found no precedent for such regulation in Lord Hale's essay or elsewhere, and they vigorously asserted that erecting a warehouse by private capital did not "constitute the building a public warehouse" They saw in this regulation a bold assertion of state power "to control at its discretion the property and business of the citizen."

The doctrine of affectation with the public interest came to be the basis upon which state power over a host of businesses was upheld. Immediately after the decision in Munn *v.* Illinois, railroads were held to be businesses affected with a public interest.[2] From the precedent in the Munn case, a state law regulating all warehouses was upheld [3] and regulation of a water company was found to come under the public interest formula.[4] Grist mills were likewise found to be clothed with such public interest as to admit of regulation.[5]

The principles of Munn *v.* Illinois were employed by state and lower courts in finding many other businesses affected with a public interest. Among

[1] As Professor Hamilton aptly remarked: "So Mr. Chief Justice Waite, with a rare impartiality, accepted the rule of law from the plaintiffs-in-error, affected grain elevators with a public interest, and handed the decision to the state of Illinois." *Ibid.*, p. 1096.

[2] *C. B.* and *Q. R.R. Co. v. Iowa*, 94 U.S. 155 (1877), and *Peik v. C. and N.W. Rwy. Co.*, 94 U.S. 164 (1887).

[3] *Brass v. North Dakota*, 153 U.S. 391 (1894).

[4] *Spring Valley Water Works v. Schottler*, 110 U.S. 347 (1884).

[5] *Burlington v. Beasley*, 94 U.S. 314 (1877).

others, the public-utility concept was broadened to include stockyards,[1] gas companies,[2] telephone companies,[3] and electric companies.[4]

2. *German Alliance Insurance Co. v. Kansas* (1914).[5] One of the broadest definitions of the public-utility concept was given in the case in which the United States Supreme Court upheld state regulation of insurance rates. In 1909 Kansas enacted comprehensive regulation of rates or premiums of fire-insurance companies operating in the state. When ordered to reduce its rates, the German Alliance Insurance Company challenged the law, claiming, among other things, that the fire-insurance business was private in nature.

The Supreme Court, with three justices dissenting, found against the company. The majority opinion shows difficulty in finding the insurance business to be one affected with a public interest. It was not like the warehouse business of Munn and Scott, since no virtual monopoly existed. It was unlike a railroad because no public franchise or other privilege had been obtained. No precedent for regulation could be found in the common law. Yet the Court, probably in the light of common sense, repeated the doctrine of Munn *v.* Illinois and claimed that the insurance business had come to hold "such a peculiar relation to the public interests that there is superinduced upon it the right of public regulation." To support this contention the Court pointed out that the insurance business is necessary to business and personal life, its effect is widespread since most of the country's wealth is protected by it, and the solvency and efficiency of insurance companies is of the widest public interest.

The dissenting justices pointed out that the insurance business presented no likenesses to businesses found to be affected with a public interest. The mere fact that a business is large, they claimed, constituted no fair test. While personal contracts and private property are subject to the police power, they held that regulation of price is not constitutional unless the business is a public utility. The minority found no monopoly in a prime necessity of life, for competition existed between companies. Nor were there franchises or use of the power of eminent domain. The dissenting members of the Court asserted that "there seems no escape from the conclusion that the asserted power to fix the price paid by one private person to another private person, or private corporation for a private contract of indemnity, or for his product, or his labor, or for his private contracts of any sort, will become the center of a circle of price-making legislation that, in its application, will destroy the right of private property. . . ."

[1] *Ratcliff v. Witchita Union Stock Yards Co.*, 74 Kan. 1, 86 Pac. 150 (1906).

[2] *Zanesville v. Zanesville Gas Light Co.*, 47 Ohio St. 1 (1889); *In re Pryor*, 55 Kan. 730, 41 Pac. 960 (1895).

[3] *Western Union Tel. Co. v. Pendleton*, 95 Ind. 12 (1883); *Ches. Tel. Co. v. Baltimore Tel. Co.*, 66 Md. 399, 7 Atl. 809 (1886); *Missouri v. Bell Tel. Co.*, 23 Fed. 539 (1885).

[4] *Cincinnati R.R. Co. v. Bowling Green*, 57 Ohio St. 1, 49 N.E. 123 (1896); *State v. Spokane Rwy. Co.*, 89 Wash. 605, 154 Pac. 1110 (1916).

[5] 233 U.S. 389.

3. *Wolff Packing Co. v. Kansas* (1923).[1] Until 1923, it seemed that the dissenters in the insurance case were not far from correct in believing that the concept of public interest had no practical limits. In the decade following 1923, however, the Supreme Court entered a period when the inclusiveness of the concept was limited. Before this time there seemed to be little, except the desire of state legislatures, which kept a business from being affected with a public interest and subject to economic regulation.

In 1920, Kansas embarked upon a wide program of control and declared the following industries to be affected with a public interest: (1) manufacture and preparation of food for human consumption; (2) manufacture of clothing for human wear; (3) production of any substance in common use for fuel; (4) transportation of the foregoing; (5) public utilities and common carriers. The Wolff Packing Company refused to comply with an order issued under the law, claiming that, since it was a private business, this interference with its business affairs by the state was a taking of property without due process of law.

The United States Supreme Court unanimously upheld the packing company. The Court found none of the requirements for affectation with the public interest in the preparation of food in Kansas. There was no monopoly, no emergency, and no assumption of obligation to the public, as with common carriers. The Court pointed out that a business became clothed with a public interest by its very nature and its relations to the public, not by the declaration of a legislature.

The Wolff case is best known because of the attempted definition of affectation with a public interest, made by Chief Justice Taft. He said:

> Businesses said to be clothed with a public interest justifying some public regulation may be divided into three classes:
>
> (1) Those which are carried on under the authority of a public grant of privileges which either expressedly or impliedly imposes the affirmative duty of rendering a public service demanded by any member of the public. Such are the railroads, other common carriers and public utilities.
>
> (2) Certain occupations, regarded as exceptional, the public interest attaching to which, recognized from earliest times, has survived the period of arbitrary laws by Parliament or colonial legislatures for regulating all trades and callings. Such are those of the keepers of inns, cabs, and grist mills. [Cases omitted.]
>
> (3) Businesses which, though not public at their inception, may be fairly said to have risen to be such, and have become subject in consequence to some government regulation. They have come to hold such a peculiar relation to the public that this is superimposed upon them. In the language of the cases, the owner, by devoting his business to the public use, in effect grants to the public an interest in that use, and subjects himself to public regulation to the extent of that interest, although the property continues to belong to its private owner, and to be entitled to protection accordingly....[2]

Chief Justice Taft's definition leaves much to be desired. It still does not tell when a business is affected with a public interest. Chief Justice Taft was an

[1] 262 U.S. 522. [2] *Ibid.*, p. 535.

eminent legal scholar and judge. If anyone could have been expected to give definiteness to this concept, he should have been able to do so. His classification of businesses clothed with a public interest still leaves a third group of businesses which are subject to regulation because they are so affected The fact that the definition was no clearer is indicative of the difficulty of giving meaning to so indefinite and changing a concept.

4. *Tyson v. Banton* (1922).[1] Several years after the Wolff case, the Supreme Court refused to affect the theater-ticket brokerage business with a public interest. The State of New York enacted legislation regulating the business of theater-ticket brokers in 1922. Among other things this law forbade resale of theater tickets at a price in excess of fifty cents in advance of the price printed on the face of the ticket. Tyson and Brother, ticket brokers, sought enjoinment of operation of the law on the ground that it would deprive them of their property and liberty without due process of law. Their defense was that the business of theater-ticket brokerage was a private one in which price-fixing was not a lawful aspect of regulation.

The Supreme Court divided five to four, the majority finding the ticket-brokerage business not to be included within the concept of business affected with a public interest. Reading the opinion of the majority, Mr. Justice Sutherland found that the ticket broker was a mere appendage of the theater and that the regulation of brokerage commissions was really the fixing of the price of admission to a theater. The majority held that the theater business was not affected with a public interest to the extent that its prices might be regulated. They declared that a business does not become so affected because it is large or because the legislature says it is. The theater business was held not to fall within the scope of businesses previously subjected to price regulation. Mr. Justice Sutherland agreed that the theater might be regulated in the interest of public peace, good order, and public morals, but that it was essentially a private business in which price regulation could not be upheld.

Mr. Justice Holmes, in dissenting, attacked the whole system of judicial definition of the concept of public interest. Holding that a state legislature should be allowed to do "whatever it sees fit to do unless it is restrained by some express prohibition in the constitution," he declared that "courts should be careful not to extend such prohibitions beyond their obvious meaning by reading into them conceptions of public policy that the particular court may happen to entertain." He held that "the notion that a business is clothed with a public interest and has been devoted to the public use is little more than a fiction intended to beautify what is disagreeable to the sufferers."

Mr. Justice Stone delivered some telling criticism at the logic of the majority. The problem, he maintained, was regulation of ticket brokers, not the theater business. The theater-ticket price was not fixed, for the theater owner could print any price he chose. As for the business of ticket brokers, evils existed in

[1] 273 U.S. 418.

which the public had a lawful interest. That the public had a right to be protected against these evils by price regulation seemed to Mr. Justice Stone to be amply supported by the public interest cases, in all of which he found statutory regulation directed toward prevention of exorbitant demands of buyers or sellers.

5. *Ribnik v. McBride*, 1928.[1] On the basis of the case forbidding price regulation of theater-ticket brokerage, the Supreme Court found unconstitutional economic regulation of private employment agencies. In 1918, New Jersey passed a law requiring private employment agencies to secure a license from the state Commissioner of Labor. Issuance or revocation of the license was contingent, among other requirements, upon approval of a schedule of fees by the Commissioner. A license application of one, Ribnik, was refused on the ground that the fees proposed to be charged were excessive. Claiming that the employment-agency business was private in nature, Ribnik took the case to the Supreme Court.

In a six-to-three decision, the Court found the New Jersey law unconstitutional as price regulation of a business not in the category of those affected with a public interest. Admitting that evils of extortion, fraud, and discrimination existed in the business of employment agencies, the majority of the Court held that "these are grounds for regulation but not for price-fixing."

Mr. Justice Sutherland, presenting the opinion for the majority, declared that the employment agency was simply a brokerage business not differing "in substantial character" from the business of a theater-ticket broker. He found it "not easy to see how," without overruling the Tyson case, "price-fixing legislation of other brokers of like character can be upheld."

Mr. Justice Stone, writing for the minority, found that the business of the employment agency differed markedly from that of the ticket broker. He pointed to the great number and widespread effect of evils of private employment agencies. He called attention to general enactment of regulation of these agencies and to the fact that controls, other than price, had been upheld. He challenged the reasoning of the majority by which they distinguished between price controls and other regulations, and declared that there was no valid difference "between reasonable regulation of price, if appropriate to the evil to be remedied, and other forms of appropriate regulation which curtail liberty of contract or the use and enjoyment of property." Mr. Justice Stone felt that price regulation was an appropriate means for removing some of the evils of the employment agency.

The reasoning of the majority of the Court in the Ribnik case is exceedingly weak. No necessary connection exists between businesses of brokers for theaters and for human labor. Moreover, the business of the theater-ticket broker was held to be private because the theater business was private. Apparently forgetting this reasoning, Mr. Justice Sutherland came to the conclusion that

[1] 227 U.S. 350.

the Tyson case made other brokerage businesses private. As Professor Hamilton has indicated, this "knack of putting up new wine in old bottles is one of the most valuable tricks of the judicial trade." [1]

6. *Williams v. Standard Oil Co.* (1929).[2] The judicial process of exclusion and inclusion cast more light on the concept of affectation with a public interest when the Supreme Court held the gasoline retail business to be outside the meaning of this phrase. In 1927, Tennessee adopted a statute providing for control over the prices at which gasoline might be sold. The gasoline retailers claimed that this took their property without due process of law.

With the exception of one member, the Court held that the business of selling gasoline was not one of those affected with a public interest. Although agreeing that the phrase is indefinite, Mr. Justice Sutherland, reading the opinion, said that it might be considered in an affirmative or negative sense. Affirmatively, he held that the phrase "means that a business, or property, in order to be affected with a public interest, must be such or be so employed as to justify the conclusion that it has been *devoted* to a public use and its use thereby in effect *granted* to the public." From a negative point of view, he declared that the size of a business, or the fact that the public has a "feeling of concern in respect of its maintenance," does not make it affected with a public interest.

The Supreme Court found that "gasoline is one of the ordinary commodities of trade, differing, so far as the question here is affected, in no essential respect from a great variety of other articles commonly bought and sold by merchants and private dealers in the country." As such, fixing of prices was found to be invalid.

7. *New State Ice Co. v. Liebman* (1932).[3] The Supreme Court thwarted an attempt by Oklahoma to place the manufacture and distribution of ice for sale within the category of businesses affected with a public interest. In 1925 regulation of these businesses along public-utility lines was provided by the Oklahoma legislature. The New State Ice Company was given a license to operate in Oklahoma City. Liebman attempted to go into the business of ice manufacture and sale without having obtained a certificate of convenience and necessity. He claimed that the ice business was private and that the New State Ice Company or the State of Oklahoma could not interfere with his entry into the business.

The majority of the Supreme Court agreed with Liebman. They claimed that (1) the ice business was an ordinary one; (2) no monopoly existed in the manufacture of ice (here Mr. Justice Sutherland pointed out the prevalence of mechanical refrigerators, which could be obtained by any one at a "comparatively moderate outlay"); (3) no emergency was shown which would make such control necessary; (4) no grant of public privileges was involved; and (5) protection of natural resources was not an issue. Moreover, as the Court noted, the "practical tendency of the restriction . . . is to shut out new

[1] Hamilton, W. H., *op. cit.*, p. 1092. [2] 278 U.S. 235. [3] 285 U.S. 262.

enterprises, and thus create and foster monopoly in the hands of existing establishments, against, rather than in aid of, the interest of the consuming public."

Mr. Justice Brandeis, with whom Mr. Justice Stone agreed, dissented from the finding of the majority. His opinion is a classic example of the so-called "liberal" or "expansionist" interpretation of the police power. He declared that public welfare may often demand creation of monopolies to curb wastes and dangers of "unbridled competition." The requirement of a certificate of public convenience and necessity in the ice business has as its purpose avoidance of duplication of facilities, waste, and poor service. Whether local conditions justify such control is primarily a concern of the legislature, and should not be overruled unless the latter has acted in a clearly unreasonable or arbitrary fashion.

As for the manufacture of ice in Oklahoma, Mr. Justice Brandeis found ice to be "an article of primary necessity . . . partaking of the fundamental character of electricity, gas, water, transportation, and communication." He questioned whether "means of manufacturing ice for private use are within the reach of all persons who are dependent on it." He saw in this legislation a case where extension of public control might be desirable and where a state could "try novel social and economic experiments without risk to the rest of the country." He chided the majority for using its power to prevent experimentation on the ground that a statute is "arbitrary, capricious, or unreasonable." In the exercise of this power, Mr. Justice Brandeis said, "we must be ever on our guard, lest we erect our prejudices into legal principles."

8. *Nebbia v. New York* (1934).[1] One of the most epochal decisions concerning the public-utility concept was handed down by the Supreme Court in 1934 in a case having to do with a New York milk-control law. In 1933, the New York legislature enacted a statute declaring the production, distribution, and sale of milk to be a business affecting the public interest and health, and holding the uneconomic trade practices in the business to constitute an acute emergency which menaced public health and impaired the industry. A Milk Control Board was established with temporary power to fix wholesale and retail prices of milk. The board fixed nine cents as the lawful price in Rochester. Leo Nebbia, a Rochester grocer, sold two quarts of milk and a loaf of bread for eighteen cents. He was convicted of violation of the law, and the case was carried to the Supreme Court on the ground that fixing the sale price of milk took property and liberty without due process of law.

In a five-to-four decision, the United States Supreme Court upheld the New York law. The decision is quite different from that in the ice company case two years prior, and probably represents the effect of the economic depression upon the judicial mind. The majority of the Supreme Court found adequate basis for more than ordinary public interest in the New York milk industry. They agreed that milk was an essential item of diet, that the failure of pro-

[1] 291 U.S. 502.

ducers to receive a reasonable return over a period of time threatened relaxation of vigilance against contamination, and that the production and distribution of milk largely affects the health and prosperity of people of New York State.

At the same time, the Court held that the dairy business is not, "in the accepted phrase, a public utility." Nevertheless, if the industry is subject to regulation generally, the Court believed that no "constitutional principle bars the state from correcting existing maladjustments by legislation touching prices." Holding that the due-process clause makes no mention of prices any more than other incidents of property, the majority intimated that there is nothing particularly "sacrosanct" about price as an object of regulation. As for the phrase "affected with a public interest," it was interpreted to mean "no more than that an industry, for adequate reason, is subject to control for the public good."

Reading for the majority, Mr. Justice Roberts summed up the reasoning of the Court as follows:

> If the law-making body within its sphere of government concludes that the conditions or practices in an industry make unrestricted competition an inadequate safeguard of the consumer's interests, produce waste harmful to the public, threaten ultimately to cut off the supply of a commodity needed by the public, or portend the destruction of the industry itself, appropriate statutes passed in an honest effort to correct the threatened consequences may not be set aside because the regulation adopted fixes prices reasonably deemed by the legislature to be fair to those engaged in the industry and to the consuming public.[1]

The minority, previously in the majority in the cases decided in the preceding decade, vigorously attacked the decision of the majority. In an opinion written by Mr. Justice McReynolds, the New York law was criticized as being unconstitutional. The minority declared that the milk business is not affected with a public interest so as to justify price regulation, nor was the existence of an emergency to justify such control established by the evidence. Granting that evils existed in the milk industry in New York, Mr. Justice McReynolds held that regulating price was an unjustifiable means of treating them. The evil, he noted, sprung from overproduction of milk; yet fixing a maximum price at retail, if it helped the producer at all, would probably tend to stimulate production.

The Nebbia case is startling in view of the other decisions of the Supreme Court. After the Wolff Packing case in 1923 the Court had restricted price regulation to those industries falling in the general classification of public utilities. Admitting that the milk business did not fall in this category, the Court opened the scope of price controls to other businesses where this type of regulation seemed an appropriate means of meeting evils that the state police power is competent to treat. In a sense, this decision is not at all inconsistent with that in Munn *v.* Illinois nor with that in the German Alliance Insurance Company case. In both these decisions, the validity of price regulation rested upon affectation with the public interest. But in neither case did the Supreme

[1] 291 U.S. 538.

Court throw very great limitations upon what this affectation implied.

9. Recent Cases and Economic Regulation. The distinction between private and quasi-public businesses, resting upon the validity of price and service regulation in the latter group, has tended to be broken down by decisions of the United States Supreme Court in recent years. Following the doctrine of the Nebbia case, the Supreme Court has held that the due-process clause of the Fourteenth or Fifth Amendments does not hinder the federal government from fixing minimum milk prices, coal prices, or quantity of tobacco offered on the market. While these later cases involved the federal government rather than the state governments, they do indicate that a business is not deprived of its property without due process of law if the public interest in safety, health, or welfare demands price regulation.

In a case decided in 1939, the United States Supreme Court upheld the fixing of minimum milk prices according to a plan set up by the Secretary of Agriculture under authority of the federal Agricultural Marketing Agreement Act.[1] In this case the Court pointed out that the series of price-regulation cases beginning with Munn *v.* Illinois had been re-examined and that the decision in Nebbia *v.* New York meant that, when the public interest demanded, price regulation could be undertaken without trespassing upon the due-process provisions.

Another agricultural control law was upheld in 1939 when the Supreme Court passed upon the quota restrictions applicable to marketing of tobacco.[2] The Agricultural Adjustment Act of 1938 had authorized, among other things, the fixing of quotas to each seller of tobacco in interstate commerce. The well-recognized purpose of these quotas was to control production and prices, by regulation of the flow of tobacco through marketing channels. The Supreme Court found the law constitutional as a valid regulation of interstate commerce, and expressed no concern over the deprivation of property without due process of persons in a traditionally "private" business.

Measures to fix prices of bituminous coal in interstate commerce were also supported by the United States Supreme Court in 1940.[3] This case involved a federal law designed to stabilize coal prices and production through strong regulatory devices applied to the bituminous coal industry. The Court pointed out that price control is one of the means available to the states and to Congress for the protection and promotion of the welfare of the economic system. The Court also interestingly admitted that "the problem of fixing reasonable prices for bituminous coal cannot be differentiated legally from the task of fixing rates under the Interstate Commerce Act." [4]

[1] *U.S. v. Rock Royal Co-operative, Inc.*, 307 U.S. 533 (1939). See discussion of this law and the case, *infra*, pp. 626–30.

[2] *Mulford v. Smith*, 307 U.S. 38 (1939). See also *infra*, pp. 628–29.

[3] *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940). See also *infra*, p. 650. The control of oil production through proration schemes has also been upheld as valid exercise of the state police power. See *Champlin Ref. Co. v. Corp. Com.*, 286 U.S. 210 (1932), and *R.R. Com. v. Rowan & Nichols Oil Co.*, 310 U.S. 573 (1940).

[4] *Ibid.*, p. 398.

The tendency of the Supreme Court to follow the broad principles of the Nebbia case indicates that the concept of "affectation with a public interest" is losing its significance. If price and production controls have become proper legislative tools for regulating any business, as seems to be the case, there appears to be little legal basis for separating "private" businesses from "quasi-public," or public-utility, businesses. Nevertheless, it seems to be useful for purposes of analysis to make such a separation. In the first place, the Supreme Court still appears to be careful in allowing regulation of economic activities of businesses outside the traditional sphere of the public-utility industries. Second, the long-standing tradition of "affectation with a public interest" and the considerable experience with intensive regulation in the public-utility field make a separate study of regulation of public utilities advisable for the student.

B. THE LEGAL CONCEPT OF A PUBLIC UTILITY

A person looking for a clear definition of the legal concept of a public utility is doomed to be disappointed by his study of the cases on affectation with a public interest. To say that a business is affected with a public interest is merely to say that its price may be regulated by government without infringing upon rights protected by the due-process clauses of the Fifth and Fourteenth Amendments. Price control is the crux of the problem. Other controls may also be implied. Curtailment of competition by requiring certificates or permits to enter service, and regulation of finances, are merely handmaidens to aid in price control. From a legal point of view, control over service with a view to enforcing adequacy and fair treatment becomes a probable field for government regulation of any business found to be "affected with a public interest."

There is no reliable set of criteria which can be used for determining the existence of affectation with a public interest. The economic good furnished has always been one which is relatively indispensable for public welfare. But not all businesses producing such indispensable goods fall within the public-utility concept. Manufacture and sale of most foods have been included in the sphere of "private" businesses. Nor is the existence of monopoly a criterion of affectation. Most common carriers and insurance companies are not monopolies, while some so-called private businesses, such as the aluminum industry, are virtual monopolies.

All businesses having franchises or rights of eminent domain are likely to be within the scope of the concept. Nevertheless, some businesses found to be affected with a public interest have not been given these governmental privileges. The insurance companies, motor carriers, and milk dealers are a few cases at point. An economic emergency does not cause a business to be affected with a public interest, although in some cases it has accentuated the need for protection under the police power.

For a light on the meaning of the concept of a public utility one must look at the businesses found to be affected with a public interest. A list of the most common businesses classed as such was given at the beginning of this chapter. If one can generalize at all, it may be noted that businesses affected with a public interest have been those involving a fairly indispensable good of wide public use, and in which some peculiar condition exists whereby competition does not work to the public benefit.

If the public-utility concept is made broad enough to include all those businesses which may be validly subject to price and service regulation, then the Nebbia *v.* New York case gives strong evidence that the milk business is a public utility. The decisions in this and later cases indicate that the sanctity of price control has been broken down and that price-fixing has become merely another means of applying the police power. If this is so, other economic controls would appear to be equally valid. This would seem to mean that the category of businesses affected with a public interest has been split wide to include all businesses, so that the distinction between quasi-public, or public-utility, and private enterprises would be lost.

On the other hand, the Nebbia case and succeeding ones do not necessarily destroy this distinction. What the Supreme Court has really decided is that where price control is a necessary and appropriate means of dealing with an evil endangering public welfare, it may be used without transcending the federal Constitution. Whether or not such control or other economic regulation is appropriate or necessary to protect public welfare is still a matter for the courts to decide. It matters little whether, in the "accepted" sense of the word, the business is a public utility. The significant point is that when economic regulations are allowed, the principles and problems of control are likely to be the same as those encountered in the generally acknowledged public-utility industries.

Final determination of the public-utility status still lies in the courts, particularly in the Supreme Court of the United States. If legislatures choose to extend the public-utility kind of control to more industries in the future, they will still have to meet the test as to the degree of public interest involved. Because the Supreme Court has become more "liberal," owing to shifts in the attitude of several older members and to changes in personnel, it would appear that the concept of a public utility may be broadened to include more industries. This depends, first of all, upon the action of state and federal legislatures. If their regulations are not too unreasonable or arbitrary, acceptance of these by the Supreme Court seems more probable than it has been since the Wolff Packing Company case in 1923 ushered in an era of restriction upon the public-utility concept.

C. ECONOMIC CHARACTERISTICS OF A PUBLIC UTILITY

Using the term "public utility" in its more restricted sense,[1] the public-utility industries have been subject to somewhat generally similar economic characteristics. Some of the economic features are like those already noted in the transportation field. An understanding of these is helpful in appreciating the problems and principles of regulation.

1. PUBLIC INTEREST IN THE SERVICE. The service of public utilities is relatively indispensable. Except for water, no service of these utilities is absolutely essential for life. Even in case of water service, an individual cut off from the local distribution system could probably find another source of supply. But modern life finds the services of public utilities practically indispensable. A moment's reflection will bring to mind the various ways in which modern social and industrial living depends upon electric, water, gas, communication, and local transport services.

This dependence upon service embraces also the quality of service. The needs of today, from the point of view both of public health and safety and of industrial welfare, make quality of service of great public interest. Not only is the public interested in adequate service of a quality high enough to meet demands, but it has an interest in seeing that the service is given without unfair discrimination. In the industrial field alone, discrimination between users of a particular service might well cause victory or loss in the struggle of business competition.

2. NATURAL MONOPOLIES. Public utilities are generally declared to be "natural" monopolies. All this term means is that competition is likely neither to be efficient nor to be effective. As a matter of fact, the economic tendency toward monopoly is one of the most important reasons for placing these businesses under regulation.

There are several reasons why monopoly tends to be more efficient than competition. Public utilities tend to be industries requiring a relatively large capital outlay. Production facilities and distribution lines are extremely costly. The importance of this capital investment is apparent when one compares the rates of capital turnover.[2] Capital may turn over eight times annually in a chain-store business, nearly once a year in an automobile-manufacturing business, and once in three years in a steel plant, but a public utility will have a capital turnover of once in four or five years. With such large capital outlay, fixed investment and maintenance costs are very important. Moreover, in the operations themselves a large proportion of costs are relatively fixed.

The importance of fixed costs means that costs per unit of output tend to be

[1] For example, as distinguished from the transportation agencies. In the succeeding pages, the study of public utilities will be confined to telephone, telegraph, gas, electricity, water, and local street-railway or bus companies.

[2] Capital turnover = $\frac{\text{Annual gross revenues}}{\text{Total capital invested in the enterprise}}$.

markedly lower as the plant capacity is approached. Decreasing costs are also encountered as the plants become larger, as well as with full utilization of existing plants. For example, a 1,000,000-kilowatt generating station does not carry twice the investment or operating cost of a 500,000-kilowatt station. Although distribution costs may tend to increase as the size of a public-utility plant increases, the cost per unit of service apparently does not, and in some cases (as where high-tension lines may be used by an electric company) it may actually decrease.

A further cause for decreasing per unit costs with the larger public-utility plants comes from the character of demands made on them by customers. Obviously, a public utility must have investment in facilities adequate to meet peak demands. The more customers a plant has, the less likely it is that all or most of them will want their maximum service at the same time. This means that the capital investment per customer will tend to be less and the cost of serving will also be lower through the more efficient utilization of the plant.[1]

The fact that costs per unit of service are generally lower with the larger plant means that monopoly, rather than competition, is more efficient for the public.

Monopoly is more efficient also in its use of the city streets and other facilities. If competitive telephone, gas, water, electricity, or street-railway lines were allowed to build multiple lines down the city streets or across property, the result would be a confusing and inefficient mass of duplicating facilities. These might not only hamper use of the streets but impair the quality of service.

Competition is also not conducive to the lowest costs of investment capital. A single monopolistic company can become better known and occupy a better position in the investment market than rival companies. Because of the inevitable cut-throat character of competition which would grow out of the high fixed costs of rival companies, earnings would be impaired and financial stability threatened. Such a situation would cause investors to want a higher return for their capital before embarking it in an enterprise.

Competition would be ineffective as well as inefficient. With high fixed costs per unit, costs would be lower with more complete utilization. Per unit costs would also tend to be lower as the result of production on a larger scale. Both these types of decreasing costs would cause a strong competition for business. Unless restricted by an effective agreement among operators — a move tantamount to monopoly — the struggle for business would probably give rise to cut-throat competition. The economic minimum of price being out-of-pocket,

[1] The telephone industry is one which is sometimes pointed out as being operated under conditions of increasing costs as the size of plant increases. It is said that the cost per subscriber in a system of ten thousand subscribers is greater than in one of one thousand. The reason given is that the number of possible connections increases in a geometric ratio. However, if the service actually given is taken into account, the telephone industry still seems to be one in which costs decrease with increasing size. While the cost per *subscriber* may increase, the cost per possible call or per call-mile-minute would seem to decrease.

or direct, costs, this competition could be carried on only at a loss. The ultimate result of such rivalry would probably be monopoly, with the strongest company surviving.

Thus competition cannot be relied on to protect the public, even if it were not an expensive way of conducting the public-utility business. Moreover, the quality of service given to patrons would probably be impaired. This is particularly well dramatized by experience in the telephone field. When two or more telephone companies are in a locality, adequate service means that each customer must have telephones of each company.

3. Local Character of the Service. As contrasted to most transportation agencies, notably those whose regulation was discussed in previous chapters, public utilities usually serve a local market. Long-distance transportation of gas, electricity, or water is not uncommon, but the cost of such distribution is so high that these services, as a rule, are furnished by local producing and distributing plants. Although long-distance telephone service is important, the local interchange of messages is far more significant.

This local character has both economic and political effects. From an economic point of view, costs are materially affected by the demands for service and the economic features of the locality. A local utility plant may have little opportunity to spread its risks over a diverse market. Its utilization may be greatly influenced by the prosperity of the community and the relative proportion of industrial or commercial and residential demands. The quality of service demanded varies from locality to locality, and costs differ widely with these demands. Geographical location also may have much to do with variation in costs, as sources of supply are near or far, as characteristics of terrain are diverse, and as labor conditions are dissimilar.

From a political point of view, the predominantly local character of the market means that regulation is more likely to come from the county, municipality, or state. The federal government does have an appropriate field for control where certain interstate features of the industry affect the adequacy of local control, or where some public-utility operations extend across state lines. On the whole, however, regulation of public utilities properly belongs to the state and its subdivisions. The local nature of the business, and the fact that most public-utility service involves carrying the service to the home or office of the user, give rise to problems which cannot be dealt with most effectively from afar.

4. Stability of Income. Public utilities characteristically have relatively stable incomes. This may be accounted for by several factors. They are highly monopolistic and their monopoly position is usually protected by law. Furthermore, their rates are under government supervision and are protected from an unreasonable government attitude by the due-process clause of the federal Constitution. The service, especially for residential, office, and store users, has a fairly inelastic demand. This, of course, means that the quan-

tity taken is not as greatly affected by price as most industrial products. Owing to a high proportion of fixed costs, the total costs of public utilities are not as influenced by price increases and decreases as in most other industries.

At the same time, income from operations of public utilities is not as stable as many have supposed. Commissions have sometimes based rate-making in prosperity upon the assumption that the same return can be made at the same rates in a period of depression. The net return in a regulated industry is not a guaranteed return. Despite constitutional protection against the taking of property, a rate has no meaning if it cannot be collected. Demand for public-utility service may change from time to time, both in absolute amount at a price and in elasticity. Moreover, an increasing volume of public-utility business has been taken by industry. Obviously, the more industrial business an electric or gas company has, the more elastic is the demand, and the more likely is the shift in it as business conditions change. It is the industrial load which has done much to cause instability of income in some public-utility companies. Nevertheless, even with these companies, the character of demand by residential and small commercial users made their income during the depression far more stable than that of most private concerns.

5. Position of the Investor. Risks exist in public-utility enterprises as in all businesses. Many of the street-railway or gas-lighting company investors have had this point brought cruelly to their attention. As a rule, however, the public-utility investor is in a fairly unique situation. The business in which he has invested, as a bondholder or stockholder, is pretty much a monopoly. It has ordinarily been regulated for some years as to its financial practices and its security issuance. It is a business in which earnings are fairly stable.

In the case of stockholders, there is little opportunity for extremely large profits, although this depends upon the effectiveness of regulation and upon the degree to which the company trades on the equity. On the other hand, the stockholder has a certain degree of protection thrown about his dividend. Companies and commissions alike have characteristically favored a system of moderate and regular dividends to stockholders. Hence, the public-utility stockholder is more often in the position of the holder of a debenture bond with a fairly fixed income. This peculiar status of the stockholder is not found in all companies, and has been far from the situation in public-utility holding, as distinct from operating, companies. However, there seems to be a tendency on the part of commissions to regard the public-utility stockholder in a purely investment rôle as one who has embarked funds in an enterprise and expects a reasonable and stable return.

6. Kind of Labor Problem. Except for the telephone and telegraph industries, labor is a much less important item of cost in the public utilities than in the transportation industry. Where steam-railroad salaries and wages take about forty-five per cent of gross revenues, those in gas, electric, and water companies are less than half this proportion. This fact does not spring from

lower wages but from the lesser importance of the labor element in total costs.

Most public-utility employees are highly skilled workers. Despite this fact, unionization is a relatively new development in this field. With the development of organization, however, the labor problem is not likely to be too difficult to handle. Because of the monopolistic character of public-utility companies in a certain territory, employees are singularly dependent upon the individual companies. More important is the fact that strikes or other labor disturbances are sure to be highly unpopular with the public, which so directly bears the brunt of interference with service. Furthermore, it is not likely that government would long tolerate a stoppage of work in these quasi-public enterprises.

D. PUBLIC UTILITIES: A DYNAMIC CONCEPT

Certain businesses are clearly included within the broad scope of the public-utility concept. In some of these industries regulation has become fairly complete and intensive. Such an industry is that producing electric light and power. In other industries regulation is only partially developed and applied to only a few aspects of the business. An example of this incomplete control is found in the hotel business, where certain service requirements are the total of regulation, or in the New York dairy business, where state control was temporary and extended little beyond the fixing of retail prices.

As has been indicated, what constitutes a public utility is a changing concept. The path leading to extensive and detailed economic controls is marked by the growth of public opinion in favor of the regulation, followed by legislative enactment of the control, and finally climaxed by court acceptance of the law as being within the confines of due process.

Public opinion changes with changing public need for regulation. It changes with modifications in the relationship of business to public welfare. No business, however much regarded as private at any one time, is beyond the possible scope of the public-utility concept. The basic consideration is really whether the public wishes to bring the business under economic controls applicable to public utilities. The due-process clause is notably elastic. Constitutional government can be maintained in the face of widespread increase in government control. All that is needed for constitutionality is for the courts to see, in a certain legislative enactment, regulation of what is conceived to be a business "affected with the public interest." As loyal to precedents as courts are, they are nonetheless mindful of the force of public opinion, even though recognition of this force often lags somewhat.

As a touchstone for determining the content of the public-utility concept, certain underlying considerations have been suggested. Professor R. G. Tugwell has held that courts allow regulation when a rate of charge or a standard of service under competition would be harmful to the consumer and had to be

accepted by him with the alternative of not receiving service at all.[1] This theory of public interest, referred to by the writer as a "theory of consumer's disadvantage," is an interesting attempt to explain the underlying nature of the public-utility concept. Examination of the experience in regulation will tend to support its accuracy. But the theory overlooks the possibility that public regulation may be embarked upon for the express purpose of promoting a monopoly, and then controlling it to prevent injury to the consumer.

Mr Justice Stone has suggested a similar consideration. In a dissenting opinion in 1927, he declared that the element common to all lawful price regulation has been "the existence of a situation or a combination of circumstances materially restricting the regulative force of competition, so that buyers or sellers are placed at such a disadvantage in the bargaining struggle that serious economic consequences result to a very large number of members of the community." [2] This is probably as good a statement of the considerations underlying the public-utility concept as can be composed. It emphasizes how the public-utility status awaits only the conditions and the public response to those conditions before a business is included within it.

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[1] Tugwell, R. G., *The Economic Basis of Public Interest* (Menasha, Wis.: Banta Publishing Company, 1922).

[2] *Tyson v. Banton*, 273 U.S. 418, 451–52.

CHAPTER

14

STATE REGULATION OF PUBLIC-UTILITY SERVICE

THE primary interest of public-utility consumers is in securing good service. This fact has sometimes been overlooked in controversies over rates, financial practices, and public ownership; yet these matters are really secondary to the quality of service. To be sure, under private enterprise public-utility service in this country has reached a high standard and consumers have found relatively little basis for complaint. This has perhaps been due to the stimulus of profit, to a degree of competition between public utilities in instances where a customer has an alternative choice, to the fear of public ownership, and to regulatory supervision. Nevertheless, particularly in some localities, service standards leave something to be desired and effective control by commissions is ever necessary to insure high quality. Customers are far more likely to complain of the price of service than of its attributes. Regulatory commissions are also more prone to give price and its attendant problems more scrutiny than they give to service.

Service and rates are closely related. A high standard of service involves high costs, and rates must reflect this expense. Low rates may induce a utility to lower its quality of service unless the latter is safeguarded. Should a commission be initially successful in forcing a higher-grade service than rates can support, the resultant effect upon earnings almost inevitably leads to impaired service. It is often poor economy to insist upon reduced rates without taking into account the character of service demanded by the public and the cost of furnishing it.

Under the common law, all common carriers had certain service obligations. They were bound to receive and carry all goods or persons offered for transportation, of the kind they were accustomed to carry, in a suitable condition for transport, and to the extent of their facilities, if a reasonable compensation was tendered for such service. In addition, they were obligated to carry safely,

subject to a few exceptions,[1] to furnish reasonably adequate facilities, and to carry with reasonable dispatch.

These common-law obligations of the common carrier were transferred to other businesses affected with a public interest. They have become the basis of service regulation in the public-utility field. If no statutory service regulation were provided, or if the existing statutes were incomplete, an aggrieved customer could sue for damages under common law if a public utility did not serve adequately, continuously, expeditiously, and without unreasonable discrimination. Although breaches of these obligations are thus causes for action, and would therefore have some regulatory effect in the absence of statutory controls, effective regulation depends upon continuous supervision by a fully authorized commission. The individual customer who feels that he has a grievance cannot always afford a lawsuit, nor will he always go to the trouble of suing for redress.

Commission regulation of public-utility service has been similar to that placed on transportation agencies. Its main aspects are controls over entry into service, abandonment of service, extension of facilities, discrimination in service, and service standards. Relatively less attention has been given to regulation for safety than with carriers, because the public safety is not so much involved. On the other hand, more supervision of the standards of service has been undertaken, probably because of the more monopolistic position of the local utilities and their closer relations with the public. A further difference is found in the practice of safeguarding public utilities against competition of like service to a greater degree than is characteristic of transportation.

A. SCOPE OF STATE REGULATION OVER SERVICE

There is naturally much difference in the scope of regulatory jurisdiction over service among the forty-eight states and the District of Columbia. All these governments except Delaware, which has no commission regulation of public utilities, have some commission control over service. In Texas, regulation is limited to railroads and gas utilities, and in Nebraska and Iowa the commission has no power to interfere with electric service (or rate) regulation within the limits of municipal corporations. As of June, 1940,[2] five states gave commissions no jurisdiction over electric companies at all and hence not over electric utility service; [3] six placed no control over gas utilities; [4] two excluded

[1] At first the common law recognized that the carrier was not responsible for losses due to "acts of God" and acts of public enemies. Later, there was added as exceptions (1) acts of public authority, (2) inherent nature of the goods shipped which caused loss, and (3) negligence of the shipper.

[2] Data adapted from Welch, F. X., *Cases on Public Utility Regulation* (Washington: Public Utility Reports, Inc., 1936), supplement (1940), p. 120.

[3] Florida, Minnesota, Mississippi, South Dakota, and Texas.

[4] Florida, Iowa, Minnesota, Mississippi, Nebraska, and South Dakota.

street railways; [1] ten states and the District of Columbia did not regulate water companies; [2] two states excepted telephone companies; [3] and only thirteen provided for commission regulation of municipally owned public utilities.[4]

As might be expected, service regulation even where found is not uniform. The character of commission jurisdiction varies, and the extent of actual regulation through similar powers differs between commissions. Most states have power to authorize establishment and abandonment of service, to prevent discriminations, and to define adequacy of service. Power to require extensions within municipal limits is customary, and many states empower commissions to require private utilities to make extensions into rural areas.[5] While most states establish service standards for public utilities, relatively few commissions maintain systematic inspection, grading, and policing of these standards.

B. ENTRY INTO SERVICE

Private enterprise is not free to embark upon the business of furnishing public-utility service. Under the common law, such entry was unrestricted; today, practically all states require that permission from the public-utility commission be obtained. In some states, the public also has no right to enter the field by construction or purchase of a municipally owned plant, unless approval is had from the state agency. As in the carrier field, this approval takes the form of the grant of a certificate of convenience and necessity; the purpose of this, of course, is the certification that the public interest requires the service, and that the applicant is in a position to serve consistently with that interest.

In most jurisdictions, a public-utility company needs more than a certificate of convenience and necessity from the state commission. In order to use the public streets and other facilities, municipal corporations or other state subdivisions require the obtaining of a franchise. This instrument customarily grants special rights to supply service and to use streets for lines to distribute it. In addition, it often contains provisions respecting rates, kinds of service, and other matters. Although the franchise is a contractual right to use public facilities for utility service, modern regulatory statutes make actual commencement of service contingent, in the last analysis, upon the receipt of a certificate of convenience and necessity from the state commission.

As has been noted in a previous chapter,[6] franchises vary from short-term

[1] Mississippi and South Dakota.

[2] District of Columbia, Florida, Georgia, Iowa, Michigan, Minnesota, Mississippi, New Mexico, New York, South Dakota, and Texas.

[3] Iowa and Texas.

[4] Indiana, Maine, Maryland, Massachusetts, Missouri, Montana, Nevada, New York, Rhode Island, Vermont, West Virginia, Wisconsin, and Wyoming.

[5] The Federal Power Commission in 1935 found that thirty-five commissions had authority to require private electric plants to extend service to rural areas. See Federal Power Commission, *Electric Rate Survey*, Series No. 6, p. 9 (1935).

[6] See Chapter 4.

contract grants to perpetual grants. When franchises were the principal form by which the local authority regulated public utilities, control of their length of term and detailed provisions was of the utmost importance. With development of commission regulation the franchise has become far less important and its regulatory features have been largely superseded.

In a few cases public utilities have operated under franchises which had no fixed term but were revocable at will by the municipality or the state commission. In Massachusetts, franchises for street railways have long been revocable. Prior to 1921, a municipality could revoke them without compensation to the utility or permission from the commission. Since 1921, such revocation has had to have commission approval. In the District of Columbia, Congress has provided that all franchises given to public-utility companies are subject to repeal or alteration by the government at any time. Wisconsin has made the indeterminate permit an integral part of its regulatory system since 1907. The law provides that franchises are to be given for no specific time. A municipality, subject to commission approval, may purchase the plant of a public utility at a just compensation at any time. Although franchises in effect before 1907, being contracts, could not be changed, the state offered certain legal privileges to induce companies holding them to take out indeterminate permits.

The short-term or indeterminate franchise does not subject public-utility companies to particularly great danger of arbitrarily and unjustly having their operating rights taken from them. So long as a company serves satisfactorily, there is likely to be no public demand for revocation. Public-utility commissions, also, have usually recognized that allowing unreasonable destruction of private investment is not conducive to favorable future investment or to good service. Moreover, since revocation of an operating permit ordinarily requires that the property receive just compensation, municipalities are not always willing or able to buy the existing private plant.

1. Purposes of Restricting Entry into Service. The primary purpose of requiring a certificate of convenience and necessity is found in the economics of monopoly. Attention has already been called to the injurious and uneconomic nature of competition in the public-utility field. The ultimate losers if unrestrained competition were allowed appear to be the customers themselves. So great has been the public interest in avoiding wastes and evils of competition that modern statutes do not leave this control to municipalities and state subdivisions, but place it in the hands of a state commission.

Restriction of entry into service also has other purposes. Commissions consider the financial standing and responsibility of applicants, and do much to stimulate good service by refusing to grant certificates to those who do not have the required qualifications. Favorable action on an application has often been contingent upon approval of the financial plan of the new company. By refusing to approve where the investors seem to be subject to too great dangers, commissions have used the certificate as a means of protecting them. Because

a certificate does not grant an exclusive right to do business, and a commission can allow others to enter the same field, it has sometimes found the threat of approving the application of a competing company to be an effective means of control.

2. PROTECTION OF EXISTING COMPANIES FROM COMPETITION. The obvious purpose of the certificate of convenience and necessity is, as has been said, to protect existing utility companies from competition. On the whole, state commissions have adhered to this purpose. However, in a few cases they have taken the position that the certificate represents a privilege, and that if a utility abuses that privilege by not giving adequate service at reasonable rates, a competitor should be allowed to enter the field. Such a position has been taken by the California commission.[1] This agency has held that if rates are unreasonable, or service poor in quality or not extended adequately over the field, a utility will be given only until the time of entry of the threatened competition to mend its ways. When a new utility actually applies for a certificate and the existing one is still giving poor service at an unreasonable price, the competitive company will be granted the permit.

In a sense, this policy is an effective means of stimulating existing utilities to good service and reasonable rates. But if it means that facilities will actually be duplicated, the increased business risk resulting can only have the effect of higher investment costs and higher costs to customers. Regulation by commission order is cheaper than regulation by competition. Only as a last resort should competitive services be permitted in the public-utility field, if costs are to be kept down.

C. EXTENSION OF SERVICE

Most commissions require that a public utility obtain a certificate of convenience and necessity for voluntary extension of service. In most cases where the extension is into territory already served or into adjacent territory not served by another company, certificates are not required. Where they are, they are handled much like permits to enter service and present no particularly difficult problems.

Far more difficulty is encountered where a commission orders a public utility to extend its service involuntarily. The great majority of commissions have statutory power to require such extension, even into rural areas. This follows from the common-law obligation to serve adequately. This power, however, is not without limitation. Under well-established legal doctrine, the United States Supreme Court has held that a public utility cannot be required to extend service into areas which it has not held itself out to serve.[2] The bounds of

[1] See Jones, Eliot, and Bigham, T. C., *Principles of Public Utilities* (New York: The Macmillan Company, 1932), pp. 397–401.

[2] See *I.C.C. v. Oregon-Wash. R.R. and Nav. Co.*, 288 U.S. 14 (1932), and cases there cited.

a territory which a utility has professed to serve are determined by the facts in each case; actual doing of business, franchise limits, and the definition of territory in the corporate charter are elements of such evidence.

Even within the general area in which a utility has professed to serve, the requirement of adequate service means only reasonable extensions. As the United States Supreme Court has said:

> The court will not substitute its own judgment as to what extensions are reasonable for the determination of the commission. [Citation omitted.] But it will consider the advantages to result to the public from the extensions ordered; it will also consider the investment required to make the necessary additions to property, the cost of furnishing gas in the added territory, the effect of the new service upon the company's income as a whole; and, if it appears that the power to regulate was so used as to pass beyond the exercise of reasonable judgment and to amount to an infringement of the right of ownership, the order will be held invalid as repugnant to the due process clause. Under the guise of regulation, the State may not require the company to make large expenditures for the extension of its mains and service into new territory when the necessary result will be to compel the company to use its property for the public convenience without just compensation. [Citations omitted.] [1]

Where extensions are ordered into sparsely settled areas, whether in municipal or rural territory, commissions have been rather careful to safeguard orders by setting up rules whereby customers will compensate the utility for the service. In rural electric extensions commissions often require a minimum number of subscribers per mile of line, a high minimum bill, or part payment of the cost of construction by the customers. If the extension appears to be compensatory at a higher rate than that currently charged, and if it appears that the higher rate can be collected, the courts have sustained commissions in ordering extension of service.[2]

D. ABANDONMENT OF SERVICE

1. COMPLETE ABANDONMENT. As in the case of railroads, public utilities do not have the right to abandon service as they wish. They may, however, abandon all of this service if continuance would mean loss.[3] Otherwise, a privately owned company would be forced to use its property for the public without fair compensation and would be deprived of its property without due process of law. The legal rule is well established that states may require public-service companies to obtain a certificate allowing abandonment, whether total or partial.[4] Protection of public welfare under the police

[1] *Woodhaven Gas and Light Co. v. P. S. Com.*, 269 U.S. 244, 248 (1925).

[2] *Ibid.*, p. 249.

[3] *Brooks-Scanlon Co. v. R.R. Com.*, 251 U.S. 396 (1920).

[4] See Field, O. P., "The Withdrawal from Service of Public Utilities Companies," 35 *Yale Law Jour.*, pp. 169–90 (December, 1925). See also *Western and Atlantic R.R. v. P. S. Com.*, 267 U.S. 493 (1925).

power gives a ground for this rule. Since the service is likely to be comparatively indispensable, this safeguard would seem to be entirely lawful. Nevertheless, where the abandonment contemplated is complete and follows a period of losses, a commission cannot ordinarily refuse to grant the certificate within a reasonable time.

One exception to the right for complete withdrawal may be noted. Where a public utility has agreed to a franchise by which it has assumed the contractual obligation to serve for a period of time under specified circumstances, it may be compelled to operate in spite of loss.[1] The courts tend to interpret such contracts strictly, however, and the obligation of the public utility must be clearly shown. One might note that in case of bankruptcy of the utility, abandonment could legally follow irrespective of such contracts.

2. PARTIAL ABANDONMENT. Most of the difficulty regarding abandonment is encountered when a utility desires to discontinue a part of the service found to be unprofitable. The same principles apply here as were noted with railroads. A public utility has no legal right to abandon a part of the service even though this portion be carried on at a loss.[2] So long as it continues to operate, it is obligated to perform reasonably adequate service.

Where a portion of the service causes loss large enough to affect the return on the property as a whole, the question of right to abandonment is a little confused. In one case, the Supreme Court said that "a carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage." [3] In another case, however, the Court took the position that a utility might not discontinue a portion of its service even though this is operated at a loss and "the system as a whole fails to earn a fair return upon the value of the property." [4] In the light of the often stated opinion that a public utility cannot continue to exercise privileges granted by its charter and refuse to serve adequately, even at some pecuniary loss on a part of the business, the latter position would seem to represent the prevailing legal view.[5]

In spite of the power of a commission to compel continuance of service at a loss, this authority should be administered sparingly. A public-utility company cannot long serve other customers well if it cannot be operated at a profit. The company and the commission have the public obligation to search for means of making a losing portion of service pay its way. If it cannot be made to pay, if it places a burden on the financial soundness of all operations, and if its discontinuance would not cause too great public harm, the commission should issue the needed permit for abandonment.

[1] *Georgia Power Co. v. Decatur*, 281 U.S. 505 (1930).

[2] *Fort Smith Lt. and Tr. Co. v. Bourland*, 267 U.S. 330 (1925).

[3] *Brooks-Scanlon Co. v. R.R. Com., supra*, p. 339 (1920).

[4] *Fort Smith Lt. and Tr. Co. v. Bourland, supra*, p. 333 (1925).

[5] See *United Fuel Gas Co. v. R.R. Com.*, 278 U.S. 300 (1928); *Texas R.R. Com. v. Eastern Texas R.R. Co.*, 264 U.S. 79 (1924); *Atlantic Coast Line R.R. Co. v. Com.*, 206 U.S. 1 (1907); *Mo. Pac. R.R. Co. v. Kansas*, 216 U.S. 262 (1910). Although some of these are railroad cases, the principles would seem equally applicable to all public utilities.

E. SERVICE DISCRIMINATION

Considering the problem broadly, the law against service discrimination involves the obligation of a public utility to serve all customers within its professed territory, and to serve them equally. The question of service extension is within the first class of obligations, although there is an additional responsibility to serve all within the territory into which lines are already extended.

These obligations are rooted in the common law of common carriers. They have been transferred to the public-utility field and are found in the statutory powers of nearly all commissions. As in the common law, these statutes do not make such obligations absolute; instead, they are required only to a reasonable extent.

1. THE DUTY TO SERVE ALL. The general rule is that public utilities must serve all who apply for service and who are in the territory which a utility professes to serve. In some cases, a public utility may properly refuse to do so. Because the determination of the lawfulness of such refusals hinges upon interpretation of reasonableness, one must look to actual cases for the meaning of the duty to serve all.[1]

A public utility is, of course, not bound to serve those who do not pay for their service, or who delay longer than a certain period in meeting their bills. Where a gas or water company has a diminishing supply and an adequate one cannot be obtained at a reasonable capital outlay, courts and commissions have allowed it to refuse to serve new customers. Courts have also upheld public utilities in refusing to serve a competitor, whether the competing company is a private manufacturer selling surplus electricity or water, or a public-service company.[2] Refusal to serve has also been upheld where a customer used abusive and obscene language over the telephone or telegraph, and where a message was in aid of an illegal purpose. It is well settled that public utilities may make reasonable rules for the conduct of their business, including requirement of a cash deposit, and refuse to serve where these rules are not obeyed.

Public utilities have been ordered to serve in many cases where at first they refused to do so. Courts and commissions have quite generally held that a public utility cannot continue to refuse to serve after a customer has paid for his back bills, or complied with rules which he had previously not obeyed. Financial embarrassment is ordinarily not held to be an excuse for failure to serve, and it is generally agreed that the proper remedy lies in application for increased rates.

2. THE DUTY TO SERVE EQUALLY. Most cases of refusal to serve are those in which customers are not served equally; in addition to these, there are some

[1] The writer has drawn on selections and notes in Welch, F. X., *Cases on Public Utility Regulation*, chaps. V–VIII.

[2] See *Rogers Iron Works v. P. S. Com.*, 323 Missouri 122 (1929), and cases there cited.

cases where a utility serves classes of customers, or certain customers within a class, differently. Here the company has not refused to serve but is serving discriminately. As with the duty to serve all, the obligation to serve equally is subject to a rule of reasonableness. This type of discrimination is closely related to rate discrimination. Most differences in service present differences in costs and rates. The claim is often made, then, that the rates are discriminatory rather than that unreasonable differences exist in service.

No question any longer exists as to the right of a public utility to serve certain classes of customers differently. For example, a residential user of electricity could hardly expect delivery of high-tension service merely because an industrial concern received it. In attempting to meet the competition of privately owned steam or Diesel electric plants, some electric companies have made inducements which in effect discriminated against other users of electricity. In a New York case the Public Service Commission found that the city electric company had been assuming the expense of changing over wires and facilities of certain private plant-owners, had been purchasing steam boilers at an excessive price, and had extended other special services at no cost or at nominal prices.[1]

F. STANDARDS OF SERVICE

The common-law obligation to serve adequately has been translated by modern public-utility laws into the establishment of certain minimum standards of service. Nearly all the state commissions have power to establish such service standards, although the scope of this authority differs. Rather few commissions who set up standards have appropriations large enough to exercise continuous supervision by inspection and grading. For progressive companies, however, service standards are regarded as minimums, and good business and public relations serve to stimulate a high quality of service.

Establishment of service standards is often a highly technical matter. What the consumer wants and should have involves both economic and engineering problems, the answer to which necessitates technical research. The engineering staffs of the more modern commissions have done much work in this field. They have been assisted to a great degree by research of the companies themselves, the United States Bureau of Standards, trade associations such as the American Gas Association and the Edison Electric Institute, and the National Association of Railroad and Utilities Commissioners.

1. GENERAL SERVICE STANDARDS. There are a few standards of service which are quite generally applicable to all public utilities. Rules are customarily promulgated for the sake of safety, both of employees and the public. Safety devices, warning signs, and periodical inspections may be required, and safety education urged. Safety rules also usually provide for reports to the commission of all accidents occurring in the business of a public utility.

[1] *Re New York Edison Company*, 21 P.U.R. (N.S.) 156 (1937).

a. Continuity of service. Because of the indispensable nature of the service, the public is interested in its being continuous. Every public utility — electric and telephone utilities in particular — has to suspend or interrupt service for lengths of time varying from seconds to weeks,[1] because of failure of equipment, weather conditions, or a variety of other factors. Interruptions, even for very short periods, are extremely vexing to customers. With a view to reducing them, public-utility commissions require stand-by equipment and periodical inspection of installations. In addition, reports of all interruptions must often be made, with the reason for them. With such information available, a commission may find the instances where interruptions are too prevalent and take the necessary action to remove their causes if possible.

b. Accuracy of meters. When service is paid for on the basis of meter-readings, as is usually the case with gas, water, and electricity, accuracy of the meters is an important matter to the public; a company with a properly enlightened management will also be interested in this detail as an essential for good public relations. Regulation of service standards includes the requirement of accurate meters. Commission rules are generally rather detailed as to this feature of service; they provide for periodical tests, and for a test by the company on request of a subscriber without charge, and with reimbursement if the meter has caused an overpayment. To safeguard companies from customers taking undue advantage of this privilege, the rules often state that a free test cannot be had except at a certain time after an earlier one. Sometimes a customer may have a test made by a representative of the commission, in which case he must pay a fee unless the meter has been inaccurate and in favor of the company; in the latter event the fee is levied on the company.

c. Payment of bills. A third general standard of service has to do with the payment of bills. Commissions make rules defining the amount of deposit which is reasonable, the repayment of deposits, the time limit on paying, and methods for handling a dispute as to the fairness of a bill. Often commissions require merely reasonable rules by the company, but retain power to approve the rules and make them, in effect, its own.

d. Complaints. A fourth set of rules in the interest of satisfactory service concerns complaints of customers on any subject regarding service. They should be handled by some well-recognized procedure. A delayed answer to a complaint is almost as destructive of good public relations as no answer at all. If a public utility does not handle complaints expeditiously and satisfactorily, the commission should prescribe the proper procedure for doing so. Moreover, a report on the number, nature, and disposition of complaints has been found by many commissions to be a valuable source of information on the character of service rendered.

[1] In its annual report to stockholders in 1939, the Boston Edison Company noted that after the hurricane in September, 1938, normal service was not restored for two weeks. However, with two thirds of its customers without service on September 21, the company had all but six per cent served within seven days.

e. Rules and regulations. All rules and regulations of a public-service company should be made known to its customers. Information on rate schedules and classifications of customers is also a requisite of good service and good public relations. Many commissions have rules governing publicity on these matters.

2. SPECIAL SERVICE STANDARDS. In addition to standards of general application to public utilities, certain kinds of companies have special operating and service characteristics which necessitate special rules. The more important of these will be described in connection with the five classes of utilities over which state commissions have most of their administrative control.

a. Electric utilities. Commission rules generally deal with problems of variation in voltage and in the frequency of alternating current. Motors, lamps, and other electric appliances are constructed to take a certain number of volts; if voltage varies, the performance and life of these devices are materially affected. Moreover, voltage has an effect upon meters; if it is much higher than the standard for which the meter is made, the readings will tend to be higher than they should be. If alternations of current vary, the speed and performance of motors are influenced. Where electric clocks are in wide use, too, variations in alternation affect their accuracy. Commission rules often state the degree of variation in voltage and alternation allowable, provide for tests, and require records to be kept and submitted.

b. Gas utilities. Special service standards for gas companies include regulations as to pressure, heating value, and purity. An excess of pressure may cause leaks in a line, and both excessive and deficient pressure cause inefficiency in the use of heating devices. Most commissions have rules setting standards for gas pressure at the customer's outlet and allowable variations from them.

Since gas is customarily measured and paid for according to volume, the heat content of a given one thousand cubic feet of gas is of utmost importance to the user. Gas varies in heat content according to the mode of manufacture, or, as in natural gas, according to the gas field. Air or other elements can be mixed with gas, with resultant lowering of heat content in a certain volume. Because of these variations, and because customers have no way of ascertaining heat value, government regulation in this respect should be adequately and rigidly administered. Nearly all commissions specify the heat units to be supplied in a given quantity of gas and the variations to be allowed.[1] Good administration of these rules calls for periodic inspection by the company and the commission and reports of thermal content to the latter.

Gas contains several components injurious to health, disagreeable for users, or harmful to piping, appliances, and other properties of the user. Some of

[1] The heat unit used is the British thermal unit (B.T.U.) which is the amount of heat necessary to raise one pound of water one degree Fahrenheit. Thus, a commission may specify that a certain kind of gas must have 600 B.T.U. per 1000 cubic feet.

these are desirable heat elements, such as carbon compounds, especially carbon monoxide. Others are "impurities" in that they do not contribute to heat values. While carbon monoxide is very poisonous, its content is not usually restricted. It is useful for heat value, and does not furnish a hazard if appliances are sensibly used and adjusted to burn properly.

On the other hand, ammonia, hydrogen sulfide, and other forms of sulfur are not necessary for efficient heating and are disagreeable or injurious. Sulfur in gas tends to corrode metal, and in large enough quantities is not only disagreeable but injurious to health. Ammonia is also harmful to certain metals. Most impurities can be removed at rather small expense, although sulfur is not so easily removed and varies in manufactured gas with the kind of coal or oil used. Commissions have usually specified the maximum content of such impurities in a given value of gas, and have required tests to be made from time to time.

c. Water utilities. The principal special service standards prescribed for water companies deal with pressure and purity. The public need for adequate and uniform pressure and for pure water is hardly open to question. Some commissions have set up rather strict standards in this direction and have required periodic tests and reports. On the whole, however, most service standards are prescribed by the municipalities. Public-health authorities often take over the testing of water purity, and local interest in fire protection is usually adequate to insure regulation for adequate pressure. As a matter of fact, service of water utilities is frequently not regulated by state commissions at all. Because the large majority of water plants are publicly owned, their control is ordinarily left to local authorities.

d. Telephone utilities. Telephone service is a highly personal kind of business. Its standards are very difficult to formulate, since public requirements vary so between communities. Moreover, technical changes have come rapidly in the industry and any reasonable rule of today may become outmoded tomorrow. While most commissions have power to establish service standards, relatively few have done so or have exerted much effort in administration.[1]

The Wisconsin and Illinois commissions are among those few who have set up minimum standards for telephone service. These include general rules holding that the service should give connections without delay, and should be rendered so that users generally will be satisfied. Specific rules have been established requiring elimination of noise, standards of speed in making connections, courtesy and clarity of speech by operators, periodic reissue of directories, and safeguards against overloading of lines, switchboards, and other equipment.

As a matter of fact, except for some villages and rural communities, telephone service in the United States has been of an exceptionally high quality. With

[1] Herring, J. M., and Gross, G. C., *Telecommunications* (New York: McGraw-Hill Book Company, Inc., 1936), p. 350.

what is virtually a nation-wide monopoly under the control of the American Telephone and Telegraph Company, the telephone industry has been under a management whose record for good service and good public relations is enviable. Even the investigation of the Federal Communication Commission, reported in 1939, found little to criticize in the quality of service.[1]

e. Street-railway and bus utilities. Specific standards for street-railway and bus utilities have been promulgated by relatively few state commissions. Most commissions have authority to set up such standards, but the diverse character of local needs and conditions have made it difficult to agree on standards. Where special service rules have been made they have dealt with a variety of matters. Adequate service in terms of frequency and regularity has been required, although the detailed provisions have been left to individual cases and often represent agreements worked out by the company and local authorities. Rules for rush and non-rush hour equipment and the number of seats necessary have been similarly treated. Rules of more general application have been ordered in matters affecting ventilation, heating, lighting, and cleanliness of cars and buses.

G. CONCLUSIONS

Service is obviously as important to a public-utility customer as are rates. Yet beyond matters of entry and abandonment of service, the efforts at regulation have not been nearly so great in this sphere. This may be due to several factors. Measurement of adequate service is not subject to the objective calculation possible with rates and finance. Regulation of service on a broad and effective scale calls for much work and expense; most public-utility commissions have not been granted appropriations to provide for adequate and expert staffs to undertake research, inspection, and grading of service. Furthermore, private enterprise in the United States has had a good and improving record for a high grade of public-utility service, and the demand for regulation has not been great. Whether the service has been as good as modern technical progress makes possible is another question. The significant point is that the utilities have adopted enough of this technical advance to cause service consistently to improve.

The record in control of entry into service has been good, as measured by the economic advantages of monopolistic production in public-utility service. A few of the more modern commissions have made excellent progress in regulating for adequate service. In other cases, a need appears for more effective enforcement machinery. The tendency to except municipally owned utilities from service regulation is also open to question. As service requirements come to be better understood and as technical improvements become more stand-

[1] Federal Communications Commission, *Investigation of the Telephone Industry in the United States*, House Doc. No. 340, 76th Cong., 1st Sess. (1939).

ardized, a more adequate system of regulation will probably be developed. It should be remembered that a high grade of service is the primary goal of public-utility regulation.

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CHAPTER

15

STATE REGULATION OF PUBLIC-UTILITY RATES

As WITH common carriers, public utilities are obligated under common law to serve at reasonable rates. This obligation has been carried over into the statutes of the states, along with additional provisions authorizing commissions to do many things for the purpose of obtaining reasonable rates.

The difference between a level of rates and particular rates, or the rate structure, has been discussed in the chapter on railroad rates.[1] One finds the same division in the public-utility industries. The relative importance of these two aspects of rate regulation differs markedly, however. In contrast to railroads, the major problems in public-utility regulation have centered about the rate level. Because public utilities are highly monopolistic, and because many are faced with demands which are not too elastic, these quasi-public companies are often in a position, in the absence of strict regulation, to charge rates which would yield high profits. This is a situation decidedly dissimilar from that existing in the carrier business, where rate levels of many companies would not be excessive if regulation were much more lax. At the same time, many public utilities have a more elastic demand facing them than is often supposed; some managements have found, after contesting a lowering of rate levels, that their profits after rates had been reduced were greater than before.

On the other hand, while individual rates and the problem of discrimination are important in the public-utility field, they have not been of such critical significance as with railroads and other carriers. For one thing, the rate structures of public utilities are not nearly so complex. The kinds of service are far more limited and the competitive aspects far less severe.

The economic and legal bases of public-utility rate-making follow those discussed in connection with the railroads. An economically sound rate level in this field is one adequate to cover all costs for the service demanded by the public. The economically justifiable individual rate is one which covers

[1] See Chapter 6.

out-of-pocket costs and contributes a reasonable amount toward overhead costs, such contribution being limited by the value of service and by the public interest in eliminating excessive return. The legally reasonable rate level is one which is high enough to avoid confiscation of property without due process of law and yet not be more than the service is reasonably worth. Legal aspects of an individual rate require that it be reasonable *per se* and be not unreasonably discriminatory. What is reasonable is a matter to be decided in individual cases, but the courts have held that a commission may not force a railroad to charge as little as out-of-pocket costs.[1] This principle would seem to apply to public utilities.

A. SCOPE OF STATE COMMISSION AUTHORITY OVER RATES

All states except Delaware have some measure of power to regulate rates. In a number of states this power does not extend to certain utilities, and in a majority it is not applicable to municipally owned utilities. Since the general scope of rate regulation is practically identical to that of service regulation, the exceptions need not be pointed out here. However, in a few states the public-service commissions have no power to regulate rates in "home-rule" cities, or in municipalities where local rate regulation is provided in a franchise with the operating utility.[2]

Where any sort of rate regulation exists, the laws are more uniform as between states than in any other aspect of public-utility control. They generally provide that rates must be just and reasonable, that unreasonable discrimination is unlawful, that schedules must be filed and adhered to, and that changes may be made only after due notice to the commission. Nearly all commissions are given power to suspend changes in rates pending investigation. Most states also empower commissions to undertake an investigation, upon their own motion or upon complaint, as to the reasonableness of rates, and to fix a reasonable rate in the place of any found unreasonable; in a few states this power is limited to maximum rates.

In recent years an interesting rate-regulation device has become law in several states. This is the temporary-rate order. It enables a state commission to set rates which a utility must charge during the pendency of a case before the courts. State laws usually permit the temporary rate to be made on the basis of commission data as to reasonableness. When the case is decided, the temporary rate is changed to the price arising from the litigation. If the rate finally allowed is above the temporary one, the utility is allowed to make

[1] *Nor. Pac. Ruy. Co. v. N. Dakota*, 236 U.S. 585 (1915). This case seems to imply that a company has a legal right to ask for rates covering overall operating costs.

[2] See Federal Power Commission, *Electric Rate Survey*, Rate Series No. 6, p. 3. In 1935, the following states had their jurisdiction over electric utilities so limited: Colorado, Kansas, Michigan, Ohio, and Wyoming.

up the deficiency by a temporary higher charge. In 1939, United States district court upheld this device as a reasonable commission procedure.[1]

The more advanced state laws regarding public-utility rate regulation have been influenced by the Interstate Commerce Act. As a general rule, however, prohibitions against specific discriminatory practices are not found in the public-utility laws to the extent that they are in the Interstate Commerce Act. The typical act forbids undue or unreasonable discrimination, but leaves the finding of the fact of such discrimination to the commission.

B. VALUATION

As with railroads, regulation of the level of public-utility rates involves three problems: fair value, fair rate of return, and reasonable operating expenses, including taxes and depreciation allowances. Under the law, a private company is unfairly deprived of its property by a rate order which does not allow for reasonable operating expenses plus a fair rate of return upon the fair value of the property used and useful for the public service.

Owing to the predominant importance of rate-level regulation in the public-utility field, much more detailed attention will be given to these problems than was necessary with railroads. Regulation of operating expense has been limited in actual commission administration of rate-level control, largely because such expense is easily ascertained, and because commissions have hesitated to go too far into the sphere of managerial discretion. Valuation and rate of return, for economic and legal reasons, are subject to judgment as to the fair amount. Hence they have been at the center of the struggle between companies and commissions over rates.

The uncertainty of valuation is readily apparent from the differences in "values" submitted as evidence in rate cases. In one case, various competent witnesses valued a water company at figures ranging from $365,000 to $1,200,000.[2] In a telephone-company case a commission found a value of $367,000,000, although the company had experts testify that the value was over $600,000,000.[3] At a fair rate of return annually of, say, 6 per cent, a company has something well worth going to court about, if by doing so it has a chance to add one or two hundred million dollars, or even much less, to its valuation. Thus, fair value has become a well-litigated subject drawing a disproportionate amount of the time and attention of commissions.

Given a public-utility property, its value depends upon two sets of information: (1) the property items included in a computation as used and useful for public service, and (2) the method used to measure the value of these. The latter kind of information will be discussed first.

[1] *Beaver Valley Water Co. v. Driscoll*, 28 F. Supp. 722 (1939). While dodging the issue, the United States Supreme Court intimated that the device was lawful in *Driscoll v. Edison Lt. and Pwr. Co.*, 307 U.S. 104 (1939).

[2] *Bluefield, W. W. and Imp. Co. v. W. Va. P. S. Comm.*, 262 U.S. 679, 684–85 (1923).

[3] In *New York Telephone v. Prendergast*, 36 F. (2d) 54 (1929).

1. METHODS OF MEASURING VALUE. The student of economics will probably conceive value to be an exchange value, or the power of a good to command another in free and voluntary exchange. But public-utility properties are seldom bought and sold in a free and competitive market. Even if they were, their sale price would reflect the earnings that the company had been making; the earnings in turn would be affected by the regulation. Clearly one could not use exchange value, even if it were available, as a basis for public-utility rate control. As a result, various substitute methods have been used for measuring this value.

a. Original cost. One such measure is original cost. This is the actual cost to the company of the present property allocable to the capital account. If books are accurately kept according to accepted accounting principles, the actual cost should be the same as the book cost.

Sometimes original cost is used in the sense of the cost of acquiring or constructing the original property plus additions and betterments thereafter.[1] The term as used above seems to be more acceptable, however. If accounts are kept properly, original property will be written off as retired, and the books will show the original cost of present property to the company in question.

The term "historical cost" has also been used. In some cases this is used to denote original cost as defined here. Others have defined it as prudent investment.

b. Prudent investment. By prudent investment is meant original cost as modified by a standard of business prudence; ill-conceived or foolish expenditures would be subtracted from the original cost totals. The doctrine starts, then, from original cost, and eliminates costs which would not reasonably have been made by a competent and prudent business man. This method does not imply that utilities are necessarily penalized for mistakes in judgment by management, unless they are shown to be patently foolish, unwise, or of fraudulent intent.

c. Cost of reproduction. Measurement of value by a cost of reproduction standard involves the determination of the cost of reproducing the property at present prices. The purpose of this method is to stimulate competitive conditions by finding what it would cost to reproduce the existing plant. To do so, engineers usually take an inventory of the physical property, apply present prices thereto, and add estimated amounts for the cost of intangible property items.

Determination of reproduction cost is an expensive, slow, and complicated matter. Besides the matter of making an accurate inventory, problems arise as to what prices to use and what intangible items to include. Strict compliance with the principles of reproduction cost would seem to make necessary using prices as of the date of valuation. Yet prices can change during the time

[1] See Jones, Eliot, and Bigham, T. C., *Principles of Public Utilities* (New York: The Macmillan Company, 1932), pp. 197–98.

a valuation is being made, or the so-called spot prices may not be normal in the sense of representing either past or probable future prices.

Problems of a hypothetical kind arise. Should the cost of tearing up pavement to lay mains be included, even though the mains were actually laid before the street was paved? Should the cost of replacing machinery of an old type be calculated when actual reproduction would call for using modern machines? Admitting that a plant may be worth more than the mere summation of physical inventory at present prices, how much should be added for this going value?

d. Cost of reproducing the service. Under competitive conditions, present value would appear to be given better by the cost of reproducing the service, not by reproducing the present plant, but by building a plant furnishing the same service in line with modern technique. Such a method would overcome some of the weaknesses of the former one, for actually, if a new plant were to be constructed, the newest and most efficient producing and distributing equipment would be used. This method would necessitate engineering estimates of the cost of building a new plant to furnish the service delivered by the existing one, despite the fact that construction of new facilities is not contemplated. Questions would arise as to just what design is most efficient in view of costs. Much work and expense would be incurred in the making of purely hypothetical estimates.

If present costs are to be considered, this method has much to commend it. But it has not been used to any extent by companies or commissions. As a matter of fact, the courts have refused to allow it to be used as an element of valuation evidence, for they have found it too conjectural and leading to "collateral issues and investigations having only a remote bearing" on the determination of value.[1]

e. Use of index numbers. To give effect to present-day cost without going to the trouble and expense of reproduction-cost calculations, the use of index numbers of prices has been suggested. At least one commission, the Maryland Public Service Commission, has adopted this method.[2] By it, costs are taken at actual amounts and are translated into present-cost estimates by applying price-index numbers. Where original costs are not obtainable over the full history of a public utility, an agreed-upon valuation as of a certain date is taken and trended by price indexes, and all additions and betterments are taken at actual cost and the price indexes applied. The greatest problem in using this method, aside from the question of its acceptance as lawful evidence, is that agreement upon accurate and suitable price indexes for public-utility property is difficult.

2. ACCRUED DEPRECIATION IN VALUATION. Whatever method of measuring value is used as evidence, allowance must be made for accrued depreciation.

[1] *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 417–18 (1926).

[2] With a lack of legal success, as will be shown below in the discussion of *West v. Chesapeake and Potomac Tel. Co.*, 295 U.S. 662 (1935).

Except for an entirely new plant, most of the property has lost value owing to age, wear, tear, obsolescence, or other causes. A well-maintained plant still may be depreciated. Although generators or lines are kept in an efficient state of repair, their service life has been partly consumed and their value for future use impaired, as compared to new equipment.[1]

Accrued depreciation in valuation may be computed in several ways. One method is to have engineers inspect the property and calculate the extent to which service value is lost. This depreciation is usually stated in a percentage of condition new. Because the method ordinarily leads to a lower estimate of accrued depreciation than other means of computing loss in value, public-utility companies have favored using it. Another method is referred to as the service-life, or straight-line, method. This involves estimates of the length of service life of each kind of equipment, based upon experience data. If such an estimate is twenty years for a unit of equipment and the actual age is ten years, then the accrued depreciation is 50 per cent.[2] This method has the advantage of being consistent with widely accepted accounting principles. It also avoids the error, often committed in the observation method, of failing to consider loss of value which cannot be seen.

Given the percentage of service loss, there remains its application to the depreciation base. Accountants hold that this base should be original cost as carried on the books. Others claim that it should be whatever measure of value is used to ascertain the fair value, whether it be original cost or reproduction cost. Whatever base is used, the calculation must make allowance for certain property items which are not depreciable, such as land, or items which lose value, if at all, only because of obsolescence, such as intangible property values.

3. Elements of Value. Aside from the problem of how to measure value, there is the question of what property to include in computing fair value. The measures of value refer to the *way* property is valued; the elements of value refer to the *things* which are valued. In a broad sense, elements of value are synonymous with the idea of property used and useful for the public service. Commissions, however, have employed the "used and useful" category to include only physical property, and have added various intangible items to it in computing the aggregate of items to be included in fair value.

Physical property used and useful for the public service has been interpreted to mean all the physical plant and equipment which is being used in the public-utility business and which may reasonably be required for service to customers, even though not actually used. Standby producing equipment,

[1] As one eminent accountant has said, "All machinery is on an irresistible march to the junk heap, and its progress, while it may be delayed, cannot be prevented by repairs." Hatfield, H. R., *Accounting* (New York: D. Appleton and Company, 1929), p. 130.

[2] Actually, salvage value is taken into account and this affects the depreciation percentage. Thus, if a unit has a cost of $100, an estimated salvage value of $20, and an estimated service life of twenty years, after ten years the estimated depreciation is $40 and the percentage of loss is 40 per cent.

or plant facilities bought in reasonable amount in anticipation of future demands, although not in use at the time of a valuation, may be included in a calculation of fair value for rate-making purposes.[1] Property bought purely for investment, such as a block of land not reasonably needed for public-utility operations in the near future, or an office building not used for such purposes, may not be embraced in the fair-value figures.

Other elements of value are working capital and intangible property items. A public utility needs a certain amount of cash, supplies, or assets readily convertible into cash for the purpose of meeting current obligations and financing operations pending collection of bills. Since credit is not often given for periods longer than a month or two, the amount of working capital needed is small relative to other items of value.

Intangible assets include general structural overhead, going value, and various rights to use, such as water and patent rights. General structural overhead items are expenses incurred in bringing a public-utility plant into being, but which are not reflected in the value of physical property; interest and taxes during construction, engineering and superintendence, and costs of organization are examples.

Going value represents the value of a plant established as a going concern over that of the physical property items. It must not be confused with goodwill, because a public utility, whose customers have practically no alternative in dealing with it, hardly has a property asset of this sort. Some commissions add a lump sum to the physical property for going value. Others make a practice of valuing the physical property as an established conglomerate of items, and make no additional allowance.

Rights to use, such as the right to a water supply on a stream or patent rights, are clearly valuable and, even though intangible, should be included in fair value. Rights growing out of franchises, while valuable, should not be included in fair value for rate-making purposes, unless the public utility has paid for them. Otherwise, the public would be forced to pay a private company for using a privilege which it had itself granted.

4. Economic Aspects of Valuation. The purpose of ascertaining fair value is to arrive at a rate base to which a fair rate of return may be applied, thus obtaining a fair return, to be allowed over and above operating costs, for remunerating investors who furnish public-utility capital. From an economic point of view, this return should be adequate to keep capital flowing into the industry. As such, its economic soundness must be judged primarily in the light of long-time considerations and competition for investment capital. A return which may seem adequate to attract capital at one time may not be high enough to protect credit standing over a period of years. Thus the return to railroads in the 1920's was adequate, for the most part, to enable ready flota-

[1] For sale or tax purposes, everything a public-utility company owns may be included in the computation of value.

tion of bonds and stocks; but it did not enable many carriers to build up reserves or retire bonds and get into a financial position which made it possible for them to weather the depression after 1929. Happily, considerations of this kind have not been as important in the public-utility industry as in railroads. Because of the monopolistic position of public utilities and the character of the demand facing them, earnings have not been as affected by depression as has been the case with railroads.

Some commentators have said that the public-utility investor, whether bondholder or stockholder, is and should be interested in obtaining a fixed and steady dollar return upon his investment. Because bondholders enter a contract stipulating a fixed monetary return, this contention is doubtless true as applied to that class of investor. Stockholders, on the other hand, do not make such a contract; they usually accept the risk of ownership in return for the possibility of returns higher than those current for bonds. Indeed, in recent years more and more "conservative" investors have purchased common stock or participating preferred stock because they believe that dollar returns on it will increase as general prices rise. Buying such stocks as a hedge against inflation is an increasingly important motive behind stock purchases.

Unless the great majority of public-utility financing is to be done by fixed-return-bearing securities, a practice not countenanced by the tenets of sound private-corporation financing, consideration must be given to a changing dollar return for stock. Otherwise, public utilities may find themselves unable to obtain investment capital in a competitive capital market. If prices should rise materially, or if investors should believe that they would rise, a public utility might find it difficult to sell fixed-dollar-return securities against the investors' opportunities to invest in private industry where dollar return is not so limited.

From an economic standpoint, then, the public-utility return should not be frozen at a fixed-dollar income for a certain dollar investment. Now, this change in dollar return can be effected by changing the rate base with price changes or by changing the rate of return. The possibilities of varying the rate of return are subject to limitations, as will be noted presently. In terms of measurements of value, the economic necessities of a sound rate level make any original-cost method subject to some infirmity. The rate base, fixed upon original cost, is more or less frozen to the amount of money invested, and the return calculated upon it tends also to be fixed in terms of dollars. In the face of an increasing price level, this would seem to place a public utility at a disadvantage so far as obtaining stock capital is concerned. If prices should change substantially, or show promise of doing so, the market for bonds might also be affected adversely.

Use of a value measure taking into account present costs would make for a rate base changing with the price level; allowable return would likewise vary. The economic difficulty with a present-cost measure lies in the fact that public

utilities are customarily financed with around half their capitalization in bonds. If prices rise and the rate base and return in dollars are increased, the dollar return to bondholders remains the same, and the stockholders receive a more than proportionate enlargement of their dollar income at the expense of ratepayers. If prices fall, the contracted dollar return to bondholders stays at the same level, and dollar earnings for stock fall precipitously, or disappear, or become deficits endangering the payment of fixed interest to bondholders.

If one looks to the economic nature of public-utility investment, the logical position of present-cost measures of value becomes much stronger. While an investor's contribution is measured in dollars, what he really invests is capital or that which dollars will buy. He does not hold title to dollars, but claims against physical and intangible property. It is an elementary concept of economics that original cost, stated in dollars, has no particular significance as value, except at the time the expenditure is made. As price levels change, original costs may come to have little more importance than an interesting historical fact. An extreme example of the fallacy of original cost is found in the German inflation of 1923. The original cost of all German railroads, in terms of marks, was the equivalent of an American cent or two in 1923.

Calculation of accrued depreciation for valuation by a service-life method appears to be economically valid. A piece of property tends to lose its value from the time it is installed. The causes of this loss are such that an engineer cannot always observe them in analyzing a given item of equipment. Experience has been gained as to the service life of most property, and data are available to indicate it. Should they be affected by new elements of obsolescence, service-life estimates can be corrected. Contrary to some opinion, a piece of equipment does not usually become obsolete all at once. The development from invention to practical commercial use is a time-consuming process.

5. Administrative Aspects of Valuation. One of the goals of regulation is effective control. Besides economic and legal aspects, a solution of a problem in government control should meet the test of sound and efficient administration.

If accounts have been prescribed by commissions for a long enough time, and have been subject to inspection and audit by the government, they may show original costs fairly accurately. In ascertaining these costs for rate-base purposes, a public-utility commission is faced with a fairly simple task. Although adequate accounting control takes much time of the commission and requires sizable appropriations for an accounting staff both in the office and in the field, it is useful in nearly every aspect of public-utility control. Hence, regulation of accounts for valuation purposes need not place an unreasonable burden upon a commission.

Where accounts have not been prescribed or policed to any appreciable extent, or where the accounting regulation has not been in effect long enough, books of public-utility companies may not give an accurate picture of original

cost. In cases of this kind, the commission is faced with expensive investigations and a resort to unsatisfactory estimates for the ascertainment of original cost. Where this is true, the administrative problem of determining original cost makes this method little less difficult than computing present costs. Nevertheless, once a record of original cost is computed or estimated, accounting control thereafter can keep the original cost up to date without much trouble.

Calculation of reproduction cost new is a complicated administrative task. The discussion above as to how reproduction cost is obtained indicates that. The process of inventorying thousands of articles from poles to desks and applying unit prices is complex enough. Add to this the laborious task of estimating intangible items of property and the honest differences of opinion that can exist between experts, and one can understand how expensive this method is. The company ordinarily makes an estimate of reproduction cost, as well as the commission. Often, interested municipalities make estimates. Mosher and Crawford refer to a case where a company spent $5,000,000 to appraise a property finally valued at $500,000,000.[1] Expenditures of 1 per cent of the valuation by one party in a valuation dispute are not at all unusual. Furthermore, the hypothetical character of cost of reproduction lends itself to conflicts in judgment and resort to legal processes. These ordinarily involve delays in settling a rate case, a decade or more having elapsed in some instances before final decision.

Critics also point out that cost-of-reproduction estimates cannot accurately reflect present costs. By the time an investigation is completed, the prices used are obsolete; to keep cost of reproduction up to date, such estimates would have to be made continually. As a matter of fact, this is an extreme criticism. No one familiar with rate regulation expects detailed accuracy. Cost-of-reproduction estimates need be made, moreover, only when a rate change is contemplated, whether by the company or the commission. Even then, the dispute may not be of such a nature as to force resort to measuring value anew, and often data of previous valuations reduce the complexity of the task in making a new estimate of fair value.

Use either of cost of reproduction of a given plant or of cost of reproducing the service is subject to considerable objection on the score of administration of regulation. If this objection is outweighed by legal and economic advantages, it may be that the expense and complexities will have to be accepted as a necessary problem of government control.

Taking present costs into account in the rate base should not necessitate computation of cost of reproduction. Irrespective of the discouraging attitude of the courts to date, the device of modifying original-cost figures by price indexes has much to commend it. Any attempt at valuation is fraught with uncertain-

[1] Mosher, W. E., and Crawford, F. G., *Public Utility Regulation* (New York: Harper and Brothers, 1933), p. 205.

ties and inaccuracies. Although a price index free from criticism has not yet been devised, fairly satisfactory indexes are available, and better ones might be developed. The administrative job of computing the rate base would be fairly simple with these indexes, and the results possible would appear to be within reasonable accuracy.

In arriving at an amount representative of accrued depreciation, administrative as well as economic aspects make the service-life method the most acceptable. Compiling data as to service life is not an easy task, but it offers far more opportunity for certitude than the estimates of experts who examine property. Furthermore, such data can be kept up to date for continuous use in arriving at a rate base. Maintenance of such information can also be helpful to a commission in fixing the annual allowance for depreciation for operating-expense control and general accounting supervision.

6. Fair Value and the Law: Valuation Methods. The job of regulating public-utility rate levels has been complicated by the position of the courts. Whenever a public utility believes that rates allowed by a commission are too low, it has had little difficulty in getting a hearing before the courts. The federal courts have furnished the principal stage for these suits, for the usual complaint of the company is that the rate level is so low that private property is being taken without due process of law. Seldom has a case involving rate levels been contested that the crux of the disagreement has not been the rate base. The courts have been unable or unwilling to lay down an understandable formula as to what constitutes a rate base which is within due process. As a result, in order to appreciate the legal aspects of valuation measures one must look to the cases. A fair picture of the legal point of view can be obtained by noting decisions in a few leading cases of the last four decades.

a. Smyth v. Ames (1898).[1] A railroad rate case decided at the close of the nineteenth century has furnished the basis for the measure of fair value in the whole field of rate regulation. The case of Smyth *v.* Ames arose as the result of a Nebraska statute which fixed maximum freight rates for railroads within the state. Arguing, among other things, that the rates fixed would be so low that operating expenses would not even be covered, the railroads contested the law as taking property without due process of law. They claimed that they were entitled to rates adequate to pay operating expenses plus interest upon bonds plus dividends upon stock.

The state of Nebraska, with William Jennings Bryan as one of the counsel, argued that state authority to fix maximum rates should not be interfered with if rates yielded operating expenses. However, if the courts were to pass upon the reasonableness of additional return, the basis upon which this profit should be computed should be the present cost of reproduction rather than the investment cost as measured by the stocks and bonds. In view of the public attitude toward measures of value in future years, this espousal of present cost is inter-

[1] 169 U.S. 466.

esting. It was based upon the fact that price levels in the 1890's were lower than for some decades before, and, as it turned out, lower than at any time since. Furthermore, the public had good reason to believe that the total of railroad stocks and bonds bore little relation to actual capital invested in the railroads.

The Supreme Court found the Nebraska rates so low as not to cover operating expenses in some instances and to allow only a slight margin of profit in others. In a decision from which no justices dissented, the United States Supreme Court held that a privately owned business was entitled to rates which would cover reasonable operating expenses plus a fair return upon the fair value of the property being used for the convenience of the public. Ominously pointing out that the question of fair value "will always be an embarrassing question," the Court undertook to indicate some of the "necessary elements" in determining fair value. These have been referred to in the discussion of fair value for railroads,[1] but they may well be repeated here, for they have been used as a criterion for value in every succeeding public-utility case. The Court said:

> And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stocks, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property.[2]

Reducing this "formula" to those measures of practical consequence as determinants of value, one has left the admonition to consider present costs and original costs. Earning power and market value of securities obviously depend to a large extent on the rate allowed by regulatory authorities. They should consequently have little bearing on the determination of value for rate-making purposes. Note that the Supreme Court gave no hint as to how much consideration should be given to these measures, or whether consideration means that a fair-value calculation must reflect both. The Court also left the way clear for the introduction of other measures of value.

b. Southwestern Bell Telephone Company case (1923).[3] Although adhered to in many decisions between 1898 and 1923, the doctrine of Smyth *v.* Ames achieved new importance in the decade following the first World War. With the rise in prices during the war, and with a level afterward materially above that of 1914, public-utility companies found good reason to ask for valuations based upon these higher prices. The Southwestern Bell Telephone Company case is typical of the struggle between companies and commissions in the post-

[1] *Supra*, p. 100. [2] 169 U.S. 466, 546–47.

[3] *Southwestern Bell Tel. Co. v. P. S. Com. of Missouri*, 262 U.S. 276.

war period, and the decision of the Supreme Court is of utmost importance in giving meaning to the legal aspects of fair value.

The Public Service Commission of Missouri ordered a reduction in rates of the Southwestern Bell Telephone Company in 1919. The Commission fixed a fair value of $20,400,000 for certain telephone properties in the state. This figure was arrived at after taking property appraisals of three telephone exchanges as made in 1913, 1914, and 1916; adding actual cost of additions subsequent to such dates; calculating the ratio of the total appraisal plus cost at these exchanges to the reproduction cost claimed by the company at the same places; and applying this ratio to the total reproduction cost offered by the company. Thus the Commission's "fair value" was essentially an estimate of pre-war appraisal plus actual costs of additions thereafter.

The company placed in evidence book cost of plant, supplies, equipment, and working capital amounting to nearly $23,000,000. It also presented data showing reproduction cost new as of June 30, 1919, to be $35,100,000 and reproduction cost new less depreciation as $31,356,000. Since the Commission had allowed only a 5.65 per cent rate of return on its value, if its rate base was too low there would almost surely be deprivation of property without due process of law.

The Supreme Court found that the Commission's valuation was far too low in that it did not accord "any weight to the greatly enhanced costs of material, labor, supplies, etc., over those prevailing in 1913, 1914, and 1916." The Court pointed out that a computation of fair value must take into account costs at the time of investigation. Declaring that "an honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances is essential," it held that "such a forecast becomes impossible" if the "element of present costs is wholly disregarded." Reading the opinion for the majority, Mr. Justice McReynolds insisted that "estimates for tomorrow cannot ignore prices of today." [1]

Mr. Justice Brandeis and Mr. Justice Holmes concurred in the judgment of the majority but differed in the reasoning. They found the rates to be confiscatory, not because the Commission overlooked present costs, but because the rates would not return a fair profit upon the amount prudently invested in the business. The opinion, written by Mr. Justice Brandeis, is one of the most ably written papers proposing the prudent-investment method of measuring fair value. He found the "rule of Smyth *v.* Ames legally and economically unsound," as well as impracticable to use. He stated that the due-process clause would be well observed if rate regulation allowed to investors the reasonable cost of doing business, including the cost of obtaining capital and maintaining credit.

c. McCardle v. Indianapolis Water Company (1926).[2] Insistence upon commission consideration of present costs in arriving at fair value reached a new high

[1] *Southwestern Bell Tel. Co. v. P. S. Com. of Missouri*, 262 U.S. 276, 288. [2] 272 U.S. 400.

in the Indianapolis Water Company case of 1926. Here, the Indiana Commission had given some consideration to cost of reproduction less depreciation. Taking a ten-year average of prices from 1912 to 1921, the Commission's engineer had estimated cost of reproduction less depreciation as $14,700,000. With an average of prices for the ten years ending in 1923, the same estimate was given as about $17,000,000. Taking prices prevailing on January 1, 1924, the engineer fixed cost of reproduction less depreciation as $19,500,000. Holding that original cost was 12 to 20 per cent less than the fair value fixed, the Commission found the fair value to be a little over $15,000,000.

The company claimed a fair value of more than $22,500,000. To support this claim, the testimony of valuation engineers was submitted. One firm found cost of reproduction new as of December 31, 1923, including both physical and non-physical property, to be $25,400,000 on the basis of present prices, and $22,360,000 on the basis of average prices for ten years preceding. Another firm submitted estimates of $24,860,000 and $21,890,000 respectively for the same two measures of value.

When the case was tried before the Federal District Court, the Commission's finding was overruled and the court held that the fair value of the company's property was at least $19,000,000, rather than the $15,260,000 used by the Commission. The United States Supreme Court upheld the lower court. Delivering the opinion for the majority, Mr. Justice Butler declared that "in determining present value, consideration must be given to prices and wages prevailing at the time of the investigation," and that "there must be an honest and intelligent forecast as to probable price and wage levels during a reasonable period in the immediate future." [1] Mr. Justice Butler emphasized the need for considering present prices, especially when original costs no longer reflected present costs.

Mr. Justice Brandeis, with whom Mr. Justice Holmes concurred, dissented from the decision. He pointed out that the rule of Smyth *v.* Ames did not make value tantamount to reproduction cost. Moreover, he expressed the belief that the lower court, whose decision was upheld, had no right to make a finding of fact as it did when it held the fair value to be not less than $19,000,000.

d. Los Angeles Gas and Electric case (1933).[2] It was generally supposed after the Indianapolis Water Company case that a commission must give predominant weight to present cost in arriving at fair value for rate-making. Indeed, the language of that case did seem to make present cost the equivalent of fair value. In looking, however, to what the Court *decided* rather than what it *said*, this conclusion is not entirely justified. It merely decided that the Commission's calculation had not given enough consideration to present costs. In the light of the evidence of both commission and company engineers, the Commission, while considering present cost as evidence, apparently did not let present cost affect its judgment of fair value materially.

[1] 272 U.S. 400, 408.

[2] *Los Angeles G. and E. Corp. v. R.R. Com. of California*, 289 U.S. 287.

In 1933, the Supreme Court published the plainest statement of valuation policy that has yet been found in any decision of that tribunal. The California Railroad Commission, with jurisdiction over all public utilities in the state, fixed rates for the Los Angeles Gas and Electric Company in 1930, lowering the previous rate level. In arriving at this conclusion, the Commission found a fair value of $65,500,000. It took historical cost of plant, without deduction for depreciation, and added land at current values, working capital and organization expenses, coming to a figure of $60,704,000. To this it added a lump sum of $4,796,000 and concluded with a rate base of $65,500,000.[1]

The company put in evidence data purporting to show the rate base to be $95,800,000. It had used prices prevailing during the years 1927 to 1929, had added substantial amounts for intangibles, and had subtracted accrued depreciation of $3,500,000. The Commission examined these data and disallowed many items of the claimed value. It rejected large claims for going value, promoters' remuneration, and costs of financing. It reduced claims for other intangible overheads by more than one half. Over $12,000,000 was excluded from cost of reproduction as the cost of reproducing a gas-manufacturing plant no longer used. Accrued depreciation was taken at twice the figure used by the company. With these modifications, the Commission found that cost of reproduction was not over $65,500,000.[2]

When the case reached the Supreme Court and was decided in favor of the Commission, the majority of the Court pointed out that it did "not sit as a board of revision, but to enforce constitutional rights," and that it was not concerned with either the method used by a commission to calculate rates or the determination itself, "so long as constitutional limitations are not transgressed." While the Court did not disavow the doctrine of Smyth *v.* Ames, it emphasized that the question of confiscation should be decided in view of the *results* of a rate order, rather than the *method* employed.

Following this line of reasoning, the Supreme Court was convinced that the California Commission rate order was not confiscatory. The Commission had given predominant weight to historical cost. But it had considered reproduction cost. Moreover, the Court took judicial notice that prices were lower in 1933 than in the period 1927-29 on which the company had based its estimates. Furthermore, since most of the construction of plant had taken place in years before the fall of prices in 1929 to 1933, the Court held that historical cost probably gave liberal effect to present prices. Inclusion of the obsolete gas

[1] This "lump sum" was probably added in view of the company's contention that it had charged capital expenditures to operating expenses and the company's higher reproduction figures, as modified by the Commission. The reason for not deducting accrued depreciation from the historical cost is found in the Commission's method of calculating annual allowances for depreciation. Since a sinking fund method is prescribed in accounts, consistency demands that no deduction be made for depreciation in the rate base. For a discussion of this point, see *Depreciation Charges of Telephone and Steam Railroad Companies*, 118 I.C.C. 295, 355 (1926), or treatment in any standard accounting text.

[2] For the details of the Commission's decision, see *Re Los Angeles G. & E. Corp.*, P.U.R. 1931 A, 132.

property in historical cost and the non-deduction of accrued depreciation were considered by it as factors which outweighed any elements of value not accepted by the Commission.

Mr. Justice Butler, with whom Mr. Justice Sutherland joined, dissented from the decision. He held that the Supreme Court should have remanded the case for further consideration in the light of the change in business conditions in 1933. If it would not do so, he declared that the rates should be set aside because of the arbitrary undervaluation involved in the "commission's refusal to apply principles of valuation established by our decisions."

The Los Angeles decision seemed to free public-service commissions from the necessity of following, as method, the measures of value handed down by the Supreme Court in Smyth *v.* Ames. The decision was generally interpreted to mean that commissions might use any reasonable method, whether original cost or present cost, and, so long as the results given were as high as those which would follow upon use of the Smyth *v.* Ames doctrine, the rates would be upheld. The thought was that this rule would become a *test* for adequacy of rates rather than a prescription of procedure to be followed in arriving at fair value for rate-making purposes.

e. Chesapeake and Potomac Telephone case (1935).[1] The Maryland Public Service Commission was administered a rebuff in the Supreme Court in 1935 in a case which again beclouds the legal aspects of fair value after the comparatively clarifying language of the Los Angeles case. For several years, the Maryland Commission had used a price-index number to give effect to present costs without going to the expense of estimating reproduction cost. It had ascertained historical cost from the books of the company or upon investigation, as of a certain date, and had prescribed accounting so that thereafter books would accurately show historical cost. When rate-making required finding fair value, the Commission merely translated these cost figures, according to the year of capital investments, into a present value by applying index numbers. Thus, if $4,000,000 were invested in 1926, and 1932 prices were 30 per cent less than those in 1926, as measured by the index, the investment of 1926 would be translated into a fair value of $2,800,000. The price index used by the Commission was in reality a weighted average of sixteen different price indexes, which were weighted in accordance with their applicability to public-utility property and an average taken.

In 1933, the Commission ordered reductions in rates of the Chesapeake and Potomac Telephone Company. Contending, among other matters, that the rate base was too low, the company challenged the order. It presented evidence to show that the historical cost and reproduction cost of its property were substantially in excess of the value found by the Commission. A lower federal court, taking historical cost less depreciation reserve as fair value, upheld the company. The Commission appealed to the United States Supreme Court.

[1] *West v. Chesapeake and Potomac Telephone Co.*, 295 U.S. 662.

The Supreme Court found that the use of index numbers was improper for the ascertainment of value, since they were not designed for appraisal purposes. Referring to the Los Angeles case and another case stating like principles,[1] the Court observed that

> Nothing said in either of these cases justifies the claim that this Court has departed from the principles announced in earlier cases as to the value upon which a utility is entitled to earn a reasonable return or the character of evidence relevant to that issue. It is apparent from what has been said that here the entire method of the Commission was erroneous and its use necessarily involved unjust and inaccurate results.[2]

The Court emphasized that price trends were properly to be considered. But it maintained that the use of index numbers, as carried on by the Maryland Commission, at least, served only to "confuse the problem" of valuation and "increase its difficulty"; and that value should be a "matter of sound judgment, involving fact data," such as historical cost and cost of reproduction.

Mr. Justice Stone, with whom Mr. Justice Brandeis and Mr. Justice Cardozo agreed, held that the method of the Maryland Commission was not clearly in opposition to procedural due process, and that the company had not shown that the rates themselves were confiscatory. He held that the use of index numbers, such as those derived by the Commission, was not only administratively advantageous but gave results which seemed to him to be no less accurate than valuations based upon the consideration of "engineers' appraisals and estimates." Declaring that "present fair value at best is but an estimate," Mr. Justice Stone said that "so far as the results of the use of standard price indices are impugned by their variation, an examination of the present record will disclose that the results obtained by application of price indices to the historical cost of plant are far less variable than engineers' valuations and in general are probably more trustworthy." [3]

f. Legal aspects of measures of value. In recent years, increasing pressure has been placed on the Supreme Court to disavow the Smyth *v.* Ames decision and to hold that use of prudent investment, or a similar measure, should be adopted.[4] Although two members of the Court [5] recently termed the Smyth *v.* Ames precedent a "mischievous" and "useless" formula and urged that the Court withdraw from the valuation tangle,[6] the Supreme Court majority has shown no clear tendency to do so.

As matters now stand, the rule of Smyth *v.* Ames is law. This need not

[1] *Dayton Pwr. and Lt. Co. v. P.U. Com.*, 295 U.S. 290, 306 (1934).

[2] 295 U.S. 662, at p. 675.

[3] *Ibid.*, pp. 690–91.

[4] In recent public-utility cases before the Supreme Court, the United States Solicitor General made such a plea. The Federal Power Commission and many state commissions have likewise intervened to ask for the adoption of prudent investment and the discard of the Smyth *v.* Ames rule.

[5] Mr. Justice Frankfurter and Mr. Justice Black.

[6] *Driscoll v. Edison Lt. and Power Co.*, 307 U.S. 104, 122 (1939).

mean, however, that commissions must compute fair value by any certain *method.* The sound construction of the law seems to be contained in the Los Angeles Gas and Electric Company case, where the measures suggested by the Court in Smyth *v.* Ames are used as *tests* of adequacy of fair value. In the absence of material changes in prices, a commission might well employ a prudent investment method without contravening the federal Constitution. If the ultimate question is confiscation of property, as it indubitably is, there must be different ways to reach reasonableness and all that should be needed is a rate base which can meet the test of present value.

The decision in the Los Angeles case seems to be consistent with a realistic interpretation of due process. The decision in the Chesapeake and Potomac case seems to this writer to be a mistake. The use of index numbers *per se* should not work a deprivation of due process. If the Maryland Commission had refused to hear other evidence or had acted arbitrarily otherwise, procedural due process might have been offended. If the resultant rate base, and rates derived therefrom, had been shown to be confiscatory by use of a present-value test, substantive due process might not have been fulfilled. But neither conclusion is possible from the reading of the Supreme Court's opinion. It is likely that the members of the majority did not understand index numbers or the whole procedure of the Commission. That index numbers may still be upheld is not at all improbable. With proper presentation of the case for this method of measuring value and reversion to the test doctrine of the Los Angeles case, a modification of the outright denial embodied in the Chesapeake and Potomac case is possible.

From a legal, as well as an economic, point of view, testing the adequacy of a rate base by emphasis upon present prices is not at all unsound. The Constitution denies the taking of property. This property is properly conceived as dollars' worth, rather than dollars, as is apparent from numerous decisions of the courts.[1] Hence, it is difficult to believe that the Supreme Court should define property in terms of original cost prices where present prices are different.

At the present time, then, a lawful rate base is one which gives adequate weight to present prices. The possibility for any other interpretation of the law would appear to necessitate change of the concept of due process, as evolved by the Supreme Court. If the Court should take the point of view that the results of a commission rate investigation will be accepted as a final finding of fact, so long as procedural due process is observed, it could consistently not insist upon consideration of present values. This would seem to be the only way to make prudent investment the legally acceptable rate base in face of price-level changes. And withdrawing from enforcement of substantive due

[1] Note, for example, in *Minnesota Rate Cases,* 230 U.S. 352, at p. 454 (1913), where the Supreme Court said: "The property is held in private ownership and it is that property, and not the original cost of it, of which the owner may not be deprived without due process of law."

process would be nothing short of revolutionary in American constitutional law. On the other hand, another way may be found to avoid the present-value doctrine, for the legal mind is dexterous and opportunistic.

7. FAIR VALUE AND THE LAW: ACCRUED DEPRECIATION. Accrued depreciation may be lawfully deducted from any original-cost or present-cost measure of value, as has been clear since the Knoxville Water Company case in 1909.[1] It makes no difference whether the company has accrued a depreciation reserve. In the language of the United States Supreme Court:

> A water plant, with all its additions, begins to depreciate from the moment of its use. Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public.... If, however, a company fails to perform this plain duty and to exact sufficient returns to keep the investment unimpaired, whether this is the result of unwarranted dividends upon overissues of securities, or of omission to exact proper prices for the output, the fault is its own.[2]

As for the measurement of accrued depreciation, the United States Supreme Court has looked with favor upon estimates made by observation, rather than upon deductions made by service-life calculations. In one case, the Court declared that "facts shown by reliable evidence [testimony of engineers] were preferable to averages based upon assumed probabilities [service-life estimates]."[3] This deduction is often much smaller than the depreciation reserve, since inspection methods seldom disclose the amount of depreciation which is accrued by a straight-line computation of annual depreciation allowances. To the extent that the depreciation reserve is larger than accrued depreciation in valuation, rate-payers are called upon to pay a return on property which they themselves have contributed. This follows from the fact that depreciation reserves are built up from charges to operating expenses, and that the latter are of course included within the total costs which rates are designed to cover.

Should depreciation reserves be excessive, the additional property obtained thereby, and in effect obtained from rate-payers, belongs to the company. Rate-payers cannot lawfully ask for the return of this property[4] although the existence of excess reserves may be used as evidence of the proper size of annual allowances.[5]

[1] *Knoxville v. Knoxville Water Co.*, 212 U.S. 1 (1909). [2] *Ibid.*, pp. 13–14.

[3] *Pacific Gas and Elec. Co. v. San Francisco*, 265 U.S. 403, 406 (1924). Material in brackets supplied.

[4] *P.U. Com. v. New York Tel. Co.*, 271 U.S. 23 (1926).

[5] *Lindheimer v. Ill. Bell Tel. Co.*, 292 U.S. 151 (1933).

C. FAIR RATE OF RETURN

Once a rate base is established, a regulatory commission has to decide what rate of return is "fair." Because this figure is not subject to objective determination and must be made by judgment in the light of evidence, claims by companies that rate levels are confiscatory are often based upon the size of the rate of return. As a matter of fact, this rate is exceedingly significant: a small change in it may be equivalent to a large change in the valuation total. Thus, a rate of return of 8 per cent on a fair value of $10,000,000 returns the same amount as a rate of 6 per cent on a fair value of more than $13,000,000.

1. ECONOMIC BASIS OF A FAIR RATE. As has been pointed out in discussing railroad rates,[1] an economically sound rate of return is one which is high enough to safeguard the credit of public utilities so that needed capital may be readily obtained; it should be high enough so that capital can be secured by stock sales, as well as by issue of bonds or notes. The rate, consequently, should be such that capital structure may be safeguarded for future financing, as well as for the present. A rate of return based upon bond-interest rates only, and fixed in contemplation of debt financing, shortsightedly overlooks the possibly deleterious results of too great a burden of fixed charges.

As one might expect, the economically proper rate of return is not necessarily the same as between companies, or as between different times. Thus, any particular fair rate must be judged in the light of the individual company and the time at which it is made. There is a danger, however, that too much attention may be given to a certain capital market and that rates may be influenced by a temporary status of capital demand and supply.

2. THE LAW AND THE FAIR RATE. The underlying legal principles by which fairness of a rate of return is determined are almost identical to the economic characteristics of a fair rate. The Supreme Court has stated the legal position as follows:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.... The return should be reasonably sufficient to insure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties.[2]

In another case, the Court held that a rate which did not allow something to go to surplus was inadequate.[3]

[1] *Supra*, p. 103. [2] *Bluefield W. W. and Imp. Co. v. W. Va.*, 262 U.S. 679, 692–93 (1923).
[3] *United Rwys. and Elec. Co. v. West*, 280 U.S. 234, 252 (1930).

Actual rates fixed by commissions vary from 5 to 9 per cent, according to certain studies which have been made.[1] The majority of rates of return have fallen between 5 and 8 per cent, with the average around 6 per cent. With the fall in interest rates after 1929, many public-utility commissions have fixed fair rates of return at less than 6 per cent.

The function of the courts is not to fix fair rates but to determine whether a rate established by a commission is reasonable enough to avoid confiscation. However, they have on many occasions found that a reasonable rate of return would be no less than a certain per cent.[2]

Although lower rates of return have been allowed in recent years,[3] courts generally have shown a tendency to look with disfavor upon those of less than 6 per cent. In a dissenting opinion, Mr. Justice Stone suggested in 1935 that, in view of capital market conditions, a company might have difficulty in proving that a return of 4½ per cent was so low as to be confiscatory.[4]

3. Factors to Be Considered by Commissions. After all, the fixing of a fair rate of return is a highly practical matter. Suppose a commission desires to set it at an amount which will insure a free flow of capital into an enterprise. What statistical data will it consider in making its judgment? Various factors have been suggested. Certainly the prevailing long-time rate of interest would be one. Earnings of industries with comparable risks and the prices of securities of these industries, as well as their record for freely obtaining capital investment, should be considered. The record of the public utility itself and the probable effects of taxation, competitive enterprises, and future government regulatory policies might well influence the judgment of a commission. Because some companies are small, or are located in a relatively unknown geographic area, they may be unable to finance on as favorable terms as other companies.

Some writers have suggested that a rate of return might reflect changes in the price level.[5] They hold that a constant base might be used and the rate varied according to an index number so that purchasing power of earnings might be kept constant. Thus dollar income would be made to vary with changes in the price level.

This is an ingenious method of reflecting price-level fluctuations. But if index numbers are to be used at all, they could almost as easily be applied to

[1] For an excellent summary of these studies, see Welch, F. X., and others, *Cases on Public Utility Regulation* (Washington: Public Utilities Reports, Inc., 2d ed., 1936), pp. 434–38, and supplement (1940), pp. 45–46.

[2] For example, in the United Railways and Electric Company case (280 U.S. 234, at p. 252), the Supreme Court found that a rate of return of less than 7.44 per cent (the amount suggested by the company) would be confiscatory.

[3] In *Peoples Gas Light and Coke Co. v. Hart*, 373 Ill. 31 (1939), the Illinois Supreme Court refused to deny the validity of a 5 per cent rate of return. The United States Supreme Court denied a petition for appeal. See 309 U.S. 634 (1940).

[4] *West v. Chesapeake and Potomac Tel. Co.*, 295 U.S. 662, 683.

[5] Wilson, G. L., Herring, J. M., and Eutsler, R. B., *Public Utility Regulation* (New York: McGraw-Hill Book Company, Inc., 1938), p. 167.

the rate base where the real shift in value occurs. Moreover, if prices should fall and the rate of return be lowered, the courts might hold that the latter was so low as to be confiscatory. Suppose a rate of return is set at 7 per cent of a fixed rate base; should prices fall by half, the rate of return would be lowered to 3½ per cent. It is doubtful if the courts would find so low a rate to be valid. On the other hand, if prices rose so that the rate of return would be 10 or 12 per cent, a commission might not be able to withstand public pressure to reduce it to levels more consistent with "fairness."

Some states provide that a commission consider efficiency of management in fixing the rate of return. Plans have been devised whereby the rate is increased or decreased according to efficiency and satisfactoriness of service. This method involves a fixed rate of return which is agreed upon by the company and the commission. If service is maintained at a high level and rates are reduced, the percentage of return allowable is automatically increased. The principal difficulty with this plan lies in obtaining objective measurement of service standards agreeable to the public and the private companies. Moreover, if a rate of return becomes high under this plan, the public may feel that it has cause for complaint. If incentives to efficient management can best be given by such a plan, there is much for which it can be commended. In formulating a plan of this sort, care should be taken that the company does not obtain too great a reward for technological progress, with which a management may have little to do.

D. REASONABLE OPERATING EXPENSES

Relatively little attention has been paid to the regulation of public-utility operating expenses. Until recent years they had been regarded as peculiarly within the discretion of private management. It has been felt that management would have as much incentive as the public to keep these costs at a low level. In a few instances, such as annual depreciation allowances and charges to operating expenses for capital improvements, commissions have materially affected operating expenses through accounting control. In the last decade, attention has also been drawn to an increasing extent to expenditures made for services given by affiliated companies to a public utility in the same holding-company system.

Indeed, holding-company abuses, growing out of the practice of selling equipment and services to companies in the same system, have served to draw public attention to operating expenses. And the public realization that management, rather than stockholders, often actually controls a public utility, though it has a minor stock-ownership interest, has caused somewhat greater vigilance over salaries.

Beyond such controls as come through accounting regulation and the more recent regulation of intercompany transactions in a holding-company system,

little positive control of operating expenses is provided by public-service laws. It is still largely indirect, and grows out of the power of commissions to disallow certain costs as unreasonable or imprudent in a rate case. Thus, a public utility may claim a certain amount as necessary for operating expenses in a case involving rates. The commission may disallow certain expenses as not being proper for furnishing public service. This action means that the computation for a reasonable rate level will exclude these expenditures. It does not mean, however, that the public utility may not continue making them.

1. THE DEPRECIATION ALLOWANCE. The question of a reasonable annual allowance for depreciation most commonly arises in rate cases. Because the proper amount to be charged against operations for loss in value during a year is not capable of objective and accurate calculation, and because this item looms large in operating expenses, it has been subject to much disagreement between companies and commissions.

From an economic point of view, the annual allowance should be an amount equal to the loss in value during the year, and the loss should embrace obsolescence and inadequacy, as well as age, wear, and tear. The courts and commissions are pretty well agreed on these principles.

One wide difference of opinion has occurred in the calculation of these allowances. Since accountants, who traditionally deal with original cost, calculate them by multiplying the percentage of annual loss against original cost, commissions have insisted that computation of depreciation expense be done in this way. In one of the few cases on this subject, the Supreme Court of the United States upheld the contention of a public-utility company that present value, rather than original cost, should be used for the depreciation base.[1] The majority of the Court held that property would be taken without due process of law if a company had its depreciation allowance limited to a percentage of original cost in the face of price increases.

Note that this decision had to do with the question of confiscation in a rate case. It means that a calculation of depreciation allowance for *rate-making* purposes cannot be limited to original cost. Where control of accounts is concerned and depreciation allowances are prescribed in accounts, the calculation may lawfully be made on original cost.[2] The attitude of the United States Supreme Court in this connection has been that prescription of accounts is an administrative matter which, to be unlawful, must be so "entirely at odds with the fundamental principles of correct accounting as to be the expression of whim rather than an exercise of judgment." [3]

As has been noted above, depreciation reserves, once accrued, become the property of a company. In setting depreciation allowances for the future, a commission may not lawfully fix an amount smaller than necessary to cover annual depreciation loss, on the ground that the deficiency can be made up

[1] *United Rwy. and Elec. Co. v. West*, 280 U.S. 234 (1930).
[2] *Am. Tel. and Tel. Co. v. U.S.*, 299 U.S. 232 (1936).
[3] *Ibid.*, pp. 236–37.

from excess reserves.[1] But the Supreme Court has held that continually increasing excess reserves furnish strong evidence that current annual allowances are too high.[2]

2. SERVICE CONTRACTS. Public utilities often purchase a variety of services from companies specializing in these. Many public-utility companies are not in a position to employ on a full-time basis specialized valuation engineers, construction engineers, or other technical advisers, and therefore contract with engineering and management companies for such services. So long as the contracts are made between two independent parties, they are not likely to incur excessive expenses. But where, as has so often been the case, both the public utility and the engineering company are controlled by the same public-utility holding company, the cost of service may be excessive. The holding company has a clear motive to have its management or engineering subsidiary make a good profit from transactions with the public-utility subsidiary, for the latter may enter the charge as an expense upon which rates should be paid.

Because these service companies were usually engaged in interstate commerce and were not brought under federal government control until 1935, the states had some difficulty for a time in regulating expenses for service contracts. The state public-utility commissions had no power to fix the amounts to be charged for interstate business transactions; nor could they require service companies to submit to investigation so that reasonableness of their charges could be established. The difficulties of regulation were somewhat removed by a Supreme Court decision in 1932.[3] The Court held that where there is "an absence of arm's length bargaining," a state commission may insist that the reasonableness of an intercompany charge be proved by evidence.

Until the control of public-utility holding companies, subsidiaries, and affiliates was effected by the Federal Holding Company Act of 1935,[4] this was about the extent of state regulation of service contracts. Many states did provide for their control through restrictions of various kinds placed upon operating utilities. Before the federal government entered the field, however, these measures were of doubtful effectiveness.

3. OTHER OPERATING EXPENSES. With very few exceptions, little has been done by state public-utility commissions with regard to other operating expenses. There are scattered cases where various expenses have been disallowed in rate cases. These include excessive amounts for salaries, advertising expenses, bad debts, public donations, and political contributions.

At least one state has practiced continuous budgetary control for several years. The Oregon Public Utilities Commissioner (a one-man commission) is empowered to examine the annual budget of expenditures for all public utilities within the state. After investigation he may order that any expenditure

[1] *P. U Com. v. New York Tel. Co.*, 271 U.S. 23 (1926).
[2] *Lindheimer v. Ill. Bell Tel. Co.*, 292 U.S. 151 (1933).
[3] *Western Distributing Co. v. Kansas*, 285 U.S. 119 (1932).
[4] See *infra*, pp. 362–76.

contrary to public interest shall not be recognized in a rate case. This does not necessarily prohibit the company from actually making the outlay. But if the Commission finds that an expenditure is "imprudent or unwise," he may order that it not be made at all.

E. THE RATE STRUCTURE

The structure of individual rates of public utilities is far less complex than that of the railroads. Most public utilities serve a single locality and are usually smaller in size than railroad companies. Their services are not nearly so varied, and rate differentiation is limited to fewer different classes of users.

Nevertheless, the economic basis for discrimination is the same as that in the case of railroads. Because of a high proportion of investment costs to total costs and a relatively high degree of overhead operating costs, public utilities ordinarily operate under conditions of decreasing costs. Moreover, larger plants generally make possible lower costs of furnishing service. In either event, costs tend to decrease with increased output and tremendous economic pressure to increase the use of service results. At the same time, economic motives dictate that customers be classified, and be charged rates within such classification, so that adequate revenues may be secured to cover all costs and the cost burden be distributed equitably over the different classes of customers.

Ideally, all customers should be charged per unit of service consumed an amount equal to their proportionate share of total costs, including out-of-pocket and fixed costs. But obviously this share will vary with the quantity of service sold. If making sales at a price less than overall costs will still cover out-of-pocket costs plus something toward overhead, or fixed, costs, and if these sales could not otherwise be made, the burden of fixed costs upon other customers may be reduced. In this way, the total costs to others may be diminished, and their rates may be lowered. This simple economic principle accounts for the prevalence of rate discrimination in the public-utility as well as in the transport field.

Rate discrimination is typically practiced between classes of customers. Thus, large users of high-tension electric power almost invariably pay less per kilowatt-hour consumed than do residential customers. But rate discrimination also exists between different customers within the same classification. For example, a residential user of electricity who uses 10 kilowatt-hours per month may be required to pay 10 cents per kilowatt-hour. In the same month, a customer who consumes 300 kilowatt-hours may pay only an average of 3 cents per kilowatt-hour. The reason for this discrepancy is found in the economics of overhead costs. With increased utilization, since fixed costs remain practically the same, average total costs fall rapidly. Moreover, unless a customer could receive the lower average rate with increased use, he would probably not use the larger amount. In other words, customer demand tends to be fairly elastic, particularly at lower prices.

The law, as interpreted by courts and administered by commissions, recognizes these economic principles in public-utility rate-making. Discrimination in rates, or rate differentiation, as it is often called, is not unlawful unless found to be unreasonable. So far as individual rates are concerned, the reasonableness of discrimination depends upon economic principles. Differences in rates are presumably reasonable if based upon differences in cost, or if necessary for economic utilization of plant and distribution of fixed operating expenses.

1. Factors Which Affect Public-Utility Rates. Costs for furnishing public-utility service may be classified as readiness-to-serve costs, production costs, and customer costs. Regardless of the amount of service used by a customer at any particular time, a public utility must incur cost in investment for production and distribution equipment and expense in keeping this equipment in readiness to serve. Other costs are necessarily involved in the generation of electricity or gas, the pumping of water, the making of telephone connections, or the giving of local transport service. These costs are in addition to the expense incurred in being ready to serve. Finally, there are certain costs, such as meter equipment, meter-reading, billing, and collection of revenue, which are attributable to customers.

In each of these classes of costs there may be both fixed and variable costs. Readiness-to-serve costs, however, are mainly fixed in that they do not vary much with use. Production costs are variable for the most part in that they are directly related to the quantity of output. Customer costs are both variable and fixed.

The greatest difficulty occurs in attempting to trace responsibility for readiness-to-serve costs. A few factors may be considered in levying some of these costs, however. The time of consumption influences the need for investment in plant facilities and for other readiness-to-serve costs. If a customer takes service at off-peak times, relatively little of these costs need be allocated to him. If he takes services mainly at the time of maximum demand on plant and distribution equipment, a rather large proportion of such costs ought fairly to be charged against this use. The variety of demands in a particular group of users tends to reduce the readiness-to-serve costs allocable to any one of them, for this diversity makes possible a fuller utilization of production and distribution facilities. Likewise the volume of use tends to reduce readiness-to-serve costs which might be attributed to each unit of service purchased.

As for production costs, since most of these vary directly with quantity of service consumed, rates should include an allocation of them in accordance with the number of units of service used. Customer costs have little relation to volume of service purchased, or time of use, as these costs are practically the same for every customer.

Despite any attempt to distribute costs on a responsibility basis, a large share of cost in the public-utility business cannot be allocated in accordance with this

principle. These costs, ordinarily fixed in nature, are joint to all users of the service. The only recourse is to assign them on a value-of-service principle. In other words, after taking out-of-pocket costs and adding a share of overhead costs which can be attributed to a given class of customers, a public utility is economically justified in charging the other costs on the basis of ability to collect them. This involves consideration of the elasticity of customer demand. In allotting certain overhead costs to classes of customers, one may be economically justified in making exceptions if certain customers will not purchase service except at a price which little more than covers out-of-pocket costs.

These economic considerations point the way to sound rate-making, whether by a private company or by a public-service commission. They indicate that rates should be made with costs in mind so far as practicable, should encourage maximum use, should increase the variety of customers, and should recognize that, where certain business cannot be obtained at rates high enough to cover all costs, a concession in price, within limits, might be advantageous.

2. Regulation of Rate Discrimination. A few examples of regulation aimed at rate discrimination may be noted, although an extensive treatment of this subject is neither practicable nor desirable. The principles upon which reasonable discrimination may be made have been discussed. Their application in determining the question of reasonable or unreasonable differentiation is a matter of individual cases.

One kind of unreasonable discrimination arises from the nature of rate schedules themselves. Rates are sometimes made with a flat charge for service over a period of time, and sometimes with a flat charge per unit of service consumed in a certain period. Because flat rates do not accurately reflect costs or encourage economic utilization, they have been frowned upon by most commissions. By not adequately considering costs, flat rates discriminate unreasonably between customers. Rate schedules which do not account for customer costs or do not encourage efficient utilization have also been held to be unreasonable. In utility businesses, such as local telephone and street-railway and bus companies, flat rates may be justified on purely practical grounds. It may be extremely difficult to fix a scientific rate schedule for these services, although ways of metering telephone service and taking into account time and length of use of local transport services have been devised.

Unreasonable rate discrimination often results from free services to municipalities or reduced rates to charitable or public-welfare institutions. The granting of free electricity for street lighting, or free transportation for policemen, as well as lower rates to such agencies as churches, discriminates against other users. While justification may be advanced for these acts of discrimination, the placing of burdens upon other users is hardly sound economic policy.

Unreasonable differences in rates may arise through special contracts with large customers. Many electric and gas companies, as well as other utilities,

sell services to large users at special rates. At times these rates may be well grounded upon economic factors. But if they are not justified by cost or value of service considerations, or if like terms are not extended to customers in a similar situation, unreasonable discrimination follows. Commissions have been exercising increasing vigilance over these contracts; they often require that they be filed for approval, and sometimes order the terms to be made public.

In order to encourage utilization, public utilities have sometimes scheduled optional rates for certain classes of users. Two or more rate schedules are posted, usually varying in the degree to which they encourage large use. A customer may elect any rate schedule he desires, but he must ordinarily continue with that schedule for a minimum period of time. Unless customers are well informed as to the nature of these rates and the advantages under each schedule, misunderstandings and discriminations may arise. If a customer selects a certain schedule and could actually obtain a lower rate by choosing another, he is subject to a discrimination which is hardly reasonable. The attitude of commissions on optional rates is somewhat mixed, though some have taken a decided stand against them.[1]

F. CONCLUSIONS

Regulation of prices is an extremely complicated undertaking. The problems encountered in the public-utility field, although the emphasis is somewhat different, are similar to those dealt with in regulation of carrier rates. The results here have been somewhat better as measured by financial stability of operating companies. Despite reduced earnings in the depression following 1929, the record of these companies, with the exception of street railways, has been remarkably good. Few of them have been forced into bankruptcy, and most have been able to pay interest on bonds and moderate to good dividends on stock.

Whether this test can be used as a measure of successful regulation is another question. The indispensable nature of public-utility service, the fairly monopolistic position of the companies, and their high standard of business management have probably been the principal factors in this relatively successful record.

In dealing with regulation of rates, commissions are faced with many problems. In the first place, considering the character and diversity of tasks before them, they are notoriously understaffed. Mosher finds evidence that total appropriations are so low that not only can enough staff members not be hired, but salaries high enough to attract highly qualified experts are not often paid.[2]

[1] See, for example, the decision of the New York Commission in *Re Long Island Lighting Co.*, P.U.R. 1931 D, 353 (1931).

[2] Mosher, W. E., "Defects of State Regulation of Public Utilities," 201 *Annals of Acad. of Pol. and Soc. Science*, pp. 105–10 (1939).

This means that commissions are frequently reduced to awaiting protests of organized consumer groups and sitting as judges in deciding the disputes, instead of exercising a continuous supervision of rate and other matters.

Of all problems facing commissions, the determination of fair value is the most difficult. Because of court insistence upon fair value reflecting present costs, commissions have been forced into a field where research is complex and judgments fair to both customers and companies are extremely difficult to make. As a matter of fact, some commentators have claimed that the problem of determining fair value for rate-making is so difficult that the very existence of private enterprise under government control is threatened. They reason that government ownership usually comes when other methods fail. If regulation fails, then private enterprise can no longer be expected to continue in public utilities.

One can hardly deny that the administrative difficulties in valuation present the greatest obstacle to successful public-utility regulation. It need not be an insuperable obstacle, however. Admitting that use of original cost or prudent investment may be subject to shortcomings from economic and legal points of view, one or the other device may still be accepted. These methods admittedly have administrative advantages. The courts could conceivably allow one of them as a lawful *method*. The economic drawbacks of prudent investment or original cost might be eliminated if commissions would keep in mind that the fundamental purpose of regulation is to see that rate levels are kept high enough to maintain, under efficient management, the standard of service demanded by the public.

Perhaps suitable ways out of the valuation tangle may be found without risking either legal or economic criticism. The writer is not convinced that the use of index numbers, or similar devices for giving effect to present values, is beyond the realm of possibility. The contract-rate base also offers a possible solution.[1] By this method agreed-upon valuations would be made between commissions and companies. Contracts would be entered into for specified periods up to ten years, under which the base valuation, as modified by depreciation and new investment, would be employed for rate-making purposes. At the end of the contract period, new valuations would be made. This method would seem to give enough consideration to price changes and would facilitate commission administration. But most commissions would have to have enlarged appropriations to carry on the initial valuations. Some difficulty might be encountered, too, in getting companies to agree to them, although most companies would probably be glad to escape the expense and trouble of adjudication in such cases.

Gaps in commission regulation are found in the control of operating expenses. In more recent years, however, machinery has been devised for stop-

[1] This method was urged by the New York Committee on Revision of the Public Service Commission Law (1930), vol. I, pt. III, pp. 16–22.

ping the more noteworthy abuses. More research and attention have been devoted to determining depreciation allowances. The wave of regulation of the public-utility holding companies and their affiliates and subsidiaries, both by state and federal governments, has reduced abuses from intercompany transactions. Other features of operating expenses, on the whole, await regulation. If regulation is extended, care should be taken lest matters properly within the discretion of private managers be unduly circumscribed.

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CHAPTER

16

REGULATION OF FINANCE AND OF HOLDING COMPANIES

THERE are many aspects of regulation of public-utility finance which need be given little attention here. So far as operating companies, as distinguished from holding companies, are concerned, much of the discussion undertaken in connection with the railroads is applicable. The reasons for government control, the principles of regulation, and the problems encountered in regulation of security issuance are practically identical with those already treated in the chapter dealing with railroad securities. Likewise, accounting control is similar to that imposed upon railroads by the Interstate Commerce Commission. The regulation of railroad accounting undertaken by the federal government has clearly influenced the character of state accounting provisions in respect to public utilities.

In the field of combinations and financial transactions, the holding company has dominated the public-utility industry. Although non-holding-company aspects may be found, the major portion of regulation of combinations and financial transactions is closely related to that of the holding company.

Because of this prevailing influence, and the far-flung nature of holding-company transactions, one finds the field of finance regulation occupied by both state and federal governments. This may be somewhat confusing to the student. To aid in understanding this control, it is well to remember that there are really four types of companies included in the broad field of public-utility regulation. These are the intrastate, or local, public-utility operating company; the interstate operating company; the public-utility holding company; and affiliate companies. The latter two types do not actually engage in public-utility operations. Holding companies exist primarily to hold stock and control other companies. The affiliate companies are members of holding-company systems and are ordinarily in the business of selling service, supplies, or equipment to operating public utilities.

Regulation of interstate operating companies will be treated in the following

chapter, where all federal control of operating public utilities is discussed. Because of the close relationship between state control of public-utility finance and federal regulation of holding companies and affiliate companies, these problems will be analyzed in the present chapter.

A. OPERATING-COMPANY SECURITY ISSUANCE

The same motive which led to control of railroad security issuance has accounted for state control of securities issued by local public-utility companies. This may be summarized as the prevention of overcapitalization, with its effects upon rates, service, and investors. The methods, problems, and principles of regulation are practically the same in so far as effective state regulation exists.

State regulation of security issuance of public utilities dates from the early laws of Massachusetts, passed during the 1850's, by which railroad and other corporations were not allowed to issue stock for less than par value. Other laws were passed within the next few decades, and in 1894 Massachusetts enacted a fairly comprehensive plan of regulation. Other states passed security-issuance laws: New York in 1889, Texas in 1893, and New Hampshire in 1897. These laws were rather pioneering in nature, and the more general and effective ones were passed around 1910.

1. Scope of State Commission Control. As late as 1940, many state public-service commissions had no jurisdiction over public-utility security issuance. At that time nineteen such commissions had no power to control it[1] and a few other states gave only limited control. South Carolina empowered its commission to control electric-utility securities only, and Minnesota gave its commission jurisdiction over street railways. In still other states, no control of any kind has been provided for certain types of utilities.[2]

The real extent of commission control is not stated accurately when provision for security issuance is noted. State laws vary from the mere requirement of publicity for new issues to detailed supervision, including power to approve the nature of securities, use of proceeds, and terms of sale. Where strict security regulation is provided for, approval before issue is normally required, except for a limited amount of short-term notes. The company must show that the proceeds are necessary and appropriate in the public interest, that the method of raising the funds is consistent with sound finance, and that the terms of sale are fair and reasonable. Where securities are issued for considerations other than cash, the commission is generally empowered to inquire into the reasonableness of the amount paid for such acquisitions.

[1] Welch, F. X., *Cases on Public Utility Regulation*, Supplement (1940), p. 120. These states were Colorado, Florida, Idaho, Iowa, Louisiana, Mississippi, Montana, Nevada, New Mexico, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Utah, Washington, West Virginia, and Wyoming.

[2] See *supra*, pp. 299-300.

Regulation of public-utility security issuance is not too satisfactory, although its quality and extent have improved in recent years. The lack of control by many states and variations in state laws can probably be traced to a certain degree of apathy in some quarters. Many people have believed that if regulation of rates and service is adequate, there is little need for government control over security issues. This reasoning accounted in large part for holding up the regulation of railroad security issues until 1920.

With increased attention given to abuses from uncontrolled security issuance since 1929 and the realization that securities do affect rates and services, the trend is now toward greater government control in this field. This is as it should be. When one considers the reasons for control of railroad securities, and adds the abuses made possible, at least in the past, by the holding-company device in the public-utility field, the case for improved security regulation is exceedingly strong.

2. Scope of Federal Control. The federal government has a limited control over the issuance of public-utility securities under the Securities Act of 1933. In addition to approval by a state commission of local operating-company securities and by a federal commission of interstate public-utility operating- and holding-company securities, these must be registered, as are industrial securities, with the federal Securities and Exchange Commission.[1] It is interesting to note that carrier securities issued by authority of the Interstate Commerce Commission are exempted from the requirements of the Securities Act. Evidently its framers did not wish to leave investors in public-utility securities open to the dangers of omission in state law; and other federal measures were not yet developed in 1933.

The basis of government control under the Securities Act is different from that under state public-utility acts. The purpose of the former is not to pass upon the reasons for, or character of, securities, but to protect investors through full and accurate disclosure of information regarding the sale of a proposed issue. The object is to see that an investor is well informed as to the nature of an issue, and not to insure that the issue will safeguard rates and service.

For the most part, security-issue control by the federal government, except that having to do with full disclosure of information, is limited to public-utility holding companies and certain interstate operating utilities. In these fields, regulation is similar to the more advanced kind of state control of operating companies and the control of carriers under the Interstate Commerce Commission. It should be noted, however, that the federal government, through regulation of holding companies, is extending its control to local operating-company finance where these companies are in a holding-company system. These regulations will be dealt with presently.

[1] See *infra*, pp. 561–74.

B. STATE CONTROL OVER COMBINATIONS

In discussing state control over consolidations, it is planned to overlook for the moment combinations effected through holding companies. These will be treated in the more specialized study of the public-utility holding company. The present discussion will be limited to consolidation through merger or amalgamation or combination through lease or stock control by operating public utilities.

1. Scope of Commission Control. Because consolidations of operating utilities require the issuance of new securities, commission control in this respect is practically identical with that of security issuance. In addition, the more progressive states [1] have special laws placing under definite control of public-service commissions all kinds of consolidations, leases, acquisitions of control, and operating contracts. The commissions are directed to make a finding as to whether the proposed combination is in the public interest; if it is, they may grant its approval. In certain cases they may impose conditions with which the company must comply before the combination is consummated. The laws usually provide that consolidation may not increase the capitalization of a new company beyond the total value of bonds and stocks in the combining companies. Where a purchase price is involved, some statutes require that the value of assumed obligations, or new stocks and bonds, must not exceed the reasonable cost of the facilities to be purchased.

2. Economics of Combination. The encouragement of combination in the public-utility industries has many economic advantages, especially where physical combination of properties is effected. The case is not so strong if the combination is one of unified management of scattered operating properties. But where operations can be merged or co-ordinated, it is possible not only to reduce costs but to improve service.

The advantages of monopoly in the public-utility field have already been pointed out. To the extent that combination makes this monopoly more effective, it is to be encouraged. Public utilities are definitely businesses in which the economies of large-scale production are great. Large production and distribution plants can be operated more efficiently than small plants, and the larger companies through a diversity of customer demand have a better opportunity fully to utilize them. Other economies come from the ability to hire superior management, to float securities on more favorable terms, and to purchase supplies and equipment at lower prices. As competition tends to impair service and interfere with the use of city streets, so monopoly is likely to result in a higher grade of service.

It should not be inferred that there may not be limits to the economic growth of public utilities. A company may become so large that it cannot be operated effectively and efficiently as a unit. The diseconomies of large-scale enterprise

[1] Note, for example, Illinois and New York.

are well known. As the size of a business increases, management becomes more difficult and expensive, the organization becomes less flexible, and less enterprise may be shown in adopting new techniques of production and distribution. A business may also become so large that regulation becomes difficult, if not ineffective. The tendency also for competition in purchasing new companies may mean that the company desiring control is forced to pay so much that overcapitalization results. Except possibly for telephone companies, there are limits, too, beyond which improvement of service is negligible.

On the whole, commission regulation has not stood in the way of economic development of combination. If anything, commissions have permitted combinations which have had little economic justification; however, not all of the questionable combinations or unsound financial practices may be blamed on them. Many state boards have had little or no control over combinations. Others have probably properly conceived their function to be the supervision of terms and procedures of combination rather than approval of the economic wisdom of the move. In a number of cases, however, commissions have required that the combination have real economic advantages in the public interest.

C. ACCOUNTING AND REPORTS

Effective control of public utilities is not conceivable without accounting regulation. If reasonable rates are to be ascertained, securities approved, or combinations limited to those in the public interest, the commission must have accurate information as to operating expenses and capital expenditures. This information must not only be honest and defensible on the basis of accounting principles; it must be stated in terms which have a definite and understandable meaning and which enable comparison with information received from other companies. The content of accounting entries and statements must not only be defined but also be made uniform.

1. Extent of Commission Control. Practically all state commissions have statutory authority to prescribe uniform accounting; several states, however, despite the importance of accounting control, still do not provide their commissions with this authority.[1] Some state commissions have joined together and formulated classifications of uniform accounts. The National Association of Railroad and Utilities Commissioners has published such classifications for all public utilities with which state agencies have to deal. These are formulated for each kind of public utility, and have been adopted by approximately half the state commissions. Such classifications are obviously useful. A num-

[1] As of June, 1940, the following states had no accounting regulation: Iowa, Louisiana, Mississippi, New Mexico, North Carolina, Texas, and Virginia. See Welch, F. X., *loc. cit.* Delaware, of course, has no public-utility commission.

ber of commissions, however, have adopted plans of their own or have adopted modifications of the National Association classifications.

2. Legal Aspects of Accounting Control. The power to require uniform accounting has been adequately upheld by the courts.[1] They have shown a tendency to defer to commission discretion in this field probably more than in any other. So long as the classifications and instructions are not so at odds with accepted business and accounting principles "as to be the expression of a whim rather than an exercise of judgment," [2] the courts have upheld commissions.

3. Some Problems of Accounting Control. The most difficult aspect of accounting control arises from the need for proper policing and interpretation of classifications. Transactions are so diverse and entries so subject to varied interpretation, even by qualified accountants, that accurate and comparable accounts do not automatically result from prescribing classifications. Then, too, doing so does not mean that the amounts charged to certain accounts will be reasonable. Furthermore, effective accounting regulation would necessitate periodical audits, and most commissions do not have the staff to make such inspections often and thoroughly enough, if at all.

Perhaps the major portion of policing work is done in rate cases. Where a commission inquires into the reasonableness of data presented in support of such a case, it is given an opportunity to pass upon accounting practices of the utility in question. The sporadic character of this control, even if it should influence a company to change its book entries, is not adequate for effective regulation.

One of the principal abuses of accounting, which has caused much difficulty in rate cases, is the practice of writing up asset accounts above fair and reasonable costs. Since original cost, as shown by books, is one of the measures used in arriving at a rate base, there is clearly a strong motive to make it as high as possible. Write-ups may result in several ways. Construction work may be undertaken by a company affiliated in a holding-company system with an operating company, and excessive costs be charged. In transferring property from one company to another, especially during consolidation, the assets may be written up in value.[3] Properties have been reappraised and book values written up. Intangible values have been written into books at

[1] *I.C.C. v. Goodrich Transit Co.*, 224 U.S. 194 (1911); *Kansas City Southern Rwy. Co. v. U.S.*, 231 U.S. 423 (1913); *Am. Tel. and Tel. Co. v. U.S.*, 299 U.S. 232 (1936).

[2] *Am. Tel. and Tel. Co. v. U.S.*, *supra*, p. 237.

[3] In *Re New York State Elec. and Gas Corp.*, P.U.R. 1933 D, 264–75 (1933), an interesting case of write-ups was disclosed by the New York Public Service Commission. Through reappraisal, the Associated Gas and Electric System effected a sale to one of its operating subsidiaries of a property costing $2,271,000 at a price of $6,500,000. The property — land and water rights — was valued at the larger figure on the following basis: If the land and water rights were used for hydro-electric power production at an expense of $3,500,000, an earning power of $800,000 annually could be realized; if this were capitalized at 8 per cent, the property would be valued at $10,000,000; subtracting the $3,500,000, which might hypothetically be spent, left a "value" for the land and water rights of $6,500,000 — an inflation above cost of $4,229,000.

high figures. Results similar to write-ups occur, too, when a public utility does not retire worn-out or obsolete equipment from its books.[1]

These write-ups have occurred over the entire public-utility field in varying degrees. But apparently most of them have been made in companies controlled by public-utility holding companies. The amounts concerned have been considerable, as is evident from an investigation of the Federal Trade Commission completed in 1935. In ninety-one operating companies in sixteen holding-company systems, it found write-ups amounting to $3,300,000,000.[2] Granting that the figures of the Commission may not be entirely free from criticism as to their accuracy, these write-ups are important evidence of the shortcomings of accounting control. They show how it is possible for *amounts* charged to accounts to be inaccurate, even though the *forms* of accounts are prescribed, especially if accounts are not policed.

D. THE PUBLIC-UTILITY HOLDING COMPANY

An important development in the public-utility field has been the emergence of the public-utility holding company. Through this device, numerous scattered operating utilities have been brought under the control of fairly few holding-company systems. By 1932, in the electric industry, nearly 80 per cent of the electricity generated in the United States was under holding-company control, nearly all of which was in sixteen systems.[3] Virtually all the telephone utilities have been in one holding-company system for some years, with the American Telephone and Telegraph Company controlling 83 per cent of telephone stations in service in the United States in 1935.[4] By 1934, fifty-four holding companies controlled production of 31 per cent of natural gas and 56 per cent of artificial gas in the United States.[5]

The public-utility holding company has certain characteristics which give rise to many complex regulatory problems. The perfection of a regulatory system has been a recent development, with adequate legislation not provided until the federal government entered the field by enacting the Holding Company Act of 1935. Even yet, regulation has not really been perfected, for the administration of such laws is still in a formative stage.

The recentness of holding-company regulation is accounted for by several circumstances. The holding company did not reach a position of dominance until the middle 1920's. Even then, it was looked upon as having little or no

[1] The Federal Trade Commission noted that the Niagara Falls Power Company was carrying, at the end of 1931, in its fixed capital account the cost of a hydro-electric generating plant which had been dismantled in 1923. This item was estimated to bear a cost of $1,700,000. See *Utility Corporations*, Sen. Doc. No. 92, 70th Cong., 1st Sess. (1928–37), pt. 72 A, p. 298, and pt. 63, p. 455. Numerous other examples may be found in this investigation by the Commission.

[2] *Utility Corporations*, pt. 72 A, p. 298 (1935). [3] *Ibid.*, p. 38.

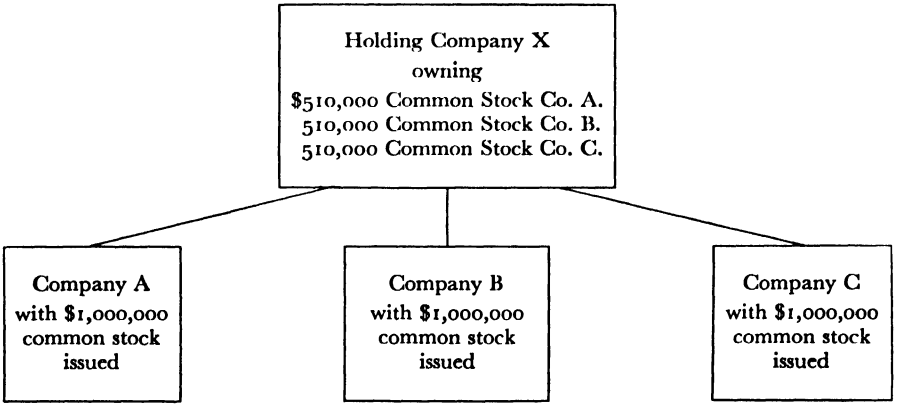
[4] Federal Communications Commission, *Investigation of the Telephone Industry in the U.S.*, House Doc. No. 340, 76th Cong., 1st Sess. (1939), p. xxiii.

[5] *Utility Corporations*, pt. 84 A, pp. 29–33.

relation to the problem of regulating local operating companies. Where regulation was believed necessary, it was thought for some time that the states might better control the holding company through the operating companies. However, the growing complexity of holding-company relations to operating companies, most of which were difficult for state authorities, confined as their jurisdictions were, to reach and the dangerous effects of the holding company upon operating-company regulation, led to the enactment of laws providing for control by the federal government.

1. THE NATURE OF THE PUBLIC-UTILITY HOLDING COMPANY. To understand this problem, it is well to note what a holding company is and what some of the characteristics of public-utility holding companies are. The holding company, as a form of organization, is found in all fields of business enterprise. It is usually a corporation empowered by charter to hold, as assets, stocks of other corporations. As distinct from a pure investment company, the holding company owns the stocks for purposes of controlling the other companies. While ordinarily a corporation, it may take other forms, such as the business trust or joint stock company, the main consideration being whether the organization holds stocks for the purpose of dominating other companies.

Holding companies may own other assets than securities held primarily for control. They often own operating assets directly, although many have little more than office furniture and a bank account in addition to the securities owned. A simple form of a pure holding company might be organized as follows:



Of course, holding company X might obtain control of companies A, B, and C with much less than a majority of their voting stock. If the other stockholders of these companies should be widely scattered and unorganized, the holding company might well gain working control by ownership of a much smaller

portion of the stock. This is made even easier by the tendency of small stockholders to assign their voting power, if they use it at all, to others, usually the inside management.

In any business organization, and particularly in the corporation, individuals find it possible to control more investment than they themselves make. The fact that majority rule is usually applied means that the majority may control the capital contributed by the minority owners. Moreover, when businesses borrow capital, so long as they live up to the terms of the credit bargain, they control the capital lent by others. In enterprises issuing securities, this control is further extended by selling ownership interests in which there is little or no right to control. An example is the non-voting preferred stock. These features of business enterprise make it possible for certain individuals to control far more capital than they invest.

The holding-company device is merely a means for magnifying the concentration of control already inherent in large business corporations. This can be shown by an oversimplified and perhaps extreme example. Suppose that company A is a holding company. Its total capital of $4,000,000 has been raised by the issuance of $2,000,000 in 5 per cent collateral trust bonds, $1,000,000 in 6 per cent non-voting and non-participating cumulative preferred stock, and 10,000 shares of common stock of $100 par value per share. Its assets are made up of $1,000,000 (10,000 shares) in each of four companies, B, C, D, and E. These companies, engaged, say, in the business of generating and selling electricity, were financed in each case with $4,000,000 in 5 per cent mortgage bonds, $2,000,000 in 6 per cent non-voting and non-participating preferred stock, and $2,000,000 (20,000 shares) of common stock. Hence, each of the four operating companies has $8,000,000 in generating and distributing assets.

Now, company A owns one half of the common stock in companies B, C, D, and E, an amount which easily insures its control of these operating companies; as a matter of fact, much less than this holding of stock might do so. Company A can be controlled by one half (more or less) of its common stock. Thus, an investment of $500,000 in its stock would insure control. But company A controls company B, C, D, and E with assets aggregating $32,000,000. A diagrammatic picture of this system is shown on page 352.

From this oversimplified picture, let us proceed to realities. Often holding companies own nearly all the stock of their operating companies. Just as often, they control operating companies by much less than half the common stock, in some cases 10 to 20 per cent. In many instances holding companies are superimposed upon holding companies. For example, if there were four holding companies like A above, controlled by a holding company, and the parent company financed in part by bonds and preferred stock, the concentration of control would be greatly magnified. There have been instances where a few individuals controlled operating assets many, many times greater

than their small investment. When the Van Sweringen railroad empire was sold in 1935, an investment of a little over $3,000,000 in a top holding company brought control to $3,000,000,000 worth of railroad property. The Federal Trade Commission noted that the equity of owners in the top Insull holding company amounted to from 0.02 to 0.05 of 1 per cent of the book value of securities in controlled operating companies.[1]

An example of the complicated type of holding-company systems is given in the chart on page 353 showing the organization of the Associated Gas and Electric System as it existed in 1929. Through a network of holding companies, around two hundred operating companies of various sorts were brought under the control of two men. With an exceedingly small personal investment, these individuals gained control of a system with nearly a billion-dollar capitalization.

Holding-company systems have not limited themselves to holding control in operating public utilities. Examination of the ownership interest of typical systems discloses a multitude of other enterprises. Most popular of these other businesses are the management or service companies, organized to give managerial, accounting, security sales, engineering, construction, purchasing, appliance merchandising, advertising, legal, and other services. These companies usually held contracts with operating companies in the same system. Other subsidiary companies furnished service for the transmission of electricity, water, and gas. Still others were organized to hold real estate for resale to operating companies or for other purposes, or to dispose of various by-products and furnish needed raw materials.

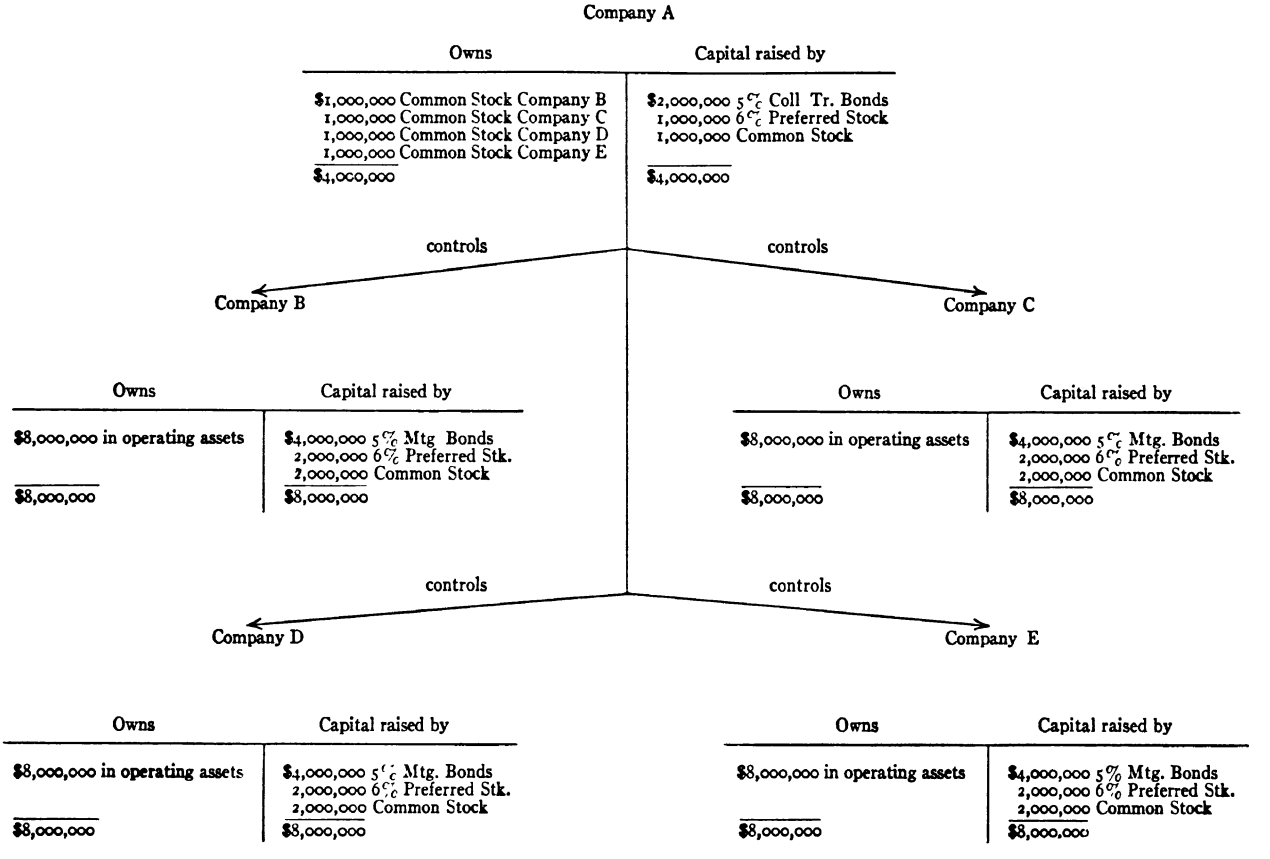
Holding-company systems often extended over wide areas. The Associated Gas and Electric System controlled properties in practically every state of the union, as well as in Canada, Mexico, and the Philippine Islands. The holdings of the Electric Bond and Share Company and other systems have been almost as extensive. Some systems have embraced operating properties which are in contiguous geographic areas where interconnection may be effected. Others have been made up of companies doing business in widely scattered places. Many systems, particularly the larger ones, have had both closely knit groups of operating companies and far-flung isolated companies.

2. Why Were Public-Utility Holding Companies Organized? Aside from certain economic and social advantages ascribable to holding companies, there are other reasons why this type of organization became so popular in the public-utility industry;[2] one of the most compelling of these has been the desire of individuals for power. Most systems have been dominated by certain individuals at one time or another, and the holding-company device gave them a means for extending their sphere of influence over wide areas. This control also proved profitable to many persons through salaries gained as officers, or

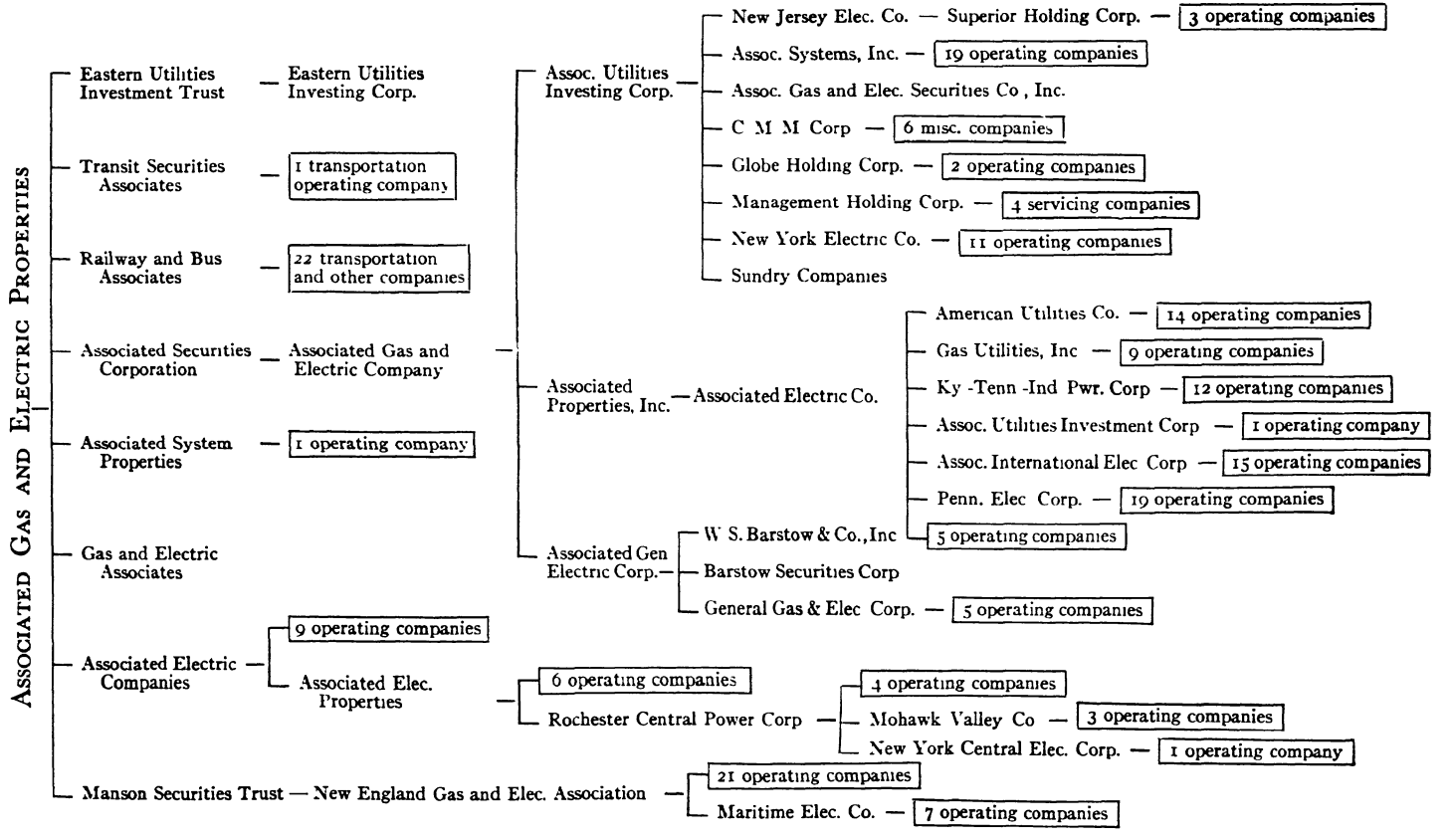
[1] *Utility Corporations*, pt. 72 A, p. 161.

[2] For a more complete discussion of this point, see *Utility Corporations*, pt. 72 A, pp. 130 ff.

CONTROL BY THE HOLDING-COMPANY DEVICE



ASSOCIATED GAS AND ELECTRIC SYSTEM (1929) (Adapted from *Utility Corporations*, v. 45, facing pp. 1013 and 1455)



NOTE: In a few cases operating companies are also holding companies controlling several subsidiary operating companies.

through lucrative businesses with a service or financial company in which they had a large ownership interest.

Some public-utility holding systems were built as a matter of expediency in specific practical situations. The United Gas Improvement Company extended its sphere of influence so that it could utilize with profit certain patented gas apparatus. The Electric Bond and Share Company, affiliated with General Electric Company interests, was formed in part so that it could develop the use of electric-plant facilities. Other companies, like H. M. Byllesby and Company, which developed the Standard Gas and Electric Group, evolved holding-company systems to assist in the carrying on of construction and managing services. When Stone and Webster found their independent construction business endangered by enlargement of holding-company systems with construction and engineering subsidiaries, they organized the Engineers Public Service Company to buy the controlling stock of their clients.

Still other holding companies received a stimulus from individuals and firms interested in the sale of public-utility securities. The beginning of the United Corporation can be traced to the accumulation of securities by investment bankers who held them as a result of their business. Halsey, Stuart, and Company, investment bankers, worked with the Insulls in developing several holding companies and obtained securities in connection with financing operations. In some cases the investment bankers gained their interest in securities through recompense for underwriting; in others the holding resulted from unsold securities which had been underwritten. In still other cases investment bankers became involved in such systems for the purpose of having willing clients whose securities they might sell.

3. Advantages of Holding Companies. In noting the advantages and disadvantages of public-utility holding companies, one may well regard these features as they affect the rate-payer, the investor, and agencies of public regulation, particularly state commissions controlling operating companies.[1] It should be remembered that these holding companies control operating companies and that the latter are fairly monopolistic, subject to extensive public regulation, and highly impressed with public interest.

From the point of view of the rate-payer, the holding company makes possible certain economies of combination and large-scale production. Where operating properties are closely located and can be interconnected, economies are possible by the employment of larger and more efficient plants. Through a central organization other economies can be effected. More competent technical and managerial staffs may be hired where the area of service is broad and the system large than where numerous independent small companies exist. Through large-volume purchasing, economies often result. Better and more efficient financing of capital requirements has been obtained

[1] This and many following points are drawn from the Federal Trade Commission's report, *Utility Corporations*, pt. 72 A, pp. 831–82.

in many cases, because the holding-company system was in a far better position in the capital market than a small independent company could be.

The larger systems have also done something to encourage increased consumption and to improve the quality of service. The driving force of business profit and the possibilities of economies and increased business have contributed to this development, for which the holding-company systems must receive some credit.

The holding companies have also done much to consolidate operating companies brought under control. In this way the latter have been developed into large integrated properties able to take advantage of many of the efficiencies of large-scale production.

The investor in public-utility holding-company securities has likewise been benefited by the development of economies. In addition, the holding-company device made it possible for investors to get advantages of diversification. Large systems provide investors with an opportunity to participate indirectly in investments in public utilities in different geographic areas and in localities of varying market characteristics.

If public-utility holding companies honestly and seriously co-operated with state commissions regulating operating companies, they could make the task of public control much easier. Through the centralization of power in such systems, uniform policies on the part of operating companies could be worked out and executed. If these policies were developed through co-operation with regulatory authorities, public control of operating companies would be greatly assisted.

4. Disadvantages of Holding Companies. Experience with the public-utility holding company has proved that many dangers have existed. Some of them arose before the days of federal control, and probably would not have been significant if government regulation had included these companies. As with the advantages noted, the disadvantages do not apply with equal force to all companies. Nor does the fact that the disadvantages appear to be greater in number than the advantages have any definite meaning in terms of net effect. The disadvantages have led to legislation to curb their future recurrence, but the advantages may be important enough to indicate that the holding company in principle should wisely be preserved.

The disadvantages to the rate-payer and to the operating public-utility company spring largely from the fact that, in general, the possible savings have not been passed on in lower costs and lower rates but have accrued to the holding company. Excessive fees for engineering, management, and other services have been charged by affiliated companies. Because both the service company and the operating public utility were customarily in the same holding-company system, those in control of it were really making a contract with themselves, and no price for service could be objected to as being high. Since the expenses of an operating company are to be covered by rates, a high charge

by a service company could yield large profits to the holding-company system.

Because of the advantage often to be gained in a higher fair value for rate-making purposes, and for the issuance of excessive shares for promoters' remuneration, these holding companies have often increased book value of operating-company assets beyond their proper cost. Write-ups have taken many forms. Assets have been revalued at a higher scale; obsolete assets have been retained on the books when they should have been retired; property has been sold by affiliated companies to operating companies at excessive figures; intangible values, such as going value, have been written in at optimistic amounts. The result, so far as the rate-payer is concerned, has been excessive book values. Despite commission regulation, these inflated values have affected the rate base (the fair value) and the rates charged.

Inter-company sales of electricity and gas at high prices have burdened operating companies with excessive expenses. Unwise financial practices between companies under holding-company management have had a deleterious influence on operating-company credit and the cost of capital. These costs have had their effect on the rates which consumers have had to pay.

Perhaps the most serious defect of the public-utility holding company, in relation to its investors in particular, has been the pyramiding of financial structure. Each operating company and holding company in a system has usually been financed by bonds and notes with fixed interest charges, as well as by preferred stock. So long as an operating company makes adequate profits for common stock, the income of holding companies is magnified as it passes through each stratum of the holding-company structure. This may be illustrated by returning to the example outlined above on page 352. If operating companies B, C, D, and E earn 8 per cent on their operating assets, the earnings available in each company for common stock are $320,000, after paying interest on mortgage bonds and dividends on preferred stock. If all these earnings are distributed, holding company A will receive $640,000 in income. After payment of interest and dividends, its stockholders will have $480,000 available for dividends, or earnings at 48 per cent on its stock. But if earnings of the operating companies fall to 4 per cent on operating assets, in the absence of adequate cash and a surplus, no dividends can be paid on their stock. Holding company A would receive no income; faced with fixed charges on its bonds, it would be forced into bankruptcy.

With holding companies built upon holding companies, a relatively small change in operating-company earnings can have tremendous results on the holding-company earnings. Where such structures have been built up and each company has fixed charges to meet, depressed earnings at the bottom of the structure often cause bankruptcy of the holding company and losses to its investors. The magnification of profits and losses is a direct result of the extension of trading on the equity in holding-company systems. But profits tend to accrue to holding-company common stockholders, while losses affect

all classes of security-holders. The public has usually been the principal investor in public-utility holding-company bonds and preferred stock. It is their investment that the pyramiding of financial structures has subjected to such great danger.

The investor of operating companies is also affected by the pyramiding in holding companies. When earnings fall, great pressure has been placed by holding companies to make operating companies pay dividends. By inadequate depreciation allowances, deceptive accounting, and other devices, the latter have sometimes been bled to cause paying of unearned dividends. This practice of course tends to undermine the position of the operating-company investor. Should the holding-company system collapse, the operating company may be affected. Too many investors do not differentiate between holding-company and operating-company securities, and failure of a holding company often causes a sympathetic depression of operating-company credit.

Write-ups of capital assets and accompanying overcapitalization of securities adversely affect the investor in the company concerned, and often cause the credit of other companies in the same system to suffer. One reason for inflating the capitalization of a holding or operating company is to devise a security structure which will induce investors to buy bonds and preferred stocks, thereby absorbing most or all of the actual investment, and which will leave to the holding companies common stock which cost little or nothing. Obviously, placing water in a capitalization, especially when such securities are issued to promoters, is not in the best interests of the investor who has contributed real capital investment.

Through various inter-company financial transactions, investors are sometimes harmed. When its holding-company parent forced it to lend over $688,000 on questionable security, the Green Mountain Power Company was saddled with a bad debt of that amount.[1] The Lowell Gas Light Company narrowly escaped bankruptcy in 1932 when its holding-company parent forced it to lend $1,150,000 which could not readily be repaid.[2] Numerous other examples of "upstream" loans could be cited.

Other inter-company transactions have led to operating companies being milked of assets to benefit holding companies. Sale of securities to the holding company and resale by it at much better terms,[3] sale of property at inflated values to operating companies, and sale of securities of a holding company to operating companies are some of the practices which have served to impoverish many investors.

From the point of view of public control, the primary disadvantage of the

[1] *Re Green Mountain Power Co.*, P.U.R. 1932 A, 130–35 (1931) (Vermont Pub. Ser. Com.).

[2] *Re Lowell Gas Light Co.*, P.U.R. 1933 A, 460–67 (1932) (Massachusetts Dept. of Pub. Util.).

[3] The holding company should, of course, be entitled to a reasonable profit for these transactions.

holding company has been its effect on state commission regulation of operating companies. Particularly in the period before federal control was enacted in 1935, state commissions had an extremely difficult time in coping with the influence of holding companies over operating companies. Because holding companies were usually interstate in nature, state commissions could not often reach them. Moreover, many courts and commissions took the position that a holding company was not really a public utility any more than any other operating-company security-owner, and that the commission having jurisdiction over public utilities could not regulate the holding company in any case.

The Federal Trade Commission in 1935 listed some of the objectionable features of holding companies as they affect regulation of operating companies as follows:

> (1) Confusion created in the public mind as to the situation and identities of operating utilities and the holding companies, so that proper distinctions are not made by investors and others. Since operating company security issues are in some states strictly regulated, the public sometimes entertains the idea that the holding-company issues are likewise authorized and approved by the regulatory bodies, which has never been the fact.
>
> (2) Ability under the holding company to organize separate corporations to monopolize certain functions that promise large profits and to acquire such profits at the expense of the operating company.
>
> (3) Fees and charges imposed on the operating companies with denial to the commission of adequate proof of the necessity for, and cost of, performing such services.
>
> (4) Overcapitalization of holding companies and overpayments by the holding companies in acquiring control of operating companies, which, while theoretically not a concern of the operating company, nevertheless are practices that react on the operating company to its detriment.
>
> (5) The frequent inflation of the fixed-capital accounts of operating utilities through construction fees not justified by costs, or through putative interest and other charges.
>
> (6) The practice of some holding companies of utilizing the employees of operating companies to sell holding company securities without segregation of time of employment in such activities from the regular operating time.
>
> (7) Refunding operations of doubtful value to the operating companies, issuance of excessive amounts of short-term notes and excessive proportions of interest-bearing securities, "upstream" loans exacted from operating utilities by a holding company, and other hurtful or weakening financial transactions devised to circumvent existing laws and to support commitments of the holding company in other ventures.
>
> (8) The use of local dummy directors and of local officers without real authority, the real dealing with local conditions being through absentee holding-company officials.
>
> (9) Pressure from holding companies upon operating utilities for the payment of excessive dividends, fully earned with a surplus balance, if possible, but if not fully earned, out of capital surplus or by reckoning as income items which are not true income.[1]

[1] *Utility Corporations*, pt. 72 A, pp. 876–77.

Even with federal control, the holding companies will remain a difficult problem for regulatory authorities. Their intricate corporate arrangements, complex financial structures, and perplexing inter-company transactions will ever be obstacles to simple public control. Although there is evidence that public-utility holding-company management has become far more enlightened and impressed with a greater sense of public duty, it is only natural that a few individuals in positions of power should attempt to circumvent regulation and use their position for a personal gain not consistent with the best and cheapest public service.

E. STATE COMMISSION CONTROL OF HOLDING COMPANIES

Many states attempted to regulate public-utility holding companies before the federal government entered the field in 1935. Even with its assertion of jurisdiction, state commissions still find it necessary to regulate holding companies. This control may be direct in some cases, and in others indirect through regulation of operating companies. Except for those few holding-company systems which are intrastate in nature, however, the rôle of the states is diminishing in importance as federal control gains experience.

1. SCOPE OF REGULATION. Although a few states had laws which dealt with holding-company activities in the public-utility field before 1930, most state legislation followed this date. Slightly more than half the states now have some kind of legislation for regulating holding companies. The provisions vary considerably from state to state, and the success of state commission administration of the laws differs to an even greater extent.

State laws respecting holding companies may be summarized by the following types of provisions: [1]

(1) The requirement that all agreements, including service contracts and other transactions, between utility and holding companies or affiliated interests be filed with the public-service commission. The public-service commission is ordinarily given power to investigate these agreements and to make just and reasonable orders in approving or disapproving them.

(2) Extension of commission jurisdiction over public-utility operating companies to holding companies and affiliated companies. In some cases the commission jurisdiction is extended to all holders of a "substantial interest" (defined as 1 to 10 per cent) in voting capital stock of public utilities and affiliated interests having transactions with public utilities.

(3) Forbidding foreign corporations to own, control, hold, or vote stocks or bonds of local public-utility companies. This prohibition is sometimes absolute, but is more generally subject to relinquishment upon approval of the state commission.

(4) Forbidding local public-utility operating companies from transferring or selling stocks or bonds to a holding company without permission of the state commission.

[1] See *Utility Corporations*, pt. 69 A, pp. 198–221; see also pt. 73 A.

In a few states the only provision applicable to public-utility holding companies is the anti-combination law which deals with all businesses. Under it, combinations by any means, including a holding company, which unduly lessen competition may be found unlawful.

In many states, whether special legislation exists or not, courts have upheld commissions in their right to investigate expenditures made, and other transactions entered into, by operating companies with holding companies or their affiliated companies.

In the more advanced state laws, especially those existing in New York, Illinois, Indiana, Kansas, and Washington, rather detailed provisions dealing with inter-company transactions are found. They include power on the part of a commission to examine records of affiliated companies doing business with local public-utility corporations, to require filing of reports on certain transactions, to restrict payment of dividends by utilities, and to exclude from accounts of utilities payments to affiliated companies for service, materials, or commodities furnished to them. These laws often declare that a company, whether interstate or not, doing business with an intrastate public-utility company is deemed to be doing a local business and is subject to the public-service commission.

2. Legal Aspects of State Control. State regulations affecting holding companies and their affiliates have not been tested thoroughly in the courts. Where they operate in intrastate commerce, the power of states to regulate them has not been subject to much question. But most of these transactions are in interstate commerce, and state jurisdiction cannot generally be extended over it. Moreover, the state authority, while complete, may not be used arbitrarily. It is interesting to note in this connection that courts have denied to public-utility commissions the power to disallow service charges under contracts made between operating utilities and holding-company affiliates where "there is nothing to indicate bad faith." [1]

The weight of court decisions is clearly against the ability of a state commission to *fix* the terms of any interstate transactions. Prescription of rates for sale of electricity or gas sold in interstate commerce by one company to another has been held to be beyond the powers of a state commission.[2] While this seemed to place interstate transactions beyond the scope of state control, even where they materially affected a local public-utility operating company,

[1] *Southwestern Bell Tel. Co. v. Missouri Com.*, 262 U.S. 276, 288 (1923). In this case the Supreme Court quoted with approval an opinion of the Illinois Supreme Court *Springfield v. Springfield G. and E. Co.*, 291 Ill. 209, 234, (1920)], saying that "the commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by corporate officers."

[2] *Missouri v. Kansas Natural Gas Co.*, 265 U.S. 298 (1924), and *P.U. Com. v. Attleboro Steam and Elec. Co.*, 273 U.S. 83 (1927). But where an interstate company serves a locality at retail, regulation of the rates by a state commission has been upheld as placing an incidental rather than a direct burden on interstate commerce. See *Pennsylvania Gas Co. v. P.S. Com.*, 252 U.S. 23 (1920).

possibilities for state regulation were shown in a case in 1932. In the Western Distributing Company case,[1] the United States Supreme Court held that a state commission might insist upon evidence as to the reasonableness of charges made by one company in a holding-company system to an operating company in the same system, even though the transaction was interstate. This position was based on the fact that there was an absence of arm's-length bargaining between the two companies. This seems to mean that while the commission may not fix the terms of the contract between such companies, it may insist upon evidence as to the reasonableness of the terms, and make its findings in a rate case conform with reasonable charges. Thus it may disallow unreasonable charges growing out of holding-company transactions in a rate case, but power to forbid the making of such transactions is very uncertain.

Regulations designed to keep foreign (out-of-state) corporations from doing a public-utility business or from owning securities in local public utilities seem to be within the power of a state; and power to investigate holders of a substantial interest in operating companies has not been seriously contested. Yet these regulations may easily be circumvented. For example, a Massachusetts law prohibits a foreign corporation which owns or controls a majority of the common stock of a domestic corporation from issuing securities based on the former's holding of securities in the latter, under penalty of dissolution of the domestic corporation, except upon approval of the state. But this law was nullified by forming business trusts to hold the securities of domestic corporations, the trusts in turn being under control of a holding-company system. Laws requiring intrastate business to be done by locally incorporated companies have been circumvented by having a foreign corporation control the several intrastate ones. Legislation to regulate holders of substantial interests has been nullified in many instances by the creation of a number of dummy holders of stock.[2] Some state laws have also been made practically worthless by the inability of state commissions to reach interstate holding companies and their affiliates. These commissions cannot extend their activities across state lines and require uniform accounting or investigate books and records.

3. Weaknesses in State Control. Rigorous control of operating companies by state commissions can do much to prevent abuses of inter-company dealings growing out of holding-company affiliations. Through regulation of operating-company rates and practices, a certain pressure can be placed on the holding companies and their affiliates. Through power to require local corporations to carry on utility business, and to dissolve them for abuse of this privilege, the states have a greater basis for control than has generally been supposed.

[1] *Western Distributing Co. v. Kansas*, 285 U.S. 119 (1932). The decision in this case was foreshadowed by an earlier finding in *Smith v. Ill. Bell Tel. Co.*, 282 U.S. 133 (1930).

[2] These dummy holders are kept under control of actual holders by devices whereby the latter may recover their stock at any time.

Nevertheless, there are weaknesses in state control that make federal regulation desirable. The ability of holding companies to circumvent state laws, and to stay out of reach of state commissions, has been noted. It is also uncertain to what extent the states may *affirmatively* control holding companies and their affiliates, especially in the light of the interstate problems created. Moreover, a single state can hardly be expected to deal efficiently with the broad character of holding-company operations, even if it had authority to do so. Limitations in staff and appropriations for regulation make this out of the question. States also differ too much in the scope and character of regulations affecting public-utility holding companies to make the regulation effective. Furthermore, even the best state regulation does little to protect the public-utility holding company investor.

F. FEDERAL CONTROL OF HOLDING COMPANIES: THE ACT OF 1935

The Public Utility Act of 1935, Title I of which deals with holding companies, was passed as the result of the voluminous investigation made by the Federal Trade Commission and the increasing public demand to curb the abuses of these companies. When depression set in in 1929, many security-holders in holding companies found their investment position uncertain, if not actually destroyed. In addition, with greater attention drawn to public-utility rates, abuses of the holding companies were brought more strikingly to public attention. In 1932, even the National Association of Railroad and Utility Commissioners, a group composed largely of state commissioners opposing encroachment by the federal government in the public-utility field, recommended that facts as to holding-company relationships be determined by it.[1]

After a vigorous fight in Congress, the Public Utility Holding Company Act was passed in 1935. Its administration was placed in the Securities and Exchange Commission. This law represents one of the most aggressive regulatory statutes found in all government control of business. The complexity of holding-company structures and practices, as well as the intricacy of the law, means that an appraisal of the act in terms of results cannot yet be had. The Securities and Exchange Commission has approached its administration cautiously, and years will pass before the main constitutional aspects of the act are interpreted and its meaning has become known.

1. PURPOSE OF THE LAW. The purpose of the Holding Company Act is the prevention of abuses found in holding-company systems, as they affect the public-utility rate-payer, investor, and the agencies of public control. The purposes of the act are stated as follows:

[1] National Association of Railroad and Utility Commissioners, *Proceedings* (1932), pp. 467–68.

> ... to meet the problems and eliminate the evils... connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.[1]

2. Bases of the Law. In passing the Holding Company Act, Congress placed its main reliance for power on the interstate commerce clause. Declaring that holding-company securities are widely marketed and distributed in interstate commerce, that service and other contracts are made and performed therein, that subsidiaries often use instrumentalities of interstate commerce, and that holding-company practices materially affect it, Congress justified, in large part, its regulatory program on that power.

The Holding Company Act was also based on the postal power. In this connection it was pointed out how these companies and their subsidiaries made extensive use of the mails. In addition, the systems were held to be affected with a national public interest because of their many interstate and mail activities, as well as because their activities made state control of operating companies difficult if not impossible.

3. Registration of Companies. As a first step in regulation, the holding companies were required to register with the Securities and Exchange Commission between October 1 and December 1, 1935, unless they were granted exemption under the terms of the act. If a holding company did not register within the specified time, certain activities were henceforth to become unlawful. Whether done directly or indirectly, an unregistered holding company was forbidden:

> (1) to sell transport, transmit, or distribute, or own or operate any utility assets for the transportation, transmission, or distribution of, natural or manufactured gas or electricity in interstate commerce;
>
> (2) by use of the mails or any means or instrumentality of interstate commerce, to negotiate, enter into, or take any step in the performance of, any service, sales, or construction contract undertaking to perform services or construction work for, or sell goods to, any public-utility company or holding company;
>
> (3) to distribute or make any public offering for sale or exchange of any security of such holding company, *or affiliates*, by use of the mails, or any means or instrumentality of interstate commerce...;
>
> (4) by use of the mails or any means or instrumentality of interstate commerce, to acquire or negotiate for the acquisition of any security or utility assets of any *holding company or subsidiaries, or affiliates*;
>
> (5) to engage in any business in interstate commerce; or
>
> (6) to own, control, or hold with power to vote any security of any subsidiary company thereof that does any of the acts enumerated *above*.[2]

[1] Act of Aug. 6, 1935; Chap. 679, Title I, 49 Stat. 803, sec. 1, par. (C).

[2] Sec. 4 (a). Italics mine.

In registering with the Commission, the holding companies are required to file statements containing a large amount of information concerning their activities and relationships. These include all corporate and other contracts, financial data, information as to control and persons controlling, and any other facts which the Commission deems to be necessary for protecting the public interest.

4. Companies Covered by the Act. The Holding Company Act applies to all gas and electric holding companies, their subsidiaries and affiliates. It defines a holding company as any company owning, holding, or controlling 10 per cent or more of the voting stock of a public-utility operating company or of any holding company doing so. While companies holding this percentage might be found by the Securities and Exchange Commission not to be a holding company, other persons not having this percentage of control might be declared by it to be within the purview of the act, if they exercised such control over management as to make their regulation in the public interest.

The Commission is empowered to exempt any holding company or subsidiary from any part of the law if it is found consistent with the public interest to do so, and if the company falls within certain categories. Characteristics making grounds for exemption are as follows:

(1) Those companies predominantly intrastate in character and carrying on their business substantially within a single state;

(2) Those companies predominantly an operating company carrying on business in the state of organization and in states contiguous thereto;

(3) Those companies only incidentally a public utility holding company deriving a material part of their revenue outside the public utility field;

(4) Such companies as are temporarily a holding company because of acquisition of securities in liquidation of debt previously contracted or in connection with distribution of securities;

(5) Those companies deriving the material part of their income outside of the United States.

5. Regulation of Corporate Structures. Some of the most drastic features of the law deal with control over corporate structures. They are designed to reduce the complexity of holding-company systems and to police further acquisitions so that these systems may be kept on a more simplified status. As given in the law, the Commission is directed to

> examine the corporate structure of every registered holding company and subsidiary company thereof, the relationships among the companies in the holding-company system of every such company and the character of the interests thereof and the properties owned or controlled thereby to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system.[1]

[1] Sec. 11 (a).

As soon as practicable after January 1, 1938, the Securities and Exchange Commission was to require each holding-company system to limit its operations to a single integrated public-utility operating system. According to the words of Congress, such a system is to be one whose operating assets are capable of being physically interconnected and economically run as a single co-ordinated system in a single area, but which would not be so large as to impair the advantages of localized management, efficient operation, and effectiveness of regulation. These assets might be owned by one or more companies, even though interconnection and co-ordination were effected virtually under one management.

Where permitted by the Commission, a registered holding company might control one or more additional integrated systems. For this permission to be granted, however, it must be shown that (1) each additional system cannot be operated as an independent system without loss of substantial economies which could be obtained by retention of control; (2) all additional systems are located in one state or in adjoining states, or in a contiguous foreign country; and (3) the combination of systems is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission is also directed as soon as practicable after January 1, 1938, to take such steps as it deems necessary to insure that the corporate structure or continued existence of any company does not unnecessarily complicate the structure or inequitably distribute voting power among security-holders. To eliminate these complications, it is empowered to order that a "holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company." [1] This cumbersome phrase, popularly known as the "death sentence," means that holding-company structures will ultimately be limited to two strata of holding companies. In other words, an operating company may have only one holding company between it and the top holding company.

6. Acquisition of Securities and Assets. Supervision of development of holding-company systems is provided for by several sections of the law dealing with acquisition of securities and utility assets. Unless with the approval of the Securities and Exchange Commission, registered holding companies are forbidden to acquire any securities or utility assets or any other interest in any business, nor can affiliated companies do so. This prohibition does not apply to (1) acquisition of public-utility assets expressly authorized by a state commission; and (2) acquisitions of securities of public-utility operating company subsidiaries, authorized by a state commission, where these subsidiaries and all other public-utility subsidiaries in the system are organized in the same state and the business of such companies is substantially confined to the same state. Nor does the prohibition apply to acquisitions of government securities,

[1] Sec. 11 (b), (2).

or marketable securities and commercial paper prescribed by the Commission as appropriate for investment of current funds.

In order to obtain approval for security and other acquisitions, not excepted from the prohibition above, the company must file financial and other information so that the Commission may know the extent to which such acquisitions are appropriate in the public interest, and in the interest of investors and consumers. The Commission must be satisfied that (1) the proposed acquisition will not lead to results detrimental to the public interest or to the purposes of the provision respecting holding-company simplification; and (2) the acquisition will not lead to excessive capitalization, by virtue of the price paid, the remuneration for acquisition, or the character of the acquired securities or property.

Where a state law prohibits ownership by a single company of electric-utility and gas-utility assets in the same territory, a public-utility holding company is required to obtain the authorization of the state commission before it can make any such acquisition.

7. Issuance of Securities. Issuance of securities of holding companies and subsidiaries is also subject to rigorous control. All such issuance, and the exercise of any privilege or right to alter priorities, preferences, voting power, or other rights of holders of outstanding securities, are subject to approval of the Securities and Exchange Commission. This requirement does not apply to short-term notes of nine months or less, not offered to the public, and not aggregating more than 5 per cent of the outstanding capitalization. The Commission may exempt issues of a subsidiary where the securities have been authorized by the commission of a state in which the company is organized and operating.

Before granting its approval for issuance of securities or exercise of rights noted above, the Securities and Exchange Commission must find that certain requirements of the law are observed, in addition to any rule found necessary and appropriate in the public interest by it. According to section 7 of the law, in order to be approved securities must fall in *one* of the three following general classifications:

(1) Securities that are par value common stock without preference as to dividends, assets, or voting rights; bonds secured directly or indirectly by a first lien on physical property; bonds secured by assets of a type and character approved by the commission; guaranty of, or assumption of liability on, a security of another company; receiver's, or trustee's certificates.

(2) Refunding securities, or securities growing out of reorganization or consolidation of holding companies; securities issued for the purpose of financing operating public utility business; or securities found by the commission to be necessary for urgent corporate purposes, where the requirements of paragraph (1) would impose an unreasonable financial burden on the holding company. Thus, normally, no-par common stock, preferred stock, and unsecured bonds can only be issued by operating companies, by holding companies in reorganization, and by holding companies undergoing consolidation. However, where necessary for

urgent financing, these securities may be allowed by the commission for other holding companies.

(3) Securities issued before January 1, 1935, and authorized by the commission as necessary or appropriate in the public interest.

In addition securities must be (1) reasonably adapted to the security structure of the holding company and other companies in the system; (2) reasonably adapted to earning power; (3) necessary and appropriate to economical and efficient operation of the applicant; (4) distributed and sold at a reasonable cost; (5) a reasonable risk, where a guaranty or assumption of obligation is involved; and (6) sold under terms and conditions not detrimental to the public interest or the interest of investors and consumers.

8. Financial Transactions. Financial transactions between companies in the same holding-company system are subject to strict regulation by the Securities and Exchange Commission. Registered holding companies are forbidden in the future to borrow from any public-utility operating company or other subsidiary company in the same system. They may not lend to other companies in the system, except in accordance with the rules of the Commission. Thus "upstream" loans are definitely prohibited, while "downstream" loans may be made only according to regulation by the Commission.

Registered holding companies and subsidiary companies are forbidden to declare or pay dividends, or to acquire, retire, or redeem securities in contravention of rules and regulations of the Commission. The latter's rules are to be appropriate to protect the financial integrity of companies in the system, to safeguard the working capital of operating companies, and to prevent payment of dividends out of capital or unearned surplus.

Sale of securities and assets of operating companies, owned by a holding company, can be made only by approval of the Commission. It is directed to consider among other matters the amount received for the sale, the maintenance of competitive conditions in the industry, fees and commissions for sale, and the position of interested parties.

Solicitation of proxies and of other authorizations regarding securities of holding companies and subsidiaries is also placed under the supervision of the Commission, with power to create rules and regulations. It is further given a blanket power to make rules and regulations regarding reports, accounts, costs, maintenance of competitive conditions, disclosure of interest, duration of contracts, and similar matters, where necessary to prevent circumvention of the provisions dealing with financial transactions. The companies concerned are prohibited from negotiating or making agreements or contracts, except in accordance with such rules.

Financial contributions for political purposes [1] are prohibited. The law

[1] Defined as contributions "in connection with the candidacy, nomination, election, or appointment of any person for or to any office or position" in government service; and contributions to "any political party or any committee or agency thereof." See Sec. 12 (h).

provides regulation by the Securities and Exchange Commission of activities which "present, advocate, or oppose any matter affecting" registered holding companies or their subsidaries before Congress or its members, the Securities and Exchange Commission, the Federal Power Commission, and their staffs.[1] Persons employed or retained by a holding company or subsidiary for these purposes must register with the Commission and submit to its rules and regulations in respect to the subject matter of their employment, its nature and character, and the amount of compensation received.

9. SERVICE CONTRACTS. Except as exempted by the Commission as necessary in the public interest, registered holding companies may not enter into or take any step in the performance of any service, sales, or construction contracts, by which such holding companies undertake to perform services or construction work for, or sell goods to, any subsidiary public-utility operating company, or a mutual service company.[2] Registered holding companies, mutual service companies, subsidiary service companies, and other subsidiary companies are required by the law to make contracts in accordance with rules and regulations prescribed by the Securities and Exchange Commission. Among other things these rules must insure that contracts be performed economically and efficiently for the benefit of the associate companies at a cost fairly and equitably allocated. The Commission may exempt such transactions where the associate company is not an operating company within the United States, or does not derive a material part of its income from sources within the United States, and where special or unusual circumstances are involved.

To be an approved mutual service company, a service company must be

> so organized as to ownership, costs, revenues, and the sharing thereof as reasonably to insure the efficient and economical performance of service, sales, or construction contracts by such company for member companies, at cost fairly and equitably allocated among such member companies, at a reasonable saving to member companies over the cost to such companies of comparable contracts performed by independent persons.[3]

In order to obtain an accurate knowledge and fair distribution of costs of mutual service companies, special authority is given to the Commission to provide for the keeping of cost accounts and records. Similar regulations are imposed on subsidiary service companies. Service companies as well as subsidiary operating companies are forbidden to make service, sales, and construction contracts, except in accordance with the rules and regula-

[1] Sec. 12 (i).

[2] A mutual service company is a company in a holding-company system whose stock is owned by member operating companies, and which is engaged in performing a service, sales, or construction work for other companies, particularly operating public utilities, in the same system. A subsidiary service company is one engaged in the same activities, but one whose stock is controlled by the holding company. The practical significance of the distinction between these two kinds of service companies is not very great.

[3] Sec. 13 (d).

tions of the Commission. Even where a service company is independent of a holding-company system, its contracts are placed under the supervision of the Commission.

10. OTHER PROVISIONS. The Holding Company Act provides for complete control by the Commission over the accounts of holding companies and their subsidiaries, as well as persons whose principal business is the performance of service, sales, or construction contracts. This control embodies the prescription of uniform accounting methods, including cost accounting. Not only is regulation of the form of accounts provided for, but the law gives the Commission power to police the content of accounts, and to require an accounting entry to be modified or supplemented so as to show proper costs. Owing to the fact that many holding-company subsidiaries are operating utilities already under state control, the federal law directs that this accounting control be not inconsistent with state commission regulation. The Securities and Exchange Commission, however, may impose additional accounting requirements beyond those prescribed by the states.

The Commission is empowered to require regular reports as well as special ones upon matters necessary or appropriate in the public interest. Special information as to security holdings of officers and directors must be given to it. In order to prevent unfair use of information obtained by officers and directors, detailed information of purchase and sale of securities in the holding-company system must be given. Where a profit arises in a purchase or sale made within any period less than six months, such profit becomes recoverable by the holding company or subsidiary company concerned. Except where permitted by the Commission, holding companies or subsidiaries may not have as an officer or director any person affiliated with the controlling group of a bank, trust company, or investment banker. This provision is designed to eliminate banking control found by the Commission to be contrary to the public interest.

Adequate enforcement machinery is provided by the law. The Securities and Exchange Commission may make studies and investigations, call witnesses, hold hearings, and prosecute offenders in the courts. An order of the Commission is enforceable only by application to the federal courts. But the rôle of the courts, the procedure to be used, and punishments for non-conformance to be meted out are provided for in detail by the law.

G. FEDERAL CONTROL UNDER THE ACT OF 1935

The above summary of the Holding Company Act is adequate evidence of its complicated and extensive character. When the great number of holding companies, sub-holding companies, and subsidiary operating and service companies is considered, the magnitude of the administrative task is obvious. As yet, very few legal points have been defined by court interpretation. In ad-

ministering the law, the Securities and Exchange Commission has moved cautiously. The dates of enforcing most parts of the act are defined as being as "soon as practicable" after a certain time. The Commission has approached its task with restraint, and has awaited the gathering of sufficient data before promulgating rules or directing compliance.

1. CONSTITUTIONAL ASPECTS. Many questions of constitutionality are presented by the Holding Company Act. Is the business of a holding company which owns stocks of other companies and uses this ownership for control one in interstate commerce? Can Congress close the mails and the channels of interstate commerce to transactions which affect the public only indirectly, through their effect on the public-utility investor and rate-payer? May Congress go so far as to force the elimination of certain companies it regards as useless or uneconomical? Can Congress require that those who do business with holding companies and their subsidiaries, that is, service companies, submit to regulation? Can control be extended to public utilities operating intrastate, because they are subsidiaries of holding companies, or because they make contracts with service companies in the same system? If the act should be valid in general, are certain provisions, such as control over loans, dividends, political contributions, and lobbying activities, reasonable regulatory measures? These and many other questions may be raised concerning the constitutional features of the act.

The only point which has been adjudicated by the Supreme Court of the United States up to 1941 is that concerning the registration provision of law. In the decision in the famous Electric Bond and Share Company case, handed down in 1938, the Court held that the registration requirements of the act were within the constitutional powers of Congress.[1] It declared that the registration provisions were separable from other features of the law, and that in upholding the power of Congress to require companies to register it did not automatically validate other portions of the act. The question of the constitutionality of the rest of the act was reserved for decision, if and when concrete situations develop.

By upholding the power of Congress to require registration, the Supreme Court made an important decision. It decided that holding companies like the Electric Bond and Share Company were engaged in transactions in interstate commerce. The fact, said the Court, "that they conduct such transactions through the instrumentality of subsidiaries cannot avail to remove them from the reach of the federal power," since "it is the substance of what they do and not the form in which they clothe their transactions, which must afford the test."[2]

With the broadening concept of interstate commerce adopted by the Supreme Court in recent years,[3] this decision seems to foreshadow finding most of the

[1] *Electric Bond and Share Co. v. S.E.C.*, 303 U.S. 419 (1938). [2] *Ibid.*, p. 440.

[3] See *supra*, pp. 42–45.

holding-company act constitutional. If the holding companies, their affiliates, and their subsidiaries are really businesses in interstate commerce, then regulation of their practices would seem to be constitutional.

Regulation of security issuance and control over accounting are among the features for which railroad regulation would furnish an applicable precedent in favor of constitutionality. The regulation of acquisitions of assets and securities of other companies would also seem to be constitutional on the same grounds. Whether the regulation of the affairs of service companies, including the price charged to holding-company subsidiaries, is valid is not so clear. If these companies are held to be affected with a public interest by virtue of their close connection with public-utility companies, such regulation might well be upheld. Or, with the tendency to give Congress a fairly free rein in the regulation of interstate commerce, it might be approved as a means of controlling transactions in its flow.

The Holding Company Act goes further into the sphere of managerial discretion than any other federal peace-time law up to the present time. The making of business contracts, the character of financial or corporate structure, and the general nature of holding-company operations in different geographical areas are matters which have generally been left to management. If the control of such aspects of holding-company management is proved to the Supreme Court to be a reasonable adjunct of effective regulation, it may well be upheld. Where the greatest element of constitutional doubt lies, however, is in the provisions requiring outright elimination of companies in a holding-company system, or the detachment of other companies. This would seem to go pretty far in the field of regulation. Yet large combinations have been forced to dissolve under the anti-trust laws.[1] Railroad companies have been compelled to divest themselves of ownership of coal and other companies whose products they carry.[2] Hence, if widespread regulation of the holding companies seems to be in the public interest, there are even precedents for the death sentence.

2. Commission Administration. In administering the Public Utility Holding Company Act, the Securities and Exchange Commission has formulated a multitude of rules and regulations giving meaning to the many discretionary powers granted to it. To discuss all these rules, however, would require a more detailed treatment than seems desirable here. It may be said that they show that the Securities and Exchange Commission intends to use its powers in order effectively to promote what it believes to be sound financial policy. Where rules are formulated, and where discretionary authority must be interpreted in the light of facts in individual cases (such as definitions of "reasonable" or "necessary and appropriate"), the Commission has kept its policies elastic. It has shown that it does not intend to be so literal as to impede fair and well-intentioned efforts of holding companies to adapt them-

[1] See *infra*, Chapter 19. [2] See *U.S. v. Lehigh Valley R.R. Co.*, 220 U.S. 257 (1911).

selves to the requirements of the law. At the same time, it has insisted that it will not budge from the stated purposes of the law, although it wishes to achieve them by co-operative action of government and management.

a. Security issues. Perhaps the largest part of the Commission's actions have been devoted to regulation of security issues. It has not yet insisted that all stocks be of par value or that bonds be secured by physical property or liens on physical property. Where good reasons are shown, it has permitted the alternatives in section 7 [1] to be used as a basis of approval of security issues. This is a good example of the practical point of view of the Commission.

A like attitude has been shown in respect to the marketing of securities. The Commission has generally insisted upon arm's-length bargaining in underwriting agreements, so that excessive selling costs will not find their way into the pockets of investment bankers with an interest in the holding-company system. But this has not meant that competitive bidding for underwriting new issues has been required, although it has been encouraged. Where issues are sold without competitive bidding by underwriters, or by negotiations not at arm's length, the Commission has indicated that it will look primarily to the results. If the cost is reasonable, the underwriting contract will be approved.[2]

The issuance of stock dividends out of what appeared to be capital, rather than earned, surplus was also approved by the Commission in 1938.[3] In this case the company had asked for permission to issue stock dividends on both preferred and common stock. Owing to the practical exigencies of the situation, the Commission allowed dividends on preferred stock but refused them on common stock. Furthermore, it conditioned this permission upon the proviso that equivalent amounts be restored to surplus from the first available earnings. It did not condone payment of stock dividends from capital surplus, but found such action in this case to be necessary and appropriate for the financial betterment of the corporation.

b. Acquisitions of stock. Acquisitions of stock by holding companies and subsidiaries have been allowed in a number of cases. The Securities and Exchange Commission has required in general that these acquisitions be such as to bring together operating facilities interconnected or capable of interconnection on an efficient basis. Actual physical interconnection and complete geographical integration have not been demanded. Acquisitions have been permitted even where some parts acquired are not capable of being integrated and physically co-ordinated into a single system. However, the Commission has ruled that the major part of the properties acquired must constitute such a system, and that the acquisition must be justifiable on grounds of efficiency and economy.[4]

[1] See *supra*, pp. 366-67.
[2] See *Re The Kansas Elec. Pwr. Co.*, 1 S.E.C. 890 (1936).
[3] *Re Columbia Gas and Elec. Co.*, 16 P.U.R. (N.S.) 132 (1938).
[4] *Re Public Service Company of New Hampshire*, 1 S.E.C. 505 (1936).

c. Service contracts. The most important aspect of service-company regulation has to do with the furnishing of services at cost. The Commission has defined "cost" as a fair and equitable allocation of expenses plus a reasonable compensation for the capital employed in the business; this compensation includes the amount of interest on borrowed capital and a reasonable return on the amount of ownership capital reasonably necessary for the performance of services.[1] Besides insisting that services be furnished at cost, the Commission has insisted that a service company in the same holding-company system as the operating company with which it deals may not charge a price higher than the purchaser might be expected to pay elsewhere.

Even before the Securities and Exchange Commission began enforcing its rules in regard to service companies, most of the holding-company systems placed their service subsidiaries on a cost basis. This is a remarkably different situation from that existing in the 1920's. Then, service companies were able to make excessive charges, and to pass large dividends to the holding companies by virtue of the earnings resulting therefrom.[2] The effect of current regulation is to place these companies on the same basis as public-utility operating companies, whereby they are entitled to charges which will cover all costs, including a return to capital. Here, as in other portions of the act, is proof that the law aims to skim excess profits off the holding-company business.

d. Simplification of corporate structures. Commission administration has been particularly cautious under the simplification provisions of the law. Realizing the legal and practical complications involved, as well as the opposition to this feature of the law, the Commission has aimed to undertake enforcement of these provisions by co-operative methods. It has invited companies to submit plans for simplification and to confer with its representatives in formulating them. Many holding-company systems have taken advantage of this invitation, and may others have proceeded voluntarily with simplification of their setups.

The first plan of simplification approved in general by the Securities and Exchange Commission was that of the American Water Works and Electric Company.[3] The simplification of this system was made somewhat easier by virtue of the fact that most of the properties were fairly well integrated geographically and physically interconnected. Moreover, a large part of its business, especially in water companies, was not included within the law, since the act applied only to electric and gas public-utility companies.

In spite of certain minor exceptions, which were held to be relatively unimportant, the Commission found that the combined electric and gas opera-

[1] S.E.C. Rule No. 13–32.

[2] For a detailed discussion of this point see Buchanan, N.S., "Certain Aspects of Utility Service Contracts," 7 *Journal of Business*, pp. 106–23 (April, 1934).

[3] *Re American Water Works and Elec. Co.*, 2 S.E.C. 972 (1937).

tions were closely enough interrelated to make the subsidiaries constitute a single system, capable of economical and efficient co-ordinated operation. In regard to holdings in subsidiaries furnishing service and selling materials to other companies in the system, the Commission found that charges were made at cost and that the economies resulted from joint control. In the case of certain businesses of minor importance the ownership of which did not seem justified, the Commission took the position that their disposal would be difficult, and that they were not "presently detrimental" to the proper functioning of the integrated system.

In the case of one sub-holding company and its subsidiaries, the Commission directed that efforts be made to reorganize certain features. While it did not let this drawback interfere with general approval of the company's plan, it asked the company to study means for readjustment and submit its proposals.

The Commission also objected to certain distribution of voting rights between preferred and common stockholders. The unsatisfactory condition of voting rights of preferred stockholders, even in event of default of preferred-stock dividends, was pointed out. In view of the "long interrupted preferred stock dividend record" and the "substantial common stock equities in the companies in question," the Commission ordered no change in normal voting power, but did ask the company to give preferred stockholders more authority in case of dividend defaults.

By 1941 most of the large public-utility holding-company systems had taken steps to reduce their corporate structures to the three-tier maximum allowed by law. Through a series of trading of securities between companies in the same system and dissolving unnecessary corporations, they have made a surprisingly good start on this complicated problem.

Real difficulty has been encountered, however, in meeting the requirement of geographical integration. Practically every large holding-company system has owned properties in various parts of the United States, and many of these have been geographically separated from other utilities in the system. As a result, public-utility holding companies have been unable or unwilling to sell or trade properties fast enough to meet voluntarily the law's requirements of geographical integration. Consequently, early in 1940 the Securities and Exchange Commission started a program for geographical integration. It issued orders to nine large public-utility holding-company systems to show cause why they should not be forced to divest themselves of any companies not geographically integrated in a system.[1]

While the series of show-cause orders has meant that enforcement of inte-

[1] The systems were the following: United Gas Improvement Company System, Commonwealth and Southern Corporation System, North American Company System, Cities Service Power and Light Company System, Standard Gas and Electric Company System, Engineers Public Service Company System, United Light and Power Company System, Electric Bond and Share Company System, and Middle West Corporation System. For maps of these systems, see 25 *Public Utilities Fortnightly*, pp. 486–89 (April 11, 1940). See also 6th *Ann. Rep. S.E.C.* (1940), pp. 13–18.

gration has started in earnest, it does not signify the end of this problem. During 1940 the Securities and Exchange Commission was forced to hold extended hearings on these orders. Some companies have indicated that the orders will be taken to the Supreme Court to obtain a ruling on the validity and meaning of the integration provisions of the law. The great number of issues which must be ironed out, the many legal problems to be determined, and the complications involved in supervision of integration proceedings by the Commission promise to delay the effective administration of this feature of the law for some years.

The attitude of the Commission with respect to simplification has been reasonably sympathetic and practical, at least up to the present time. Any other attitude would seem to be unwise, and destructive to legitimate private investment. Readjustment of corporate structures is a difficult problem. If companies are to be eliminated, or properties removed from a system, the several alternatives for effecting these changes are not subject to hasty action. Properties may be sold, but buyers must be found if deals are not to be made at "distressed selling" prices. Properties may be merged by an exchange of securities. However, the existence of different classes of security-holders, with varying rights and priorities, makes this a complicated task. Securities held by one company may be allocated to owners and creditors of that company, and the company dissolved. But this method also creates problems of allocating securities to various kinds of stock- and bondholders. Properties may be traded for other properties in order to effect integration, but finding a proper trade and arranging mutually satisfactory terms are difficult and time-consuming. Other methods, such as organizing a new holding company to hold certain securities, or creating a business trust for the same purpose, present like problems.

e. Importance of exemptions. In discussing the administration of the Holding Company Act, the importance of the Securities and Exchange Commission's power to grant exemptions from this or that provision should not be overlooked. By attaching conditions upon which an exemption may be granted, the Commission has an effective regulatory tool. For example, in exempting from the security provision of the act the bonds of the Connecticut Light and Power Company, an intrastate operating subsidiary, the Commission conditioned the exemption upon the company's agreement not to pay dividends on common stock until certain minimum amounts had been set aside for repairs, renewals, and replacements.[1]

3. COMMISSION CONTROL AND FUTURE POLICY. As has been frequently noted, to date the Commission has taken a practical, co-operative, and sympathetic view of its tasks under the Holding Company Act. If this attitude continues to prevail, and if the administration of the law can be kept from undue political influence, a constructive regulatory program can develop from

[1] See S.E.C., *Holding Co. Release*, Nos. 1347 and 1348.

what at first appeared to be a destructive law. Moreover, the need for honest and helpful co-operation by management is obvious. Should holding-company managers assume that the act can be sabotaged by inaction, court fights, and disobedience based on assumptions of unconstitutionality, or by evasions, they might find the act to be surprisingly constitutional and the Commission to be a severe government body all too willing to "crack down."

The act creates tremendous problems. The questions of constitutionality, the difficulties of effecting simplification, and the intricacies of the holding companies themselves are only a few.

The development of sound standards of corporate conduct is of great significance. Unless the law results in more efficient public-utility service, involving reasonable prices to consumers and reasonable returns to investors in private property, it can hardly be counted as wise or successful. Its desirability must be judged in this light.

Experience under the Holding Company Act should be watched carefully. If the act is upheld as being constitutional, and if it gives results which seem to the public to be desirable, business standards contained therein might be extended to other businesses where widespread combination and control exist. Few businesses are now beyond the scope of interstate commerce, as the term has been defined by the Supreme Court in recent years. Detailed regulation of many other businesses might appear to the public to be as justified as the control of the public-utility holding company. Granting this even as a possibility, the significance of the Holding Company Act should be clear to everyone interested in business.

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CHAPTER

17

FEDERAL REGULATION OF PUBLIC UTILITIES

EXCEPT for transportation agencies, regulation of businesses affected with a public interest has been generally regarded as a matter for the states. Even the communication agencies, especially the telephone, have been subject to more state than federal control. Although some interstate communication by telephone or telegraph was placed under a measure of federal regulation as early as were the railroads, a positive program of such control has only recently emerged. Certain aspects of the electric and gas businesses have been brought under federal regulation even more recently, in spite of some earlier regulation of power producers using water sites on or affecting navigable streams.

The greater part of the communication, the electric-power, and the gas-utility business is in intrastate commerce. While radio is practically wholly in interstate commerce, and the telegraph business is approximately 75 per cent therein, the telephone business is 99.5 per cent intrastate, as measured by messages, and 67.6 per cent intrastate, as measured by revenues.[1] Of the 116,681,000,000 kilowatt-hours of electricity produced in the United States in 1938, only 23,262,000, or about 20 per cent, moved across state lines.[2] The Federal Trade Commission found that 27 per cent of the natural-gas production moved in interstate commerce in 1934, but that if the large quantities consumed in the fields and never entering the general market were excluded, the percentage would be materially higher.[3]

Taken as a whole, all these businesses are still predominantly of local, or intrastate, importance. Even though large quantities of natural gas and electricity enter interstate commerce, practically all of it is sold at wholesale and

[1] Herring, J. M., and Gross, G. C., *Telecommunications* (New York: McGraw-Hill Book Company, Inc., 1936), p. 213.

[2] Federal Power Commission, *Electric Power Statistics*, 1938, pp. 3, 37.

[3] Federal Trade Commission, *Utility Corporations*, pt. 84 A, p. 582.

distributed by an intrastate public-utility company. The local and long-distance telephone and telegraph services are closely interwoven, with relatively few companies handling the major portion of them. Radio is, of course, not limited to local market areas, especially within states; yet a fairly large proportion of commercial broadcasting is aimed at a narrow market near the station.

A. THE BASIS FOR FEDERAL CONTROL

The public-utility problem, then, is still primarily intrastate. Nevertheless, the interstate character of a portion of this business has unquestionably justified federal control. In recent years, too, the increase in interstate transactions, particularly in the electric and gas industries, has given rise to situations with which the federal government is alone competent to deal. The development of large systems has also made such transactions more interstate in nature. The purchasing, managerial, financial, and construction activities of holding-company subsidiaries have already been dealt with, and the need for federal control of holding companies discussed. The interrelations of companies within a holding-company system also furnish a reason for federal control of interstate business. The price charged at wholesale by an electric or gas company to a local distributing company is of as much interest to the consuming public as is the retail price. The practices of interstate public utilities partially or wholly beyond state control are a concern of the public if the interests of ultimate consumers are to be adequately protected. The direct relationship between companies and users of interstate communication service, coupled with the fact that the federal government is the only authority capable of dealing with the problems arising, is ample justification for federal control in that field.

Moreover, in the sphere of electric-power production, the conservation of water-power resources is a problem of national interest. Considering the military and commercial importance of navigable waters, and the relationship of these resources to adequate paths of interstate commerce, a special interest attaches to the use of water-power sites for private power production.

Whether a public-utility business is controlled by the federal government or by the states, many of the economic and legal problems arising — the concepts of fair price, adequate service, and sound finance, for example — are pretty much the same. The purpose here is not to repeat the legal and economic analyses of these and like questions. The student should realize that they exist in much the same form, even though attention in the present chapter is limited in general to the nature of federal control.

Federal and state regulation of public utilities have necessarily overlapped in many instances. Indeed, one of the reasons for the tardiness of federal regulation of electric and gas utilities has been the opposition of states fearing

usurpation of the field by the federal government. This conflict in jurisdiction and the opposition of state officials have accounted in large part for the lack of aggressiveness in regulation of telephone communication by the Interstate Commerce Commission during the more than two decades that interstate telephone business has been under its control.

A conflict of jurisdiction is bound to present many problems. Interstate and intrastate public-utility activities cannot be marked off into independent areas. With the more aggressive program of the federal government, marked by the Communications Act of 1934, the Public Utility Act of 1935, and the Natural Gas Act of 1938, this conflict seems likely to increase. In framing these laws, Congress has attempted to divide the jurisdiction of federal and state commissions, and to provide machinery, such as joint committees, for co-operative action. This will do much to reduce the conflict over spheres of authority, but the rôle which the federal government is likely to play in future public-utility regulation seems to be enlarging.

B. COMMUNICATIONS: COMMON CARRIERS

The economic characteristics of common carriers in the communication field are similar to those in the transportation industries. As a matter of fact, communication companies serving the public have been referred to as transporters of ideas and as carriers analogous to railways and steamships. Whether by telegraph, telephone, or wireless, most operators of communication facilities hold themselves out to serve the public in much the same way that a railroad does; their relation to the public is close, their capital investment is relatively large, and they have similar tendencies toward monopoly.

In contrast to other carriers, these monopolistic tendencies have shown more concrete results. The American Telephone and Telegraph Company, an operating and holding company, occupies a pre-eminent position in this field. Through control of more than two hundred corporations, the company supervises in the United States between 80 and 90 per cent of local telephone service, 98 per cent of long-distance telephone wires, practically all the wire facilities used by radio broadcasting, and all of the transoceanic radio telephone service.[1]

1. DEVELOPMENT OF CONTROL: TELEPHONE AND TELEGRAPH. As early as 1866, Congress provided in the Post Roads Act for the granting of federal franchise for the operation of telegraph lines over public domain, post roads, and navigable streams. Before a telegraph company could operate over, along, or under these facilities, permission had to be obtained from the federal government and the company had to agree to such terms and conditions, especially in regard to construction, as the Postmaster General might require.

[1] Federal Communications Commission, *Investigation of the Telephone Industry in the U.S.*, House Doc. No. 340, 76th Cong., 1st Sess. (1939), p. xxiii.

Further regulation was provided in 1888. At this time the Interstate Commerce Commission was authorized to require telegraph companies which received a government subsidy for construction to operate as common carriers, and to make interconnections with other companies which had submitted to the Post Roads Act of 1866.

Much more general regulation was provided for in the Mann-Elkins Act of 1910. By it the Interstate Commerce Act was amended to place interstate (but not foreign) transmission of messages by wire or wireless within many of the parts of the law applicable to railroads. Charges were required to be just and reasonable, and making or giving any undue preference or advantage to persons, places, or kinds of traffic was forbidden. The Interstate Commerce Commission was empowered to prescribe maximum and minimum rates, and to require periodic reports and uniform accounts. In 1920 jurisdiction over telephone consolidations and acquisitions of control was placed in the Commission. By the Communications Act of 1934, these, along with new powers, were placed in the new Federal Communications Commission.

The administration of control by the Interstate Commerce Commission was not particularly aggressive. It found few complaints raised in interstate telephone or telegraph matters, and was so engaged in railroad regulatory problems that it had little time to investigate communication affairs. A uniform system of accounts was prescribed soon after 1910. In the twenty-four years during which communication companies were under the Commission, only fourteen rate cases were dealt with by it.[1] Most of these had to do with rate discrimination, rather than the reasonableness of individual rates or rate levels; moreover, the decisions were relatively unimportant as regulation for protection of the general telephone or telegraph user.

Much more activity resulted from the regulation of consolidations of telephone companies. Nearly three hundred such applications were passed upon by the Commission.[2] The law provided that it should not be construed as limiting the powers of states to control telephone companies, and consequently state commissions had the power to act in opposition to consolidation decisions of the Interstate Commerce Commission. The result of federal approval was only to remove the consolidation or acquisition of control from possible action under the anti-trust laws.

The relatively ineffective regulation of telephone and telegraph companies by the Interstate Commerce Commission should not be blamed entirely upon that body. Until the Communications Act of 1934, when jurisdiction over communication companies was transferred to another commission, the law had so many omissions as to make effective administration practically impossible. The Interstate Commerce Commission could not require companies to file and post rates, nor could it investigate or suspend proposed changes in rates, classifications, or other practices pending final action. It had little power over

[1] Herring, J. M., and Gross, G. C., *Telecommunications*, p. 220. [2] *Ibid.*, p. 228.

service and no authority to require through rates or physical connection between companies, nor did it have any jurisdiction over the issuance of securities. Without such essential tools for administration and important powers of control, the Commission could not have done much even if it had the staff and the inclination to do so.

The Communications Act of 1934 forms the present basis for regulation of telephone and telegraph common carriers. This law is far from being a counterpart of the federal railroad statutes, since the breadth and depth of control provisions found in the latter are lacking. The act applies to radio as well as to telephone and telegraph companies. The present law dealing with communication regulation, to be discussed presently, is essentially this act.

2. Development of Control: Radio. Interstate, though not foreign, common-carrier radio communication was placed under the jurisdiction of the Interstate Commerce Commission in the Act of 1910, mentioned above, along with the regulations then applied to telephone and telegraph companies. As a matter of fact, this control had little effect, for it omitted foreign radio communication, did not include commercial broadcasting, and was not applicable to communication carried on by amateurs, police cars, and like noncommercial agencies. With these omissions, the Interstate Commerce Commission found even less occasion to apply regulations to radio than to telephone and telegraph communication.

Other federal laws which dealt with radio were passed before 1934. In 1910 and 1912, Congress enacted legislation placing regulation of radio communication on ships under the Department of Commerce. Besides requiring that ships carrying fifty or more passengers from any port in the United States must have wireless equipment, the laws laid down certain provisions with respect to equipment and its operation, and gave the Department of Commerce power to establish rules deemed to be necessary and proper. Another law of 1912 included some regulation of radio stations, other than marine communication. Operation under a license was provided for, and measures were included to avoid interference, maintain secrecy in messages, and give government stations certain preferences.

With the development of commercial broadcasting in the early 1920's, this early regulation proved to be no longer adequate. No special provision for wave lengths had been included, nor did the Secretary of Commerce have authority to divide station time, limit power output, or restrict station frequencies. The chaotic situation resulting was dealt with in the Radio Act of 1927. This law was broad in scope, and imposed a rather extreme kind of regulation upon an industry which had been so clearly unable to regulate itself.

The Radio Act of 1927 placed control over all kinds of interstate and foreign radio communication in the hands of a newly created Federal Radio Commission. For a time, a few matters were left to the Department of Com-

merce. These included the licensing and regulation of operators, the prohibition of willful or malicious interference with radio communication, and inspection of radio-transmitting equipment. The Commission was given authority to license all stations for a limited term of years, to assign wave lengths, power output, and time divisions, to regulate the construction of new stations, and to equalize broadcasting facilities by preventing their monopolization by a particular section of the United States.[1]

The administration of this act by the Federal Radio Commission tended to bring order out of chaos in the radio industry. But these activities were necessarily pretty much restricted to developing a fair, reasonable, and efficient use of the rather limited broadcasting frequencies available. A comprehensive program of regulation of radio as a public utility, similar to that developed with railroads and electric companies, could hardly be expected. The Federal Radio Commission was preoccupied with the effective allocation of broadcasting facilities during the seven years before 1934. Moreover, the Interstate Commerce Commission still held its nominal power over radio-message rates, and the Department of Commerce had a share in radio regulation.

While the Communications Act of 1934 did not bring about a comprehensive program of public-utility regulation for the radio-broadcasting companies, it has served to consolidate previous laws under one commission and to make some improvement upon existing statutes. All common carriers of messages, whether by wire or wireless, are regulated by the same commission and with the same legal provisions. Because of the great public importance of radio channels, special regulations are provided for radio ownership and control, as well as for the assignment of frequencies. Radio broadcasting, differing as it does from telephonic or telegraphic communication, is also naturally subjected to certain requirements not applied to common carriers in the business of transmitting messages.

3. Service Regulation. Under the Communications Act of 1934, all common carriers of messages by wire or wireless are required to furnish reasonably adequate service upon a request for it. To supervise the adequacy of service, the new Communications Commission has power to take action for the establishment of physical connection between carriers and for through routes. Construction of new lines or extension of existing ones is subject to the obtaining of a certificate of convenience and necessity from the Commission. In order to minimize the conflict with state regulation, particularly in the case of telephone companies, the federal law exempts: (1) new construction or extension of intrastate lines not a part of an interstate system; (2) local, branch, or terminal lines not more than ten miles in length; and (3) lines acquired under the consolidation provisions applying to telephone companies. The Commission is also authorized to require the extension of common-carrier com-

[1] For a further discussion of this act and its administration, see Herring, J. M., and Gross, G. C., *Telecommunications*, pp. 245-320.

munication lines when found to be in the public interest, but not to involve so great an expense as to impair the ability of a carrier to perform its duty of service to the public. As with railroad common carriers, undue or unreasonable discrimination in service is prohibited.

4. RATES. The law of 1934 provides that all charges of common carriers must be just and reasonable, and it specifically declares that the services of each carrier may be classified and different charges made for each class of service. Rate discrimination against persons and places is forbidden if found to be undue or unreasonable. Common carriers are required to file their rates with the Communications Commission, to post them for public inspection, and to abide by them. Changes in charges, classifications, or practices concerning rates must be filed with the Commission and thirty days' notice given, unless modified by its action. Any such change may be suspended by the Commission, pending investigation of its reasonableness, for a period of three months.

Upon complaint or upon its own initiative, the Communications Commission may investigate any existing charge, classification, or practice. If the investigation discloses that the rate or rate practice is unlawful, the Commission is empowered to prescribe a just and reasonable maximum or minimum charge, or to set the exact charge.

To aid the Commission in fixing a reasonable rate level, the law provides for valuation of the property of companies subject to the act. They are required to furnish information as to cost of reproduction new less depreciation and original cost. It is interesting that the law demands a rather detailed breakdown of this information depicting clearly how any resultant valuation is obtained. In showing the detail of original cost, companies must report as a separate item any costs incurred in obtaining a franchise or license from any public authority, and the Commission is directed to include in its figures at original cost nothing except lawfully incurred and reasonably necessary expenditures. It may adopt any method of valuation which shall be lawful.

While these powers are rather extensive, relatively little has been done by the Communications Commission. Valuations have been proceeding and investigations of rates and rate structures have been made. Some reductions in interstate telephone rates have been effected. However, these reductions have not been obtained through formal rate cases, but as the result of informal conferences between the American Telephone and Telegraph Company and representatives of the Commission. Some credit for rate changes must also be given to the congressional investigation of telephone companies. With special appropriations and two years' effort, a staff under Commissioner Paul A. Walker made a detailed investigation of the Bell Telephone System and the American Telephone and Telegraph Company.[1] Its conclusions and recom-

[1] Federal Communications Commission, *Investigation of the Telephone Industry in the United States, op. cit.*

mendations have been subject to much dispute; but the report has already had some regulatory effect, and will probably be the basis for further regulatory action by the Communications Commission.

5. CONSOLIDATION AND COMBINATION. As in the case of railroads, the policy of Congress as stated in the present law seems to be the maintenance of competition between companies, at least to a modified degree. The law prohibits any person from holding the position of officer or director in more than one communication company subject to the act, unless authorized by the Communications Commission upon a showing that neither public nor private interests will be adversely affected thereby. As with the Act of 1920, a rather weak control over telephone consolidations and combinations by other means is included in the present law. After hearing an application for consolidation or acquisition of control involving telephone companies, the Commission may make a finding. If it holds the combination to be in the public interest, then any laws of the federal government against combinations in restraint of trade will not apply. Nothing in the law places any limitations on the powers of the several states. As a result, a company could consolidate, if a state authority gave its permission, in the face of a refusal by the Federal Commission. The only penalty apparently attaching is possible prosecution under the federal anti-trust laws.

Although the special provisions applicable to radio will be discussed more fully below, it is interesting to note at this point the sections of the Communications Act of 1934 dealing with combinations in the field. The act definitely states that the anti-trust laws are to be applied to combinations, contracts, and agreements in restraint of trade between manufacturers and sellers of radio apparatus and devices entering or affecting foreign or interstate commerce. Moreover, those companies engaged in radio communication itself are forbidden to acquire, own, or control any wire-communication company (telephone, cable, and telegraph) where the result is substantially to lessen competition, to restrain commerce, or to tend to create a monopoly in any line of commerce.

So far as the Commission is concerned, the penalty for disobedience of these provisions applicable to radio is to revoke, or refuse to reissue, a license for operation. But before the Commission may take this action, the restraint of trade must be proved in a federal court.

Except for the section dealing with interlocking directorates, the regulation of combination of communication companies is exceedingly weak, as compared to control over combination of transportation companies. The law as it now stands is little more than a restatement of the federal acts making unreasonable restraint of trade unlawful for any business. It lays little special regulation on communication combinations as such similar to that found in the more progressive states and in other federal regulations of businesses affected with a public interest.

6. FINANCE. All communication common-carrier companies operating in interstate or foreign commerce are subject to rather complete regulation of accounts and reports. Prescription of the forms of these is provided for in the law, and adequate legal grounds for policing the accounts are included. These provisions are similar to the corresponding requirements of the Interstate Commerce Act and the better state public-utility laws.

The law gives the Communications Commission no power to regulate the terms of transactions between operating companies and affiliated companies with respect to service, purchase, financing, or construction contracts; nevertheless, the Commission can investigate these matters with a view to recommending legislation. When it is recalled that the Holding Company Act of 1935 applies only to electric and gas companies, it is easily seen how free this field is from regulation. The report of the Communications Commission in connection with the telephone investigation has recommended legislation to cover certain of these aspects of telephone-company operation.[1] Furthermore, the Communications Commission has no jurisdiction over issuance of securities.

7. CONCLUSIONS. In matters of rates and charges, the power of the Federal Communications Commission over common carriers of messages by wire or wireless seems to be broad and adequate; and the same is true of its control over accounts and reports. In other respects, the regulations are not as comprehensive as those found in the more progressive public-utility laws. A few special provisions are applied to telephone-company consolidation and combination, but these are not particularly strong. Perhaps, as will be seen from the following discussion of special radio regulation, the radio-broadcasting industry is placed under a system of control which is far superior in scope and effectiveness to that now aimed at interstate and foreign wire and wireless communication by common carriers.

Furthermore, the law respecting telephone and telegraph communication is careful to omit, wherever possible, regulation of intrastate operations and that already administered by the state public-service commissions. Perhaps this is as it should be, in view of the dominantly intrastate nature of these businesses, particularly the telephone business. Nevertheless, there are matters, such as inter-company contracts, which the states cannot deal with effectively and the regulation of which might be of interest to users generally. The inter-company relationships in the telephone and telegraph industries have not been very harmful to users and investors; at the same time, an orderly program of regulation could hardly work harm to the public or to those companies carrying on business with the best public interest in mind.

[1] Federal Communications Commission, *Investigation of the Telephone Industry in the United States*, p. 601. Note that the report, prepared by Commissioner P. A. Walker, recommended legislation for complete control of these matters by the Communications Commission. But in the final report of the whole Commission there was recommended only an amendment to authorize it to prescribe cost-accounting methods for measuring costs of items supplied by inter-company contracts.

C. COMMUNICATIONS: SPECIAL RADIO REGULATION

The development of regulation over radio has been sketched above. Except where noted, all the regulations applied to wire-communication companies are likewise devoted to radio operations. In the Federal Radio Act of 1927, and in present legislation under the Communications Act of 1934, special regulations are provided for radio. Some of these are aimed at control of broadcasting companies only, while others apply to radio communication generally.

Because radio communications know no bounds and can be used to reach practically any individual owning a receiving set, the public has felt that special control in this field is necessary. Moreover, the available frequencies are fairly limited, interference on wave lengths often results in the absence of rigorous control, and radio is susceptible to so many uses in addition to transmission of private messages, especially government, shipping, police, and entertainment communication, that public control is a much greater task than it is with the wire services. The very fact that radio broadcasting is a source of public education and entertainment distinguishes this field of communication from the others. And when one considers that broadcasting for public consumption has been undertaken on a commercial basis with advertising paying the way, the complexity and importance of the regulatory problem loom even larger.

These factors have their economic consequences. As opposed to most transportation and communication services, commercial radio broadcasting gains its greatest economic importance from its suitability as an advertising medium. The persons who use radio facilities and the way in which they are used are of far more public significance than in other public utilities. While radio broadcasting has been likened to a newspaper, and as such, it is claimed, should be given the greatest possible freedom from state action, the broadcasting station is really using channels belonging to the public, and should be required to employ these for public benefit.

On the other hand, the nature of commercial broadcasting may not make necessary the same type of regulation as that found in the public-utility field. Since one class of receiver of the service — the public — pays nothing for the entertainment, no price regulation is necessary. Because the price of time for commercial users is more or less competitively determined, rate regulation may not be necessary to protect them, even if the commercial sponsors formed a large enough group to make the price they pay of wide public interest. Nevertheless, if the present tendency for stations to make chain affiliations continues, the decline of competition, along with an increasing demand for radio time by advertisers and others, may make the rate question of much greater public importance. As matters stand now, the way radio is used and the practices employed in the industry are of more public interest than the charges made.

1. LICENSES. The greatest single instrument of power which the Federal Communications Commission holds over radio companies is the authority to grant, revoke, or withhold licenses to operate radio stations. No person is permitted by the present law to operate a station in interstate and foreign commerce (and this means in practice all radio operation) unless he has a license to do so. The law specifically states that these licenses are to be granted for a limited time, three years maximum for broadcasting licenses and five years for other licenses, and that no licensee is to have any property right in a radio channel beyond the terms, conditions, and periods of the license.

In considering applications for licenses, the Commission is directed to make such distribution of licenses and station facilities among the several states and communities as "to provide a fair, efficient, and equitable distribution of radio service to each of the same." In granting new licenses or renewing old ones the Commission must make a finding that the public interest, convenience, or necessity will be served thereby. Station licenses may not be granted to or held by any alien, any representative of an alien, any foreign government or representative, any corporation with an officer or director who is an alien or whose voting stock is owned by an alien to an extent greater than one fifth of the total, or any corporation directly or indirectly controlled by another, one fourth of the voting stock of which is held by an alien. Exceptions to foreign control of American stations are made where allowed under treaties of the United States, especially for foreign shipping.

Prohibition of foreign ownership or control of radio stations was included in the law primarily as a matter of national defense. Ownership of these facilities by an alien or a foreign government might make it difficult for the United States to maintain neutrality in event of a war among other nations. Should this country become a belligerent, a foreign interest in local stations might be inimical to the most effective prosecution of the war. Moreover, the army and navy often use private radio stations in experimental work in defense, and the presence of a foreign director or officer in a company operating a local station might not be desirable.

The Communications Commission is empowered to revoke licenses if a licensee does not operate according to the conditions of his permit, or if he violates any regulation of the Commission authorized by the law. In cases where a licensee is convicted for violation of any of the anti-trust laws, by attempts to monopolize or restrain trade, the Commission is directed to cancel the license. It is also given power to modify the terms of a license, if in its judgment such action will promote the public interest, convenience, and necessity, or the provisions of the law with respect to communications.

The broad power of the Commission over entry into radio-broadcasting service naturally gives rise to several problems. If a license is to be granted on the basis of public interest, convenience, and necessity, the Commission is placed in the position of selecting the stations which it believes to be most

capable of meeting these requirements. But in doing so it has often been accused as acting as a censor of what the radio station broadcasts. In one case before the Federal Radio Commission, renewal of a license was refused to a station on the ground that a part of its programs could hardly be deemed to be in the public interest. On appeal to the courts, the Commission's refusal was upheld as a reasonable exercise of its power which did not constitute censorship since inspection of programs in advance was not made.[1]

Refusal to renew licenses has been supplemented by an implied threat not to renew. The Commission has been extremely critical of false, fraudulent, or misleading advertising, and advertising not believed to be in the public interest. Relatively few cases exist where it has not renewed licenses.[2] In many more cases it has renewed a license on the express condition that certain program practices be discontinued. For example, in one case the Commission said:

> Upon a careful review of the entire record and considering that the record shows that a great majority of the programs carried by the stations have been in the public interest, and because of the expressed purpose of the management of the station that it will in the future exercise proper care and diligence in the selection of its programs, so that its future conduct may serve the public interest, convenience and necessity, the Commission determined to take favorable action on said application and to grant a renewal of the license.[3]

While such decisions can hardly be considered unwise, they do show how narrow the line between revocation of license, or threat of refusal to renew, and censorship can be.

In granting licenses, operating channels, and frequencies, the Communications Commission has found it necessary as a practical matter to give some stations a better channel and power than others. While there may be no way to avoid this, so long as private enterprise in radio is left relatively free, this does mean that certain stations have a more favorable position for advertising purposes and hence greater possibilities of profitable operation.

2. Operation of Stations. The powers of the Commission over operation of radio stations are also very extensive. Besides assigning frequencies and operating times, the Commission may prescribe the nature of service to be rendered by the various classes of stations, the minimum and maximum power, and the location of stations. The quality of apparatus employed may be regulated with a view to obtaining pure and sharp transmission and reducing interference. The Commission may prescribe qualifications for station operators and require their licensing. Construction of station facilities can be made only after permits are obtained from the Commission, and inspection of facilities and personnel is provided for.

[1] *KFKB Broadcasting Assoc. v. Fed. Radio Com.*, 47 Fed. (2d) 670 (1930).

[2] But see, for example, *Re McGlashan (KGFJ) et al.*, 2 F.C.C. 145 (1935), and *Re Morris et al.*, 2 F.C.C. 269 (1936).

[3] *Re The Farmers and Bankers Life Insurance Co.*, 2 F.C.C. 455, 459 (1936).

Licenses of operators may be suspended for violation of the law, for willful damage to radio apparatus, for superfluous or profane communications, or for willful or malicious interference with other radio communication. Broadcasters are prohibited from using radio facilities for advertisement of or information concerning any lottery. Where broadcast matter is paid for, or furnished, the station is required to announce the fact and the name of the person so doing. While no station is obligated to allow its facilities to be used by a candidate for a public office, if it does so equal opportunities must be afforded to all other candidates for that office.

In regulating the operation of stations, the Commission is specifically denied the right to censor communications or to interfere with the right of free speech. However, uttering obscene, profane, or indecent language is forbidden.

3. RADIO REGULATION: CONCLUSIONS. In the field of radio, as is often the case where government control of business is undertaken, the industry itself pressed for adequate regulation of the use of the air. A few months of unregulated radio activity in 1927 convinced it that it could not survive without a strong system of government control. Desirable frequencies are so limited and interference so disastrous that no one interested in the development of radio has supported a policy of *laissez-faire*.

At the same time, the radio industry has taken the attitude that regulation should be regarded as a necessary evil, rather than a benign means for improving the industry along a pattern set by legislation. Perhaps the most controversial aspect of control has to do with the influence of the Communications Commission on the policies of broadcasters and the content of broadcast programs. The Commission has followed the plan of issuing broadcasting licenses for a period of six months until 1939 and one year thereafter, rather than the maximum time of three years allowed by law. Its apparent purpose in doing so is to acquire more power to control licensees. If a longer term were granted, and the Commission wished to revoke the license before the period was over, the burden of proof for the revocation would be on the Commission if the station contested the cancellation. But where the Commission refuses to renew a license, the burden of proof is placed on the applicant.

The power of the Communications Commission to grant or refuse licenses is exceedingly great. A radio station is worthless without the right to use the air. Under the law as it now stands, the Commission has a wide range of discretion as to whether licenses shall be granted, the law merely requiring a finding of public interest, convenience, and necessity. Strong as this power is, it is made even stronger by the practice of issuing short-term licenses. Although the law expressly states that the Commission does not have the power of censorship, the same result can be obtained by its refusing to renew a license of a broadcaster whose program has offended the sensibilities of a majority of the Commission.

While censorship implies an advance examination of broadcast matter, and

the Commission does not do this, the effect is much the same if it can refuse renewal of a license because of the nature of the programs sent. Indeed, radio operators maintain that this is worse than censorship, for they do not know what the Commission dislikes.

This power of the Commission is one of the greatest in the hands of any regulatory agency. To date, there is no probative evidence that it has been abused. It does bring up the question, however, as to how much responsibility the Commission will take in connection with the quality of broadcast programs. From time to time it has indicated how broadcasting might be improved, and has been especially insistent that some of the air time be used for educational purposes. Whenever it makes such a suggestion, a conflict results as to the question of what the public *wants* and what the public *should have*. So long as radio is left to private enterprise, one cannot overlook the fact that the successful station is one which gets the most advertising revenue, and advertising revenue depends to a great extent upon formulating programs that people want. Even if the government should take over the operation of radio stations, it would still have to pay some attention to what the public desires. Otherwise, enthusiasm for listening to radio programs would wane.

Another burdensome problem has to do with the amount of power allocated to a station. There are only about ninety frequencies available for commercial broadcasting, and these have had to be divided among approximately eight hundred stations. In order to do so, the Commission has placed several stations on the same frequency, each in different geographical locations, and with a limitation on output power to reduce interference. Some stations have been so limited in power that their range is local. To a few the Commission has given much greater power, so that receivers at some distance from broadcast facilities can be served. This has naturally meant that the Commission has had to decide as between stations, and that those with strong power, being better advertising mediums, have tended to prosper to a much greater extent than others.

The natural tendency to place some stations in a more advantageous economic position has aided in the growth of monopolistic characteristics in the industry. The larger and more prosperous stations become the leaders, with an advantage over other stations in getting the more expensive national advertising programs. While chain broadcasting might well have developed without the super-power station, the lesser-powered stations find that their best chance to get advertising and good programs is to lease their time to a national chain. The result has been that much of the lucrative national advertising is now taken over by a few large chains.

Often the large chains merely lease time; in many cases, however, they purchase an ownership interest in the stations which are members of the chain. The necessary tendency is to reduce competition in the radio broadcasting field, a tendency not countenanced by the competitive policy of Congress

announced in the law. The Federal Communications Commission has been making a study of monopolistic conditions in the radio industry. As yet, no definite policy has emerged. It is a difficult problem to solve. Monopoly in the air, or even the existence of two or three large competing companies, may not be conducive to the public interest. On the other hand, so long as some competition exists, if the quality of radio programs is not impaired by national chains, if radio stations still devote much of their time to local or unaffiliated broadcasts, and if federal regulation can be made effective, there may be little to fear from the development of combination.

D. LICENSED HYDRO-ELECTRIC PROJECTS

The federal government entered the field of public control of electric utilities in 1920 by the passage of the Federal Water Power Act. This limited and hesitant entry into an important public-utility field represented its only intrusion until the holding-company and interstate-transmission laws of 1935. The Water Power Act applied only to the use of hydro-electric sites on navigable waters of the United States. As such, its primary purpose was perhaps less regulation than the conservation of these natural resources and the assurance that they be used for the benefit of the public. Both the framework of the law and the purpose of its sponsors indicate that regulation was of secondary importance.

By the law of 1920, the Federal Power Commission was created. At first made up of members of the President's cabinet, the Commission was subsequently reorganized at the behest of President Hoover in 1930 and an independent body of five full-time commissioners was composed. Under the original act the Commission was empowered to collect information on the nature and possible utilization of water-power resources under federal jurisdiction, and to grant licenses to private persons or government bodies for their development. As regards the issuance of licenses, the law specified that government agencies were to be favored, that licenses were not to run more than fifty years, and that the federal government should have the right to purchase the plants at the end of the license period. Most of the regulatory power of the Commission before 1935 was limited to seeing that the property of licensees was maintained in good operating condition, to administering accounting controls aimed at keeping an accurate record of investment, and to making projects conform with reasonably adequate utilization of the resources. Regulation of rates, service, and financial practices of licensees was conditioned upon the failure of states to control the operating utility.

The Federal Water Power Act was amended in 1935 to give the Power Commission much broader control over companies utilizing water resources on navigable waters and public lands under the jurisdiction of the federal government. Regulations of interconnection, consolidation, security issues, accounts,

interstate rates, and interlocking directorates are among some of the more important powers granted. In discussing the regulation of water-power licensees below, this broader scope of the federal law will be explained.

1. THE PROBLEM OF WATER RESOURCES. Although Albert Gallatin, Secretary of the Treasury under President Jefferson, recommended as early as 1808 that Congress take affirmative action to utilize the water resources under its jurisdiction, little was done until 1884, when Congress directed the Secretary of War to report upon interferences to navigation. In 1906, it fixed conditions upon which dams and other obstructions might be placed upon navigable waters. Until this time, however, assertion of government control over water sites had been principally a matter of navigation. With development of these sites for power purposes under private ownership, and through the vigorous conservation policy of President Theodore Roosevelt, their utilization came to be considered from the point of view of conservation of national resources.

The water-power issue was the subject of a long and bitter struggle centering about the question of how and by whom these resources should be used. Several alternatives were suggested for their development. Some groups held that the government should erect dams and power stations and sell the current directly to consumers or to private companies for resale to consumers. Others believed that the development of water resources should be left to private enterprise, with no regulation except that coming from state public-utility commissions. Still other groups felt that the federal government should retain title to the sites, but lease them to private companies for development.

When the issue was decided in 1920, the last alternative was adopted. The Federal Power Act of that year incorporated the concept that the federal government should lease the sites to private companies, retaining the right to buy them back upon payment of just compensation, and that the principal regulatory job be left to the state commissions.

Until the reorganization of the Federal Power Commission in 1930, administration of the Water Power Act of 1920 was not particularly effective. Cabinet officers could give little time to the many complex problems arising, and could not develop any very well-defined principles upon which to proceed. Moreover, since political considerations may play a large part in the granting of power sites, and apparently did so, the administration of such an act by political officers rather than by an independent commission was not conducive to the best attainment of its purposes.

Aside from the question of administrative organization, the work of the Federal Power Commission was hampered until 1935 by its restricted jurisdiction over licensees. As has been noted, most of the field of regulation was left to the states, so that the Commission could do little to check up on the character of licensees' operations and satisfy itself that they were in the public interest.

With the amendments of 1935, the Federal Power Commission emerged as a strong administrative agency. Not only does it now have much greater

power over licensees, but its jurisdiction over other interstate electric-utility business gives it a leading part in the development and use of electric power.

2. Investigatory Activities of the Commission. Some of the most meritorious work of the Federal Power Commission in its control of water-power sites, as well as its regulation of interstate transmission of electricity and gas, has consisted in its fact-finding activities. From time to time since 1920, the Commission has made investigations of developed and undeveloped water resources, of costs of development, of possible markets for electric power, and of power needs for national defense. It has made studies of the way in which licensees have made use of their privilege, and has made an extensive study of rates for electric light and power under both private and public ownership throughout the United States. In response to the Flood Control Act of 1938, the Commission has also been making an investigation of possible flood-control dams and reservoirs.

The investigatory activities of the Commission have furnished the basis for much legislative and commission policy. In addition, they have had some direct effect on regulation. The studies of electric rates, for example, by showing up differences in rates between localities, did much to cause certain companies to lower rates voluntarily.

3. Permits and Licenses. Before anyone can use any of the navigable waters or waters on public lands of the United States for the development of water power, permission must be obtained from the Federal Power Commission. The applicant is given a preliminary permit which insures for him, for a period of three years, priority over other persons who may wish to use the same resources. After receiving this permit he must hand in detailed information as to the nature, constructional specifications, legal and financial arrangements, and estimated disposition of power from the project. If these data lead the Commission to believe that the project is in the public interest, a license may be issued.

In issuing the license, which may run for a period as long as fifty years, the Federal Power Commission must give preference to government agencies, and can issue other licenses only to citizens of the United States or corporations organized under state or federal law. Where major projects are concerned, the Commission has been careful to eliminate applicants who attempt to get licenses for purposes of speculation, or who are not financially able to develop sites in the best way. It has thereby done much to place licenses in the hands of individuals or groups who will make effective use of the resources concerned. Under the law, issuance of licenses is conditioned upon certain provisos. Plans for construction are subject to approval and modification by the Commission, and a licensee cannot make a substantial change in these plans without its permission. Where necessary the project must include arrangements for maintaining navigation facilities. The licensee must agree to establish amortization reserves after the first twenty years of operation, such reserves

to be established out of surplus in excess of a reasonable rate of return on investment. He must pay a sum, fixed by the Commission, to the United States Government each year, for defraying the costs of administering the law, paying the government for the use of lands and property, and for recapturing excess profits where the state does not do so. He must also maintain the project in adequate repair for efficient use, make necessary renewals and replacements, and keep adequate depreciation reserves.

By June 30, 1940, the Federal Power Commission had issued licenses covering 128 major projects, representing a total cost to licensees of $740,000,000, and many more minor projects (100 horse-power installations and less). During 1940, it collected $814,857 from licensees for the use of water resources.[1]

The law provides that the federal government may take over the property of any licensee at the end of the license term. It also expressly reserves to the federal and state governments the right to acquire the property of any licensee by condemnation on the payment of just compensation. Moreover, the government may take over the property by mutual consent between it and the licensee. If a licensee does not live up to the terms of his agreement, the government may assume the license and purchase the property or issue the license to some other person.

When the government takes over the property of a licensee, the law specifies that the basis of compensation shall be the net investment in the project plus reasonable damages, if any, caused by the severance of the property from other properties of the licensee. This net investment, to be fixed by the Commission, is not to include the value of any property of the United States used under the license, the value of the license itself, good-will, going value, the value of prospective revenues, or the value over cost of any water rights, rights of way, and land.

4. Regulation of Hydro-Electric Licensees. One of the most important regulatory tasks of the Federal Power Commission, so far as hydro-electric licensees are concerned, has been the control over accounts. Licensees are required to adhere to the system of accounts prescribed by the Commission, to allow government inspection of accounts, and to make such reports as the Commission demands. One of the chief purposes of the accounting control was to allow the government to police investment accounts so that the net investment might be fairly and accurately determined from the records of the company. Another important purpose was to provide a basis for regulation of rates and security issues, both by the state public-utility commissions and the Federal Power Commission. Examination of the record of the Commission indicates that, particularly since 1930, this control has been carefully administered and that the Commission has insisted upon the books of a licensee showing no more than a fair net-investment cost.[2]

[1] 20th *Ann. Rep. F.P.C.* (1940), pp. 15, 143. Between June 11, 1920, and June 30, 1940, these payments had amounted to over $8,400,000. See *idem*, pp. 142–43.

[2] See, for example, *Re Alabama Power Co.*, P.U.R. 1932 D 345 (1932), and *Clarion River Power Company v. Smith* (District of Columbia Court of Appeals), 59 Fed. (2d) 861 (1932).

The other regulatory powers of the Federal Power Commission before the new control over interstate electricity and gas were not very extensive. Licensees which are public utilities must abide by regulations of states on matters of rates, service, and securities, where intrastate commerce is concerned. If the state authority is not empowered to regulate these matters, the license terms confer jurisdiction upon the Federal Power Commission. When the licensee is engaged in interstate commerce, the Federal Water Power Act has required rates and services to be reasonable and non-discriminatory. When reasonable rates and services cannot be obtained by state action, or when a state with jurisdiction over the company has no law regulating security issuance, the Federal Power Commission has been given jurisdiction.

Except for its important power to allocate natural resources through the issuance of licenses, and to force licensees to keep an accurate investment record, the Commission's jurisdiction over licensees has been rather limited. The deference to state regulation of rates, service, and securities has seriously tied its hands.

E. INTERSTATE ELECTRIC PUBLIC UTILITIES

Reference was made at the beginning of this chapter to the growth in interstate commerce of electric-power transmission and sale. Much of this field was unregulated before 1935, and the gap was filled by legislation enacted at that time. The law, as does the Holding Company Act, places the federal government in a field of regulation the subject of which has been regarded as generally local in nature and within the sphere of state control. It is interesting to see how the government has entered the province of electric-utility regulation, and at the same time honored traditional state control.

1. SCOPE OF FEDERAL CONTROL. In placing regulation of electric utilities engaged in interstate commerce under the Federal Power Commission, Congress, by declaration of policy in Title II of the Public Utility Act of 1935, stated that such regulation was "to extend only to those matters which are not subject to regulation by the states." It was to apply to "the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce, but shall not apply to any other sale of electric energy or deprive a state or state commission of its lawful authority now exercised over the exportation of hydro-electric energy which is transmitted across a state line." The federal law also exempts government-owned public utilities, whether owned by the United States, a state, its subdivision, or a government corporation.[1]

Thus no interstate transactions of electric power at retail are included in the

[1] In certain matters such as accounting and special credit contracts, the Federal Power Commission has jurisdiction over the Tennessee Valley Authority. The Commission also has the authority to approve the rate schedules of the Bonneville Administration and the Fort Peck Dam project under the Bureau of Reclamation of the Department of the Interior.

law. It was not thought necessary to include cases where a local distributing public utility happens to serve consumers, even though the sales were made across state lines. In a case in 1920, the United State Supreme Court had upheld the right of the state of New York to regulate the rates of the Pennsylvania Gas Company to certain New York cities, even though the company was engaging in an interstate business.[1] The company had been serving several communities in Pennsylvania (near the state line) and some communities in New York State. The Court held that what the New York Public Service Commission had undertaken to regulate was really local in nature and pertained to the furnishing of public-utility service to consumers within New York State. It recognized that this affected interstate commerce, but that so long as the regulations were reasonable and necessary for solution of a local problem, and until Congress should legislate on the matter, they did not violate the commerce clause of the federal Constitution.

Since the framers of federal legislation in 1935 believed that state regulation of retail sales of electric power could be adequate, they did not grant the federal government jurisdiction in this area. This provision is interesting as an evidence of the intent of Congress not to disturb but to supplement state control.

2. Interconnection and Co-ordination of Facilities. The law of 1935 directs the Federal Power Commission to divide the country into regional districts for interconnection and co-ordination of electric production and transmission facilities; these districts are to be made up of such areas as the Commission feels can be served economically. The interconnections and co-ordinations within these districts are to be effected voluntarily if possible. However, upon application of a state commission, or any person engaged in the transmission of electric energy, and after notice and hearing of interested parties, the Federal Power Commission may order a public utility to make physical connection of its transmission lines with the facilities of other public utilities engaged in the transmission or sale of electricity. Before doing so the Commission must find that no undue burden will be placed upon such public utility thereby, and it cannot make an interconnection order which would compel a public utility to enlarge its generating facilities, or would impair its ability to render adequate service to its customers.

During the existence of any war or domestic emergency, the Commission's authority over interconnections is somewhat broader. Under such circumstances it may order any interconnections it finds necessary or appropriate, but these must be temporary only.

3. Combinations. Public utilities subject to this part of the federal law may not sell, lease, or otherwise dispose of facilities without approval of the Federal Power Commission; nor can they purchase or acquire the securities of any other public utility without its permission. The Commission is empowered to

[1] *Penna. Gas Co. v. P. S. Com.*, 252 U.S. 23 (1920).

allow such transactions upon such terms and conditions as it finds necessary or appropriate to secure the maintenance of adequate service and the coordination of facilities under its control.

Combination activities effected through interlocking officers or directors are closely regulated. The law forbids any person to hold the position of officer or director in more than one public utility subject to the Commission's jurisdiction, or to hold such position and the position of officer or director of any bank, trust company, or firm authorized by law to underwrite or market public-utility securities; or to hold such position and the position of officer or director of any company supplying electrical equipment to the public utility in question. But such interlocking holding of positions may be authorized by the Commission upon a showing that neither public nor private interests will be adversely affected thereby.

This provision is aimed at holding-company control in the public-utility field, by which the same system will include numerous retailing public utilities, wholesaling, producing, and distributing companies, security-underwriting companies, and electrical equipment supply subsidiaries. It is also intended to be a means for removing domination of public utilities by banking interests which handle the marketing of new securities. Through restrictions upon interlocking directors or officers, the lawmakers hoped to remove some of the many cases of spending money under contracts not made at arm's length. The object of protecting the companies and their investors, as well as ultimate consumers, is apparent from the requirement that such interlockings are not to be allowed without a showing that *private*, in addition to public, interests will not be adversely affected.

4. SECURITIES. Electric companies subject to the Federal Power Commission's jurisdiction may not issue any security, or assume any obligation or liability with respect to any security, unless authorized by the Commission. In granting this permission, the Commission is instructed to find the issue or assumption of obligation to be for a lawful object (1) compatible with the public interest and necessary and appropriate for or consistent with the proper performance of the applicant as a public utility, and (2) reasonably necessary and appropriate for such purposes.

Notes maturing in one year or less are exempted from this provision, so long as they are not more in total than 5 per cent of the par value (market value at date of issue where no par value) of all other securities outstanding. Securities of a public utility organized and operating in a state with control over security issuance are also exempted.

The Commission is directed not to authorize the issuance of securities for franchises or contracts, in merger, lease, or consolidation, in an amount in excess of the actual payment for such franchise or contract. Public utilities are forbidden, without consent of the Commission, to apply any proceeds from the sale of securities to a purpose not stated in its approval order.

These powers respecting security issues are fairly standard in the field of public-utility regulation. There are a few provisions, however, which are worthy of note. In the exemption of notes of one year's duration, the law differs from most public-utility laws in which notes extending two and three years are usually exempted. This difference is a natural outcome of experience with exemption. While government authorities have not wanted to interfere with the discretion and flexibility necessary for current business financing, exempting notes for longer periods has led some public utilities to use them for what is really permanent investment financing, and thereby to escape some of a commission's control of security issuance.

With respect to application of the proceeds from sales of securities and to the issuance of securities against franchise and other intangible values, this control is more stringent than that usually found in public-utility laws. It is indicative of the tendency to tighten regulation, and to remove some bases for abuse of such issuance.

5. RATES. The law requires all rates and charges, demanded, made, or received, by any electric public utility under the jurisdiction of the Federal Power Commission to be just and reasonable. Rates which discriminate unduly as between persons, classes of service, or localities are forbidden. All utilities subject to this portion of the law must file their rates with the Commission for public inspection, and new or changed rates may not be made effective unless with thirty days' notice, except by permission of the Commission. During the thirty days' period, the latter may, either upon complaint or on its own motion, suspend the rates pending a hearing as to their reasonableness. While the Commission is charged to decide the question as speedily as possible, the law allows the suspension to be effective for five months.

Where a rate is found to be unreasonable, the Commission is empowered to determine and fix a reasonable rate. As an aid in doing so, it may investigate and ascertain the "actual legitimate cost" of the properties under its jurisdiction, the "depreciation therein," and other facts which bear upon the determination of cost, depreciation, or fair value. Every utility under the jurisdiction of the Commission is required, when requested by it, to file an inventory of property and original-cost data, and to keep it informed as to the cost of additions, betterments, extensions, and new construction.

In the case of electric companies for which the Commission has no rate-regulation power, it may, upon request of a state commission, investigate and determine the cost of producing or transmitting electric energy by means of facilities under its own jurisdiction. Thus, an electric producing or distributing company operating in interstate commerce, but not selling at wholesale, may be subject to investigation as to cost of electricity. This provision is for the benefit of state commissions which are unable to reach interstate company operations, although they do have power to fix a local retail public-utility rate.

6. ADEQUATE SERVICE. The Federal Power Commission has a somewhat limited authority over the quality of service of electric companies operating in interstate commerce. In case it is requested to do so by a state commission, the Commission, after notice and hearing, and after a finding that service is inadequate or insufficient, may determine and order such service as it finds to be proper, adequate, or sufficient. This order may embrace extension or increase of service. However, in exercising this power it is given no authority to compel the enlargement of generating facilities, or to do anything which would impair the ability of a public utility to render adequate service to its customers.

7. ACCOUNTS AND REPORTS. As with hydro-electric licensees, the law provides for strict control of accounts and reports of those interstate public utilities subject to the Federal Power Commission. The Commission has the authority to prescribe accounting forms and regulations necessary or appropriate to the administration of the law. Preservation of certain memoranda and filing of reports are required. The Commission is given access at all times to the books of companies for purposes of inspection or examination. Even books of persons controlling one of these public utilities may be inspected by it in so far as they relate to transactions with a public utility under its jurisdiction. The Commission is given definite power to require electric utilities under it to carry a proper and adequate depreciation account. To this end, it may fix depreciation rates upon specified classes of property.

Thus the Federal Power Commission is given considerable authority to obtain accurate information concerning the businesses under its control. Not only has it power to prescribe accounting forms and methods, but it may police these accounts and insist upon reports based upon such records. As much as this might appear to be an interference into private business matters, it is difficult to see how the various regulatory powers of the Commission could be exercised intelligently without such control.

8. CO-OPERATION WITH STATES. Throughout the Public Utility Act of 1935 there is evidence of the intent of lawmakers to reduce any duplication of regulatory effort between state and federal commissions. Moreover, since the electric-power field had been occupied by state regulation long before the entry of the federal government, and because of the opposition of state authorities to federal control, care has been taken in the law to leave state regulation much as it was and to impose federal control to stop the gaps in state regulation.

To encourage co-operation with state commissions, the law of 1935 allows the Federal Power Commission to set up joint boards of state and federal commissioners. Each of these is given full commission powers on matters delegated to it by the Federal Power Commission. In addition, the Commission is authorized to confer with state commissions regarding rates, costs, accounts, and other regulations of utilities in which both state and federal gov-

ernments have an interest. Furthermore, it may hold joint hearings with state commissions on matters with which the federal board is authorized to deal and in which state authorities have an interest.

The Federal Power Commission is also directed to make available to state commissions such information and reports as may be of assistance in the state regulation of public utilities. Whenever it can be done without harming the efficient conduct of its own affairs, the Commission is empowered to make its rate, valuation, or other experts available as witnesses to state commissions, subject to their reimbursement by the state making the request.

9. FEDERAL REGULATION OF INTERSTATE POWER: CONCLUSIONS. Study of the reports of the Federal Power Commission indicates that the major part of its activity and accomplishment has been in the field of investigation. The numerous investigations of the electric-power industry and the detailed reports published have been of inestimable value to state regulating commissions and to other federal agencies interested in the electric-utility industry. The thoroughness of these reports is evidenced from the statement of the Commission in its 1939 annual report that more than 90 per cent of the electric industries, as measured by revenues and assets, were included in the financial and statistical summaries.[1]

In most respects, the regulatory activities of the Commission have not been very extensive. This is due primarily to its limited jurisdiction. Nevertheless, it has been instrumental in bringing about uniform accounting in 90 per cent of the electric industry, its promulgated uniform system of accounts having been adopted, with certain modifications, by twenty-seven state commissions and the National Association of Railroad and Public Utility Commissioners in 1938. In the three years following 1935, the Commission acted upon applications for merger, consolidation, transfer and disposition of property, and securities involving well over a billion dollars. In 1939, as shown by the report for that year, twenty-six such applications were considered. Applications for approval of interlocking directorates have been closely scrutinized, and while few applications have been denied, administration by the Commission has resulted in the voluntary resignation of many directorates. In the annual report for 1937, the Commission noted that in one large public-utility system alone it acted upon one hundred and eighty-five applications for interlocking directors and officers. Few formal electric-rate cases have arisen, but in several cases the Commission obtained wholesale rate reductions by merely challenging companies to show cause why rates should not be reduced.

[1] 19th *Ann. Rep. F. P. C.* (1939), p. 16.

F. INTERSTATE COMMERCE IN GAS

Not until 1938 did the federal government enter upon a program of regulation of gas operating public utilities, although the Holding Company Act of 1935 dealt with companies controlling gas as well as electric companies. The law of 1938 applies only to natural-gas companies, and, as will be noted presently, has a scope not unlike that applicable to interstate electric utilities.

The demand for regulation of the natural-gas industry by the federal government is found in several factors.[1] In the first place, interstate commerce in this commodity has been increasing, particularly since 1926. Natural gas moves from five principal areas over a network of fifty thousand miles of line to thirty-seven of the forty-eight states.[2] This interstate nature of such operations has caused many state public-utility commissions difficulty in regulating local gas companies obtaining their supply from interstate companies. Many commissions were rebuffed by the courts in their attempts to regulate the interstate companies, and found it almost impossible to obtain information from these companies for use in local rate regulation.

Another reason for federal regulation was the refusal of certain interstate companies to supply cities with an adequate supply of natural gas. This situation and other factors gradually led to the belief that interstate commerce in natural gas was really a business affected with a public interest and should be regulated as such. Moreover, because the supply is limited, and because of the prevalence of wasteful practices from time to time in the industry, regulation was demanded by some in the interests of conservation.

1. THE SCOPE OF THE REGULATION. The Natural Gas Act of 1938, as stated, deals only with natural-gas operations, although these include cases where any mixture of natural and artificial gas is involved. The law applies to transportation of gas in interstate commerce and to sale therein for resale for "ultimate public consumption." The law specifically excludes production or gathering of natural gas and the local distribution of gas. This means that the Federal Power Commission, to which the administration of the law is entrusted, has no regulatory control over two general phases of natural-gas operations — production and local distribution — and that its authority is limited to the third phase — transmission.[3] Even with this phase, the business must be interstate and for ultimate public consumption.

The authority of the Federal Power Commission for fact-finding purposes is broader than its regulatory powers. It is authorized to investigate the cost of production, as well as of transportation, in instances where it has no power to fix a rate.

[1] Rice, M. M., "Gas and Government," 22 *Pub. Util. Fortnightly*, pp. 483–90 (October 13, 1938).

[2] *Ibid.*, p. 484. The five principal gas fields are the Appalachian, Mid-Continent, Southern, Rocky Mountain, and California fields.

[3] Welch, F. X., "Uncle Sam Moves in on the Gas Industry," 22 *Pub. Util. Fortnightly*, p. 217 (August 18, 1938).

Note that federal regulation of manufactured gas is not attempted. This is not surprising since the artificial-gas industry is almost entirely intrastate in nature and the production and transmission of this type of gas are directed primarily to the local user, the producer and local distributor generally being the same.

Throughout the Natural Gas Act, as was the case in the electric-power law, there is clear evidence of the intent of Congress that the federal government is not to supersede the states in regulation but to complement them. The law as drafted gives little chance for the Federal Power Commission to supplant state regulation as the Interstate Commerce Commission has done in the railroad industry.

2. Provisions Similar to Electric-Utility Regulation. Because certain parts of the Natural Gas Act are similar to provisions made applicable to interstate electric-utility operations by the federal law of 1935, they need only be noted. The rate-regulation provisions are practically identical with those of the electric-power law, and are fairly standard in their coverage of reasonable rates, rate discriminations, changes, filing, publication, suspension, and determination of costs. The law respecting accounting and reports is also similar.

The service-regulation authority is also much the same, with exceptions to be mentioned below, and the power of the Federal Power Commission to order extensions is subject also to the restriction that these orders may not impair the ability of a company to render adequate service to its customers. The Natural Gas Act also provides for the establishment of joint boards and for other means of co-operating with state commissions.

3. Differences Between Electricity and Gas Laws. The regulation of gas companies is not as extensive as that of interstate electric utilities. The Federal Power Commission has no authority over consolidations, mergers, sale of gas property, security issuance, or interlocking directorates. The Natural Gas Act does not envisage a planned national system of interconnected lines over certain regions.

In the provision dealing with the power of the Commission to order an interstate gas company to sell natural gas, specific reference is made to municipalities, as well as other "persons" authorized to engage in local distribution of natural or manufactured gas. Such specific mention was not made in the electric-power act. It is interesting to note that the law requires a natural-gas wholesaling company to serve local distributors of artifical gas adequately, as well as retailers of natural gas. This is somewhat different from the traditional regulatory principle that a public utility has no obligation to serve a competitor.

The law dealing with entry, extension, and abandonment of gas service is somewhat different from and more specific than that covering electric companies. Under the electric-utility law, the Federal Power Commission is

authorized only to approve acquisitions and disposals of property and to order extensions. When an electric company wishes to construct a line, extend its facilities, or abandon them, apparently it must obtain a certificate of convenience and necessity from the state commission. With gas utilities under the jurisdiction of the Federal Power Commission, extensions and abandonments must be approved by it. Abandonments may be approved after finding that there is depletion in the gas supply or that the present or future public convenience and necessity permit such stoppage. New construction and extensions may not be undertaken without a finding of public convenience and necessity by the Commission, if a company enters a market already being served by a natural-gas company. Apparently, unless the service is competitive, no such permission need be had. In granting authority for competitive service, the Commission is instructed to give due consideration to an applicant's ability to render adequate service at rates lower than those prevailing in the territory in question. This instruction is obviously designed to aid the Commission in holding a competitive club over the heads of interstate distributing companies.

The Federal Power Commission is made a research organization to aid in the formation and administration of interstate compacts controlling the natural-gas industry. Under the present law, if two or more states join together in a pact dealing with conservation, production, transportation, or distribution of natural gas, it becomes the duty of the Commission to assemble and keep current information pertinent to the matters covered therein.

4. Regulation of Interstate Natural-Gas Operations. As yet, the Federal Power Commission has not had much time to develop any very definite regulatory principles beyond those found in the law. It has lost no time, however, in gathering information on the gas industry. The report for 1938 noted that a general investigation of natural-gas companies was being made, and that information had been called for on pipe-line and transportation facilities, production and gathering, sales and deliveries, communities served, operating and financial details, and ownership and control. All companies were asked to file data on their rates and services.

By the latter part of 1939, the Commission had ordered the adoption of a uniform system of accounts for natural-gas companies under its jurisdiction. This system follows the pattern adopted for electric-utility companies, and provides, among other things, for a detailed restatement of accounts in terms of original cost. Several certificates allowing the building of natural-gas pipe lines had also been issued, and the Commission has taken the position that Congress did not intend it to weigh the broad social and economic effects of new gas pipe lines on the position of competitive fuels.[1]

The first year's operation of the new Natural Gas Act brought a number of rate cases before the Federal Power Commission. While many of the cases

[1] 19th *Ann. Rep. F. P. C.* (1939), pp. 22–23.

were still awaiting final disposition in 1940, the Commission has shown a tendency to base rate levels on a formula of approximately 6 per cent return upon original cost. Whether this practice will be upheld by the United States Supreme Court, in view of its valuation decisions in regard to state regulation, remains to be seen.

While the regulatory aspects of the Natural Gas Act should not be underestimated, the investigatory rôle of the Commission promises to be even more important. About one third of the marketed production of natural gas moves in interstate commerce and will be subject to regulation by the Commission. But practically the entire industry may be subject to a degree of investigation. Not only will disclosure of facts have a regulatory effect due to publicity and owing to their use by state commissions, but such data may become the basis for additional federal regulation in the future.

G. FEDERAL PUBLIC-UTILITY REGULATION: CONCLUSIONS

Recent years have seen the emergence of a definite and enlarged regulation of public utilities by the federal government. Even though the transportation industry be excepted, the statement is unquestionably true. Prior to 1920, telephone and telegraph companies alone were subjected to federal control, and even there the degree of regulation was slight. Even before 1934, the federal government had little more than entered the field, for the control over hydro-electric licensees and the radio industry was not very thorough. Since 1934 there have been changes of great significance. Communication companies have been placed under a separate federal commission, and the scope of regulation has been broadened. Electric and gas holding companies were subjected to detailed control by the federal government in 1935. The Federal Power Commission, once a weak planner of utilization of water-power sites, has been made a strong commission with powers of public-utility control over interstate operations in electricity and gas.

As might be expected, the form and implications of recently developed control by the federal government are open to some question. In the first place, the regulatory laws, as respects both content and agency entrusted with their administration, are scattered and somewhat piecemeal. Communication utilities are placed under one commission; interstate electric and gas operations are placed under another, along with the licensing of use of natural water-power resources. But transactions of holding companies in the electric and gas industries are placed under the jurisdiction of the Securities and Exchange Commission, together with the general regulation of security sales of private industry. In addition, of course, there are the many state commissions with powers over local communication, gas, electricity, and water companies. Perhaps this scattering of administration between state and national commis-

sions is inevitable under the federal system of government. Nevertheless, a question can be raised about the present allocation of authority to the federal commissions. It may not be wise to have electric and gas holding companies under one commission and interstate electric and gas operations under another. Furthermore, placing the regulation of interstate electric-power companies and radio companies in commissions also empowered to promote these industries may not be the best administrative policy. Yet the Federal Power Commission is charged with the allocation, and promotion of use, of natural resources, and the Federal Communications Commission is required to study new uses for radio and to encourage its wider and more effective employment.

In the public-utility holding-company field, the content of regulation is so extensive that it is difficult to see how the law has overlooked much. Even there, however, the application is only to companies holding electric and gas utilities. In regard to operating companies, the present laws vary considerably, and are not always very complete, especially when compared to the almost overdeveloped railroad transportation laws. The Communications Act of 1934 gives the Commission jurisdiction over telephone-company consolidation, but not over that of telegraph companies. Interstate electric companies are subject to control over issuance of securities, consolidations, mergers, and sale of property, but no such powers are applied to gas operations. Other differences could be mentioned. It would seem that unless there are compelling reasons for different treatment — and present differences do not appear so to be justified — these laws should be far more consistent.

One of the most vexing of all problems of public-utility control by the federal government is the question of federal-state relationships. The natural-gas and electric-power laws are replete with attempts to fit together these two jurisdictions with a minimum of duplication and conflict. Whether these attempts will be successful is difficult to say. State commissions fear that the federal commissions will eventually encroach upon their jurisdictions, until they find themselves in the inferior position they now occupy with respect to railroads. Despite the supposed safeguards of present laws, many state commissioners believe that these laws are susceptible of being so administered.[1]

There are those who believe that the cause of regulation has been weakened by the tendency of the federal laws to defer to state control. They see the rapid increase in interstate aspects of public-utility business. Attention is also called at times to the fact that state regulatory bodies have neither sufficient tenure of office nor adequate staffs to administer a law as effectively as can a federal commission. Moreover, the legal basis of some state regulation is not complete enough for effective control. While the commissions in Massachusetts, Wisconsin, and Illinois may be doing an effective job, there are many more states where various limitations do not permit it.

[1] See, for example, Thompson, E. O., "Federal Regulation of Gas," 22 *Pub. Util. Fortnightly*, pp. 491–93 (October 13, 1938).

On the other hand, since consumer contact with these companies is generally local, with local distributing companies, the states may be in a better position to deal with regulation than is the federal government. Perhaps a poor system of state control is to be preferred to strong, uniform, and even expert federal regulation.

Whatever the relative merits of federal and state regulation are, the future of public-utility control seems to point to increase of federal activity and relative decline in state control. One fact leading in this direction is the enlargement of interstate commerce in the utility field; economic development is no respecter of political boundaries. Another is that regulation seldom goes backward. Now that the federal government has entered the field, it will probably find that certain loopholes exist for the thwarting of effective control. As these are filled, the position of the federal government must necessarily become more powerful. Possibly, too, the public-utility industry itself may ask for the federal government to assume the leading rôle in regulation in order to escape dealing with too many commissions and laws. Regulation at the request of the regulated is not new in the development of government control.

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Part Four

REGULATION TO ENFORCE COMPETITION

CHAPTER

18

THE DECLINE OF COMPETITION AND SOCIAL POLICY

IN PREVIOUS chapters attention has been drawn to the regulation of businesses — transport agencies and other public utilities — affected with a public interest. Here governmental policy has recognized, to some extent, at least, the desirability of monopolistic conditions. These enterprises have been considered to be natural monopolies and regulatory policy has been designed to control them in such a way that the public interest might be served. While the government has not encouraged complete monopoly in the transport field, in spite of a system of regulation virtually assuming it, government control of local public utilities has shown a high degree of consistency in this regard. In principle, at least, prices have been fixed in industries as they presumably would be under competition, with regard to reasonable and fair costs, and entry into and departure from service have not been left to individual initiative. To be sure, regulated prices and service, as in the railroad industry, have often been influenced by competitive factors.

Outside the sphere of businesses affected with a public interest, the traditional approach of government has been to enforce competitive conditions and let them operate to set prices and service. For the so-called "private," as contrasted to "quasi-public," businesses, government policy has been based upon the belief that competition is the best means of obtaining efficient production, equality of business opportunity, and fair prices to consumers. Yet there has been a recognition that unregulated competition itself does not always work to the best interest of the public. Competition must be what the public regards as "fair." But in order to obtain this, freedom of competition is often curtailed by governmental action. Moreover, unregulated competition often leads to inadequate protection for the consumer or the investor. Hence, special regulation for the conduct of banking, mining, farming, and other businesses has been provided. Laws setting up standards for purity of foods and

drugs have been passed. The disadvantageous position of labor in the competitive struggle has also been strengthened by special legislation.

In a sense, all regulation not created to encourage and regulate monopolies is designed to promote the sort of competition that government, acting for the public, believes to be desirable. In this section of the book, however, attention will be paid only to those policies which seek to encourage effective competition between enterprises on a plane regarded as fair.

As every student of a *laissez-faire* philosophy of economic activity knows, leaving each individual to his own devices in a system relatively free from governmental restraint is presumed to result in a strongly competitive economic society in which production will be controlled in ways consistent with the public interest, by virtue of the forces of self-interest and competition. The failure of *laissez-faire* so to protect the public has already been touched upon in the opening chapter.

In spite of a half-century of government control aimed at the maintenance of competition, there is general belief that it is declining. Whether the growth of monopoly elements has become so great that they cannot be removed by law, as one writer suggests,[1] is difficult to say. The investigation of concentration of economic power undertaken by the Temporary National Economic Committee, a special committee of Congress, has attempted to determine in part the extent, causes, and effects of the decline in competition.[2] The Committee has sought to find the reasons for depressed economic conditions in the face of ample resources. In doing so, it has indicated that the answer may lie in the decline of competition.

Before an analysis of government policies to enforce competition can be made, it is necessary to understand some underlying economic characteristics of the present system. The nature of the decline in competition and the causes of the development of monopoly elements may shed some light on the wisdom of past and projected government regulation.

A. WHAT IS A COMPETITIVE SYSTEM?

Anti-monopoly and fair-trade laws have been predicated upon the belief that a competitive system is desirable, except in those businesses affected with a public interest in which a monopoly policy may have decided advantages. As President Franklin D. Roosevelt has said, "The enforcement of free competition is the least regulation business can expect." [3] But what is meant by free competition and a competitive system? This concept has not been well

[1] Burns, A. R., *The Decline of Competition* (New York: McGraw-Hill Book Company, Inc., 1936), p. 3.

[2] Temporary National Economic Committee, *Investigation of Concentration of Economic Power*, 75th Cong., 3d Sess. (1938–1941). For statement of this position see pt. I, pp. 170–76 (1939).

[3] *Message from the President of the United States Transmitting Recommendations Relative to the Strengthening and Enforcement of Anti-Trust Laws.* Sen. Doc. No. 173, 75th Cong., 3d Sess. (1938).

understood. Moreover, it is probably undergoing a change whereby the existence of a sort of monopolistic competition is becoming recognized.[1]

The framers of trade regulations during the last fifty years have probably thought of a freely competitive system as embodying rivalry of buyers and sellers in a free market. Such a market has been popularly conceived to be one in which the individual buyer or seller does not dominate. Under such a system price would be determined by the free interaction of both demand and supply. In the long run, a price above average total unit costs of production would not be possible, for entry of new firms or willingness of existing sellers to accept a price equal to average total unit cost (including a return on capital and wages of management) would bring the price down. Nor could prices long remain below average total unit costs, since the losses would force a reduction in the number of firms and curtail the amounts the remaining firms would be willing to offer for sale.

Under this kind of competitive system, the quality of goods would be protected by rivalry between sellers and by the shunning of goods of inferior quality at similar prices by buyers. Those businesses which produce things people want would tend to be the most profitable, and existence of returns over cost would tend to draw new enterprises into such fields. Resources would be directed to the most productive uses, as measured by consumer marginal utilities.

Where a free system of competition operates, it has been supposed that, except for short transitional periods, unused productive capacity, whether of capital or labor, could hardly exist. If capital or labor were unused, its price would fall, until at some level employment would be profitable.

This, then, in oversimplified terms, is what has generally been meant by a freely competitive system. But, as will be noted, the evidence does not bear out the existence of such a system at the present time. Whether this has been the fault of governmental policy, or is due to the fact that competition takes forms different from the traditional concept, is of the greatest importance in weighing a policy of trade regulation. For if in an inherently competitive system there are different kinds and degrees of competition, perhaps a plan of government control designed to enforce competition is doomed to failure unless it recognizes that these kinds exist and makes allowances for them.

B. EVIDENCE OF THE DECLINE OF COMPETITION

Evidence of the decline in vigor of a supposed freely competitive system is not hard to find. In the latter part of the nineteenth century competition dramatically gave way to pools and monopolistic agreements in the production of such

[1] The economic nature of varying degrees of competition will be discussed below, at pp. 420–22. At this point we are interested merely in the traditional concept of competition and the declining vigor of this kind of competition.

staple commodities as meat, salt, oil, whiskey, steel, and sugar. Even after 1890, when the federal government outlawed combinations in restraint of trade and attempts to monopolize, the number of sellers in many fields progressively declined. Over fairly long periods of time, productive capacity has sometimes gone unused although prices have remained stable. Not only have the number of sellers generally declined, but the economic position of certain sellers has increased to the point that a single one, or a few, may dominate markets in certain industries.

These facts indicate a decline in a freely competitive system. The decline is evidenced by the reduction in number of sellers, the concentration of great economic power in a few sellers, rigidity of prices, and the introduction of non-price competition.

1. Emergence of Large-Sized Businesses. Business enterprises have been increasing in size in the last half-century. In 1897 there were 44 corporations, or allied groups of corporations, with capital of $50,000,000 or more. Of these, only 8 were industrial corporations, 11 or 12 public utilities, and the majority were railroads.[1] By 1903 the number of large industrial corporations had increased to 41, and by 1933 there were 168 $50,000,000 industrial corporations.[2]

Evidence of the emergence of large-sized business is also found in studies of consolidations. Watkins found that in the period from 1890 to 1904, 237 industrial consolidations were consummated, involving a total capitalization of nearly 6 billion dollars.[3] Thorp reported a total of 1268 mergers in the decade following 1918 in manufacturing and mining industries.[4]

Increase of size is also indicated by other data. In 1909 only 15 per cent of manufacturing plants hired more than one thousand workers, but by 1929 over 24 per cent of the plants were in this class.[5] In 1904 only 24 per cent of manufacturing enterprises were corporations and in 1902 less than 29 per cent of mining and quarrying enterprises, but by 1929 these proportions had risen to 48 per cent and 63 per cent respectively.[6] While the increased use of the corporate device does not prove that business units are larger, it does show a trend in that direction. Although many very small corporations exist, the corporate form has facilitated the growth of large businesses.

2. Relative Importance of Large Businesses. Largeness of a business enterprise is important as indicating a decline of competition only when

[1] Twentieth Century Fund, *Big Business: Its Growth and its Place* (New York: Twentieth Century Fund, Inc., 1937), p. 27.

[2] *Ibid.*, pp. 27, 55. Of the 168 large corporations in 1933, 119 were in manufacturing and the remaining 49 were in agriculture, mining, construction, trade, and service. There was one agricultural corporation in this class. See *ibid.*, p. 99 n.

[3] Watkins, M. W., *Industrial Combinations and Public Policy*, quoted in the Twentieth Century Fund study, *op. cit.*, p. 29.

[4] Thorp. W. L., *The Changing Structure of Industry*, quoted in the Twentieth Century Fund study, *op. cit.*, p. 31.

[5] Twentieth Century Fund, *op. cit.*, p. 38. [6] *Ibid.*, p. 15.

treated as a relative matter. Where many business concerns are large, as measured by some absolute scale such as the $50,000,000 enterprise, there is a strong presumption that they are fairly important in their fields. Nevertheless, largeness has its fullest meaning when taken in relation to certain areas of economic activity. An enterprise with $50,000,000 of assets would have only 0.2 per cent of the total assets in the railroad industry, where billion-dollar businesses are not rare.

Only 0.2 per cent of all corporations in the United States in 1935 had assets of $50,000,000, or over. Yet these corporations held 51.5 per cent of total assets of all corporations.[1] When certain industries are considered, the importance of large businesses is all the more striking. Data measuring the extent of concentration in selected industries are given in Table X below. They range from instances in which one company controls 100 per cent of the output to one in which relatively few companies control as little as 2 per cent. In most cases, however, it is apparent that a few large companies dominate the industry so that free competition can hardly be said to exist. In such industries what certain individual sellers do is of great significance and the whole complexion of the market might be affected thereby.

3. PRICE RIGIDITY. Although stable prices over a considerable period of time are not conclusive evidence that something has occurred to impair the

TABLE X. CONCENTRATION IN SELECTED AMERICAN INDUSTRIES

Name of the Product	Number of Large Companies	Percentage of Output Controlled by Large Companies	Date of
Virgin aluminum	1	100	1937
Automobiles	3	86	1937
Beef products	2	47	1935
Bakery products	3	20	1934
Cans	3	90	*
Cement	5	40	1931
Cigarettes	3	80	1934
Coal (bituminous)	4	10	1932
Copper	4	78	1935
Corn binders	4	100	1936
Corn planters	6	91	1936
Flour	3	29	1935
Plate glass	2	95	1935
Safety glass	2	90	1935
Iron ore	4	64	1935
Oil wells	4	20	1935
Steel	3	60	1935
Whiskey	4	58	1938
Women's clothing	4	2	1935
Wood pulp	4	35	1935
Zinc	4	43	1935

* Not available.

Source: Testimony of W. L. Thorp, *Investigation of Concentration of Economic Power*, pt. I, p. 137.

[1] U.S. Treas. Dept., Bur. of Internal Rev., *Statistics of Income for 1935*, pt. 2, p. 16.

vigor of competition, this presumption is strong. When prices of certain commodities can resist changes in general price levels, costs, and consumer demand, they become rather reliable evidence of a decline of competition.

Burns has collected data concerned with the rigidity of prices in several industries.[1] Since 1901, the price of steel rails has remained fairly stable. From 1901 to 1916, the announced price was $28 per ton; from 1922 to 1932 it remained at $43. While announced prices are often shaded by leading sellers to meet competition of independent producers, the list prices do represent a sort of standard price for the industry. Occasional departure from the announced prices does not fundamentally spoil the picture of rather rigid prices.

Except for changes due to seasonal discounts and occasional breakdown in price structure, prices of anthracite coal give a picture of great stability over a long period of years. The agricultural-implement industry also has a record of fairly rigid prices. Burns finds four- and five-year periods in which no price changes were made, and on some items the depression of 1929 to 1933 failed to shake the steadiness of prices. The newsprint industry has also presented a picture of steady prices for as long as four years. Numerous other cases could be mentioned. Evidence of price rigidity ranging over periods from a few months to several years is found with the following products, to mention only a few: cement, sulfur, plate glass, nickel, cotton thread, soda crackers, cigarettes, sewing machines, bread, and milk.

The existence of price rigidities is not always due to an absence of competition. As one writer has pointed out, they may be due to other factors.[2] Some prices are affected by custom so that competition tends to be reflected in quality rather than price. In some cases, goods are produced under conditions in which variable costs are high in relation to fixed costs. Hence, total cost per unit does not vary considerably over different ranges of output. Or conceivably an industry could be faced with a stable demand and be made up of firms all operating at minimum average total unit costs.

4. Identical Prices. There are numerous instances, well known to any observer of prices, in which the price of the same products is identical. This does not always denote a lack of competition, since the necessary result of the action of free competition would be a single price for a certain good in a given market. But where the price of an article sold in different markets or produced under different cost conditions is the same, the existence of identical prices may be evidence that competition is not working as well as can be expected. When sealed bids for steel rails are opened and it is found that all producers have given identical prices, either the market is so broad and so competitive that a single price is arrived at through interaction of many buyers and sellers, or certain impediments to the free action of competition exist. The

[1] Burns, A. R., *op. cit.*, chap. V. The writer has drawn from this work in the following discussion.

[2] Tucker, R. S., "'Sensitive' and 'Administered' Prices," 51 *The Annalist* (February 4, 1938), p. 195.

use of basing points in such industries as the steel and cement field, by which prices are given as of a certain producing point plus freight costs to the consuming point, has often resulted in identical prices. With the concentration of control and the importance of few large sellers in these industries, it seems idle to contend that these prices are determined under conditions of free competition.

In many fields, such as steel, gasoline, copper, and agricultural implements, identical prices may be due to the development of price leadership. Even though some form of collusion may not exist, there is a tendency for all sellers to follow the lead of a certain seller. This price leader may not be the same seller at all times in the same industry. Such a practice, even though not strictly monopolistic, is hardly the sort of thing envisioned by a freely competitive system.

5. Existence of Unused Productive Capacity. At times, especially in years of depression, some industries are characterized by the existence of large unused productive capacity. The Brookings Institution has made a study of production capacities and their use.[1] While this study does not extend into depression years, data of unused productive capacity in 1930 are in most cases obtainable. Data for selected industries are shown in Table XI.

Existence of unused productive capacity after 1929 naturally increased in most industries. Although depression data for Nourse's study are not available,[2] some idea of the decline in production can be obtained from other

Table XI. Excess Practical Productive Capacity of Selected Industries, 1930

Industries	Percentage of Excess Capacity
Anthracite coal	23.4
Automobiles	45.0
Automobile tires	43.7
Bituminous coal	29.3
Boots and shoes	20.0 *
Cement	18.0 †
Copper refineries	26.5
Locomotives	70.0 *
Newsprint	28.0
Pig iron	31.3
Steel rolled products	26.5
Wheat flour milling	56.5
Wire	37.0 †

* 1929. † 1925–29.

Source: Nourse, E. G., and others, *America's Capacity to Produce*, pp. 132, 226, 262, 268, 274, 548 ff.

[1] Nourse, E. G., and others, *America's Capacity to Produce* (Washington: Brookings Institution, 1934).

[2] Estimates for the system as a whole were made in a later study. These show that while average unused practical productive capacity was about 20 per cent in 1929, in 1932 this had increased to more than 40 per cent, and was still nearly 40 per cent in 1934. See Moulton, H. G., *Income and Economic Progress* (Washington: The Brookings Institution, 1935), p. 22.

TABLE XII. DROP IN PRICES AND PRODUCTION, 1929–1933 IN MAJOR INDUSTRIES

Industry	Per Cent Drop in Prices	Per Cent Drop in Production
Agricultural implements	6	80
Motor vehicles	16	80
Cement	18	65
Iron and steel	20	83
Automobile tires	33	70
Textile products	45	30
Leather	50	20
Food products	49	14
Petroleum	56	20
Agricultural commodities	63	6

Source: Means, G. C., *Industrial Prices and Their Relative Inflexibility*, Sen. Doc. No. 13, 74th Cong., 1st Sess., p. 8 (1935).

sources. The data in Table XII are not in all respects comparable with those in Table XI. They are interesting, however, in denoting how sharply production decreased in certain industries in the period of 1929 to 1933, and how much less rapidly prices fell. In other industries the reverse was true.

The disjointed condition of industry in the depression years following 1929 makes it difficult to draw definite conclusions from such data as those in Table XII. So many factors have been introduced to affect price and production policies that one cannot limit a discussion of results to competitive versus monopoly elements alone. Yet in some industries the picture of rapidly falling production with slightly falling prices is so striking that some conclusions seem justified. In these industries, it would seem that free action of competition would drive a price down much more than the data indicate. If demand falls so much as to cause an 80 per cent decline in production, with only a 6 or 16 per cent price drop, the necessary inference is that under competition supply was extremely elastic. Such a condition of supply would not seem to be justified by costs, for those industries showing the greatest price rigidity in the face of falling output have a fairly high degree of fixed costs. Under such circumstances, a decline in demand — and that is apparently what happened between 1929 and 1933 — would tend to make keener the competition for the existing market, so that producers could operate more nearly at capacity.

The fact that producers in certain industries have been unwilling to lower prices so that they may operate more nearly at practical capacity seems to mean that price competition has been restricted in some way. Operations below capacity in the more normal years of 1929 and 1930, as well as depression years after, appear as fairly important evidence of a decline of competition. This restraint upon competition might be due to the disinclination of an independent seller to risk the uncertain results of a price war.

There may be cases in which excess productive capacity does not indicate

a lack of free competition. It may be that out-of-pocket costs cannot be covered with additional production at lower prices and that to use plant capacity to a greater extent would increase the loss. Unless this were true for an industry generally, there would be a tendency under free competition for firms to increase output so long as unused capacity exists. Since operating at less than practical capacity, or at costs higher than minimum average total unit cost, means production under conditions of decreasing cost, the drive for lower costs would tend to cause underselling and increased output. As a matter of fact, in the absence of some sort of restraint the severest type of competition grows out of situations in which excess output and high overhead costs are found.

6. NON-PRICE COMPETITION. Another evidence of decline of traditional competition is the development of non-price competition. By this is meant rivalry between producers to outdo each other in advertising programs, special services, and real or psychic improvement in quality. In a sense, this may not be called a decline of competition but a change. It does mean that sellers often prefer to compete on a non-price basis, largely because retaliation from other sellers is seldom as vigorous or as destructive as it would be if price competition were attempted. Moreover, a seller building up his product by advertising, services, or quality changes tends to differentiate his product from similar goods of his competitors. In doing so, he moves toward a semi-monopolistic position, for in the minds of buyers his product tends to become unique, at least to the extent that his attempts at product differentiation are successful.

Where a good is capable of product differentiation, the seller tries to stabilize his price over fairly long periods of time. One has only to look at the steadiness of prices of branded goods to note how true this is. While this may still be competition of a new kind, it at least represents a departure from what has been traditionally known as a freely competitive system.

C. CAUSES OF THE DECLINE OF COMPETITION

There are two immediate causes of the decline in competition: the fewness of sellers and the emergence of differentiated products; the former is more important. If only a few sellers exist, they can dominate the market and bring the resulting price bargain under their control, subject to limitations found in the elasticity of demand for their product. Even though they may not conspire to control the market, any individual seller may shrink from doing anything which will upset the stability of price or sales. If he does make a change in price or quality, he is likely to do so only after the leader of the industry has made the first move.

Decline in the vigor of competition is also caused by the practice of making products which are physically similar seem different to buyers. This differentiation is accomplished by selling effort designed to individualize products.

There are certain factors which underlie the development of dominant sel-

lers and differentiated products. Most of these help to explain why sellers are often so few in many industries; others may only explain the growth of differentiated products; and some factors may lie behind the rise of both phenomena.

1. Economic Advantages of Size. One of the basic explanations for the decline of competition is the fact that large-sized businesses have certain economic advantages in some industries. Among these, large-scale production in a single plant and the combination of many plants under single management are well known. Where the product is one which can be standardized and where the market is broad and stable enough, large plants can take advantage of economies through specialization and division of labor. Where the product is adaptable to the use of machinery, such plants gain by the specialized employment of expensive machinery. The latter can be used advantageously only if used all or much of the time, because idle machinery incurs cost but earns nothing. But in addition to its cost, its use results in large output and requires extensive organization for marketing. For both reasons, only the large organization can achieve the advantages to be thus derived. It may also be able to pay high salaries for men of special ability, to conduct experimentation and research, and to utilize by-products more efficiently. Advantages may also accrue in the quantity purchases of raw materials and supplies.

In combining plants under a single management, whether by vertical or horizontal combination, or both, additional economies are often available. Selling costs may be reduced. Uneconomical cross-hauling of materials may be eliminated. A continuous supply of raw materials may be assured, and co-ordination of manufacturing and distribution processes may result in savings.

It is not to be supposed that the economies of large-scale production and combination apply only to manufacturing enterprises. They may be found also in marketing, as well as in many other service industries. The chain-store movement, for example, has resulted from economies brought about because the combining of numerous retail and wholesale plants has lowered costs.

To be sure, not all economic activity lends itself to the attainment of economies through large size. Where labor is of exceptionally great importance, or a commodity cannot be standardized, or a market is limited, the most efficient size of firm may be relatively small. The same holds true where management cannot economically handle large business units. As a matter of fact, the ability of management to direct the activities of a business will always tend to limit its size. And where labor is so much more important than capital in the productive process, the fact that the latter can be managed more easily than the former will tend to make firms hiring relatively more labor small. Also, where capital investment is small relative to labor, it is easy and economical to organize and operate small units.

2. Size and Capital Requirements. Not only do large business units have

certain economic advantages, but their presence limits the entry of competitors. Few enterprisers can afford to break into many industries characterized by large firms. A continuous mill for hot-rolling steel products cost over $20,000,000 in 1937, and one steel blast furnace is said to cost $2,500,000. The DuPont Company recently built a plant for the production of a synthetic textile at a cost of $8,000,000, and the Celanese Corporation spent $10,000,000 for a plant to spin synthetic yarn.[1] Other examples could be given.

In addition, modern large-scale production, if it is to be efficient and progressive, must spend tremendous sums upon elaborate research and experimentation. These expenditures are, in a way, an investment, for they cannot be recovered until the fruits of research have become commercially profitable. To develop a thermostat for a flatiron cost $100,000.[2] The General Electric Company spends around $1,000,000 annually upon research in one of its fifteen laboratories.[3] Expenditures for research by the Bell Telephone companies average between $8,000,000 and $10,000,000 per year.[4]

The capital requirements of large industrial firms are such that one cannot speak of there being free entry into industries requiring such vast amounts of capital. Although individuals may be legally free to enter many businesses, economic requirements make such entry exceedingly difficult. For this reason, if a freely competitive system is supposed to adjust itself by free entry and exit of firms, large capital requirements hinder the operation of such a system. Moreover, the larger a firm is, generally the better known it is and the easier it can enter capital markets.

3. PRODUCT DIFFERENTIATION. The development of modern business has been accompanied by emergence of an interesting phenomenon. Through advertising, special packaging, slightly different physical characteristics, and special services, sellers have been able to differentiate essentially similar commodities in the minds of buyers and create a near-monopoly. While several brands of cigarettes are practically identical, sellers are able to create the feeling among buyers that one brand is different from another. Coffee of practically identical quality is differentiated by brand names so that buyers do not purchase coffee of a certain grade, but coffee of a certain brand.

Monopoly of brands is not hard to obtain under trade-mark and trade-name protection. Although competition does exist between sellers of different brands of the same commodity, it is not the sort usually envisioned by those who think of a freely competitive system. To the extent that persuasive advertising and other sales devices successfully create the illusion of product differences in a buyer's mind, and make the buyer believe that X Brand breakfast food is the only one which can yield him requisite satisfaction, the seller enhances his monopolistic position. An interesting feature of the development

[1] *Investigation of Concentration of Economic Power, op. cit.*, pt. I, p. 90 (1939).
[2] *Ibid.*, pt. 3, p. 890. [3] *Ibid.*, p. 915.
[4] *Investigation of the Telephone Industry, op. cit.*, p. 204.

of product differentiation is that price competition may become secondary in importance to competition in the use of sales devices other than price.

4. SOCIAL POLICY. There are many aspects of governmental policy which have contributed to the decline in traditional competition. The development of corporation laws which make possible the gathering together of large amounts of capital under one corporate roof has aided the growth of large business units. Without favorable forms of business organization, making convenient the conduct of business enterprises on a large scale and making investment in the enterprises appealing to a large class of owners and creditors, it is inconceivable that many, if any, of the $50,000,000 and larger firms could exist.

Without the protection of patent laws, there is doubt that the striking technological development of the past would have occurred. But these same laws influence the decline of competition. The idea of granting monopoly powers to holders of a patent is in itself in conflict with competition. The power to hold patents over a period of years has often been instrumental in giving one firm a dominance in an industry, and enabling it to become so strong that it could not be overcome by would-be competitors even after the original patents had expired. Such has been the case in the wire-communication, sewing-machine, shoe-machinery, and aluminum fields, to mention only a few.

The power over certain basic patents has sometimes given concerns control over the whole development of an industry, the prices charged, the output produced, and the entry of firms. The Temporary National Economic Committee disclosed in 1938 that control of patents by two companies allowed them thus completely to dominate the glass container manufacturing industry.[1]

The tremendous cost of developing many patented improvements to the point where they are ready for commercial production, and the cost of maintaining suits against infringement of valuable patents, are generally beyond the resources of individuals. As a result, there is a strong tendency for patents to be assigned to businesses already large, even if the inventor happens to be working outside the research laboratories of these concerns. This tends to place many patents in the hands of single business enterprises, thereby accentuating their monopolistic nature.

Many observers believe that the anti-trust laws themselves — those laws designed to break monopoly — have had something to do with the decline of competition. Because any kind of co-operation between producers might be interpreted as combination in restraint of trade, and because of a belief, possibly erroneous, that consolidated businesses would not so easily run afoul of the law, co-operation of independent sellers has often given way to outright consolidation. Although co-operative methods between separate sellers may become highly destructive of competition, the completeness and permanence of such reduction in competition is likely to be far greater under outright consolidation.

[1] *Investigation of Concentration of Economic Power*, pt. 2 (1939).

The very indefiniteness of government policy has hardly had a beneficial effect upon competition. Some of this indefiniteness has sprung from the law and its interpretation, and some from its administration. Government policy has not been consistent. Court interpretation has not always been clear. Different administrations in Washington have placed varying emphasis upon the enforcement of the anti-monopoly laws. In 1933, measures such as the National Industrial Recovery Act were passed which seemed to encourage monopoly by allowing business men to combine under codes. These codes and the regulation thereunder were designed to stabilize business, but they often did so through the reduction of competition. These and other collectivist national policies looking to the regulation of prices and the restriction of output have certainly contributed to the declining vigor of competition.

D. ECONOMIC ASPECTS OF THE "MONOPOLY PROBLEM"

Some of the confusion over the "monopoly problem" may be traced to a lack of understanding of the economic nature of different marketing situations. Goods are seldom sold under either pure monopoly or purely competitive conditions, but very often under variations of these. As the economist looks at the problem, there are gradations from pure competition to the absence of competition, or pure monopoly. Since the so-called monopoly problem is concerned with the presence or absence of rivalry among sellers, rather than buyers, the present discussion will be limited to these aspects.

1. A CLASSIFICATION OF MARKETING SITUATIONS. When sales are made under pure competition, certain conditions are necessary. The good sold must be completely standardized so that buyers will have no reason to prefer the offerings of one seller over those of another. The quantity offered for sale by any one seller must not be so great that anything he does, acting alone, will have an effect upon the market price. Under such conditions, the price is determined by the free play of the forces of demand and supply, and no seller need be concerned that his action will have a measurable effect upon price. Moreover, if a seller wants to make a sale, he cannot obtain a higher price than the market price and need not sell for less. Sales of such agricultural products as wheat, corn, and cotton are made under conditions of pure competition, or those approximating pure competition.

Where the product offered for sale has been differentiated in the minds of buyers, whether by advertising, packaging, slightly different quality, or special services, the marketing situation is referred to as one of monopolistic competition. Many differentiated products may be in substantial competition with each other, as in the toothpaste field, or few such goods may be in competition, as in the low-priced automobile industry. To the extent that differentiation of product is successful, buyers will have a reason to prefer one seller over another even though the price charged by the former is higher. While a seller's price

is affected by what his competitors do, he has a certain freedom of action, for he has built up a clientele for his product, even though it be priced above that of a competitor. A seller under monopolistic competition will likely establish a price which he believes to be profitable, and increase his sales by advertising and special services rather than by lowering his price. He stands in a semi-monopolistic position in contrast to the seller under pure competition, who could not sell above the general market price regardless of advertising and special services.

Where the number of sellers is so small that what any individual seller does will have a material effect upon the market, sales are said to be made under conditions of oligopoly. It is quite possible for an oligopoly to be made up of sellers of differentiated products in competition with each other, as well as by a few sellers of a standardized good. The significance of oligopolistic conditions is that a seller must ever be mindful of what his competitors might do in response to what he does. A seller will hesitate to change a price, for he knows that a competitor will immediately meet it to avoid losing his market. Indeed, the competitor might even undercut the original price-cutter and set off a price war, which nearly every seller wishes to avoid. The natural result under oligopoly is for price changes to be made cautiously and under the leadership of one of the few sellers. Where such conditions exist, it is not hard to understand the temptation for one seller to confer with another about possible price, quality, or special service changes. It is also plain that once a profitable price is fixed, it is likely to be maintained for a fairly long period, its length probably depending upon whether or not demand and cost conditions undergo any material changes so as to make price adjustments worth risking.

Pure monopoly refers to a situation in which there is but one seller of a particular commodity.[1] This seller need worry only about the elasticity of consumer demand, potential competition, or government regulation of some sort. For all practical purposes, pure monopoly may exist where there are several sellers, if these are combined in some way to effect a unified price and production policy.

2. THE DETERMINATION OF PRICE. It is often said of the pure monopolist that he endeavors to fix his price at that point where sales will result in the highest possible net profits. This is true. But it is also true of every seller, whether he is operating under pure, monopolistic, or oligopolistic competition. The real difference between these several marketing situations lies in the power of sellers to accomplish this purpose.

A seller under pure competition has no problem of price-fixing. He merely

[1] A "commodity" may be defined as a good for which there are no close substitutes arising out of product differentiation. Although there may be only one Ipana toothpaste, there are other brands of toothpaste. A pure monopoly in toothpaste, then, would be a situation where there was only one seller. To be sure, the pureness of the monopoly depends upon the other possible substitutes. In the case of toothpaste, pureness would be limited by competition of other dentrifices, such as salt, toothpowder, or ordinary soap.

takes the market price as it is and sells part or all of his stock, or waits for a more favorable price. The seller under monopolistic competition has a price problem similar to that of the price monopolist. He can fix his price; the main difference is that the demand facing the monopolist is that for the commodity, while the demand facing the seller of a differentiated product is that for a substitutable brand, and is consequently smaller and more elastic than the demand for the commodity.

Under conditions of oligopoly, it is hard to say exactly what determines price. In the absence of some form of collusion, it will often be set by one of the larger of the few firms acting as a price leader. When this occurs, the price will tend to be similar to one fixed by a pure monopoly. Since entry of new competitors is made difficult because of large capital requirements or the importance of a well-known trade name, the virtual monopoly price will not ordinarily be disturbed.

Even though individual sellers may be able to fix prices to some extent under all situations except pure competition, this power is not without limit. The elasticity of demand for a particular product will place limits upon the range of profitable prices. If demand is very elastic, so that a low price will call forth a very large increase in sales, and if additional output can be produced at low cost, the price fixed by the strongest monopolist may be low. Furthermore, too high prices or too high profits may serve to entice competitors, the ultimate result being a lowering of prices or quantity sales so that no seller makes more than his costs. This has probably happened in many parts of the drug and oil industries, to mention only two.

3. Business Practices. Certain business practices of interest to the student of the monopoly problem spring from such departures from pure competition as monopolistic and oligopolistic competition. Where an attempt is made to differentiate a product, the seller naturally places primary emphasis upon selling so that he may increase the demand for his product and, if possible, make that demand less elastic. This places a premium upon non-price competition. The result is advertising, free services, such as credit, delivery, road maps, special packaging, contests, and other devices to get buyers' attention and good-will.

Where the expense and trouble of differentiating a product has been carried by the manufacturer and he does not sell directly to the consumer, the former acquires an interest in the price policies of retailer and wholesaler. One might think that if the manufacturer of a differentiated product received a price which he felt to be satisfactory, he should not concern himself with the resale price. If some manufacturers take care that resale prices are not cut, and others do not, retailers will naturally push sales of articles the resale price of which is protected. Moreover, many manufacturers contend that a stable resale price becomes a component of the good-will which the article has, and that price-cutting tends to reduce the respect of buyers for it.

As has been pointed out, where sellers are so few that the policy of any one of them has an immediate and direct effect upon sales of other sellers, an oligopoly may be said to exist. Each seller knows that efforts to increase sales by price reductions will be met with an immediate similar response from his competitors. Hence, prices are likely to be stable and uniform among sellers for rather long periods of time. When cost or demand factors change materially, changes will be made if little or no doubt exists as to their profitability. In this case, any change is likely to be initiated by a price leader or by some kind of direct or indirect collusive action of sellers. In the latter connection, the trade association has probably played a part. Even the most innocent of trade associations can help keep an oligopoly from disturbing the market. Through data collected and distributed on such matters as cost-accounting methods, production, inventories, productive capacity, unfilled orders, and sales, the trade association may make available to sellers information by which they can set their own price and production policies in line with others. The effect of such action may approximate results under a real monopoly.

Various devices for stabilization of prices are found. Selling products in every geographical location at the same price, rather than F.O.B. plant, makes it easy for all sellers in a field to know what the standard price is. Likewise, the use of basing points, whereby sales are made at delivered prices from certain points, makes price stability easier of attainment. To make sure that he is following the practice of the industry, a seller needs only to know the basing points, prices at these points, and freight rates to any purchaser.

In instances of imperfect competition,[1] especially of the oligopolistic kind, sellers sometimes attempt to share the available market. The pooling arrangement, in which sellers pooled business and divided profits, or divided territory, was in vogue at one time. But because of its tendency to be violated and its non-enforceability under common law, the pool lost most of its popularity before 1900. In a few cases, the market has been shared by using a co-operative selling company. For example, Appalachian Coals, Inc., was established in 1932 as a selling organization handling the output of one hundred and thirty-seven soft coal operators. By allocating orders and fixing sale price, this co-operative selling organization has done an effective job in apportioning a large part of the bituminous coal market. Trade associations also aid in enabling its members to share markets; by making production and sales statistics available to members, they furnish sellers with a basis upon which they can decide what is their reasonable proportion of the market.

As Burns has pointed out, however, perhaps the most generally used basis for apportioning business is found in the willingness of members of an oligopoly to observe custom.[2] Evidence that sellers observe convention has been found in

[1] "Imperfect competition" is a generic term applicable to conditions in which competition exists but is not "pure."

[2] Burns, A. R., *op. cit.*, pp. 154–70.

the meat-packing and anthracite coal industries, as well as in many other industries. In some cases, sellers seem to observe this custom for rather long periods of time. In other instances, evidence of this "live and let live" policy is found only occasionally. When it is realized how sensitive the business of one seller is to the policies of another under conditions of oligopoly, it is easy to understand how sellers would be willing to observe such a custom.

4. MONOPOLY ELEMENTS AND COMPETITION. There are few cases, indeed, where a seller has a monopoly of an important product for which there are no very close substitutes. How many cases there are in which sellers have combined to effect what is in reality a monopoly is not known. Except where special exemptions are made, the laws have forbidden collusive action which restrains trade. Hence, examples of outright collusion to effect a monopoly are not generally known.

In the popular mind, and often in the mind of the government administrator, monopoly is not limited to the single seller or the combination of sellers. Monopoly is what monopoly does. If competition is imperfect, the result is monopoly. If prices and output are not fixed by the free action of the law of supply and demand, if prices are administered by a system of price leadership, if they are uniform or rigid, or if production is carried on at materially less than capacity, monopoly is said to exist.

One of the difficulties in dealing with the so-called "monopoly problem" is the necessity of distinguishing between real monopoly, whether of one seller or a group of sellers, and the decline of competition which has appeared to be a natural result of product differentiation, economic advantages of size, and fewness of sellers. These factors introduce elements which diminish the intensity of competition, especially of price competition. These elements may even induce sellers to do those things which constitute a real monopoly. Be that as it may, if free traditional competition, bordering upon the economist's concept of pure competition, is desired, this can only be obtained by attacking the causes of the decline of competition. Before this is done, some of the economic aspects of imperfect competition in relation to sound public policy should be understood.

E. PUBLIC POLICY AND THE MONOPOLY PROBLEM

The social and economic justification for competition lies in the belief that under a freely competitive system goods wanted most by consumers will be produced by those who can produce them at least cost; and that consumers will pay no more than the cost necessary to bring goods into being in such form and at such place as desired by consumers. There is also often the feeling that a freely competitive system encourages democratic equality by equalizing the freedom to enter the market-place as an entrepreneur.

If free competition of the traditional sort is to be obtained, some fundamental

changes in the present economic system would have to be made. Business would have to be atomized so that no seller acting alone could influence the market. Goods would have to be so standardized that no seller could gain a semi-monopolistic position through trade-names or trade-marks. Or measures might have to be taken to limit size or influence by trade-names whenever free competition is threatened. Unless such steps are taken, it would seem fruitless to try to enforce thoroughgoing competition by law.

It is by no means clear that such a drastic policy would be beneficial to consumers. Production at lowest cost seems to call for large firms in many lines of economic activity. Monopoly, or near-monopoly, may be justified upon a cost basis, owing to the lower cost incident with size and the wastes of competitive duplication of facilities. Production of branded articles and the giving of special services under monopolistic competition may increase consumer satisfaction out of all proportion to any additional cost involved.

An economically sound social policy should recognize that underlying economic factors are such that free and virile competition may not be desirable in all fields of business. There may be some industries in which a monopoly would be the most efficient producing unit. There may be others in which one firm of the most efficient size could not produce enough for the market. In such a case an oligopoly of large firms might be socially desirable. Moreover, in some industries where consumers' tastes vary, and individualized products with different service or psychic qualities satisfy these tastes best, conditions of monopolistic competition may be desirable. After these industries are determined, a large field for free competition between small business units might still be left.

In view of such considerations, social policy would have to be molded to suit underlying conditions. Where a monopoly is allowed, price and service regulation should be undertaken to insure protection of buyers. In industries earmarked for an oligopoly of large producers, social policy should depend upon the degree of competition existent. If independent rivalry between sellers is not adequate to insure consumer prices consistent with costs and economic utilization of resources, regulation to gain these ends should be enforced. Where product differentiation is found to be advisable from a social point of view, society might do what it can to enlighten buyers as to what they are receiving. The government could insist upon accurate description of the article in all advertising and labeling. Possibly a method of grading might be devised, dishonest claims outlawed, packaging regulated to indicate size accurately, and special services billed separately from the cost of the article.

One may justly insist that such a program represents a vast incursion of government into the field of business. This may be true. But many of the advantages of large business enterprises and of product differentiation come from the special protection which government has placed around business. The laws regarding patents, trade-marks, protection of good-will, and limited liability

of corporate stockholders which has made incorporation so valuable, have accounted for much of the imperfectness in the competitive system. Moreover, as has been and will again be shown, government has already extended its control generally over business.

The significant fact from an economic and social point of view is that the consumer will be protected either by selfish rivalry among freely acting competitors, or by some instrument of social policy. As a general thing, breaking up business into small competitive units does not appear to be a wise plan. While there may be some cases in which competition can and should be restored, namely those of monopolistic collusion between independent sellers in which the buyer has nothing to gain, it would seem to be better in other instances, if economically justified, to protect the consumer through regulation.

There may be political reasons why such an extension of government control would seem to endanger a system of government generally thought to be good. If other considerations outweigh the economic advantages of the plan sketched, then they should be controlling. The attempt here has been to present a short account of what this writer believes to be the economically sound program of social policy in view of the recognized decline of competition. These aspects might well be kept in mind in the following chapters in which actual government policy regarding this problem is discussed.

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CHAPTER

19

REGULATION AGAINST MONOPOLY

THERE are two principal aspects of government's interference to maintain competition in business transactions. One is concerned with regulations against monopoly; the other deals with regulation of competitive practices of businesses generally. In the first type, the usual purpose is to break down combinations of enterprises which tend unduly to endanger the competitive system; these are the laws forbidding combination in restraint of trade or attempts or conspiracies to monopolize business. The second type aims to maintain a sort of plane of business behavior conducive to effective competition; in some ways, it attempts to curtail practices, regarded by a given standard of business ethics as unfair, which lead to monopoly in some form or other.

In the present chapter, the program of government toward removal of monopoly will be analyzed; in the following one, regulation of competitive practices will be surveyed. Because both kinds of regulation are devoted to the maintenance of competition, a clear division between the two programs is not always possible. Moreover, it should be noted that government regulation as herein described applies ordinarily to private businesses, as distinguished from those affected with a public interest. In the latter type of business enterprise, competition is often replaced by regulation of price and service, and these businesses are generally exempt from most of the laws to maintain competition.

A. DEVELOPMENT OF THE TRUST PROBLEM

Because many of the early monopolistic combinations were formed by the use of the business trust device, it has been customary to call any combination of business, especially where competition is substantially curtailed, a "trust." As a matter of fact, the development of the "trust" or combination problem is practically synonymous with the growth of large business enterprises. A "trust" has become what a "trust" does. The significance of the particular

form has been lost. While businesses which have grown large owing to the economies of large-scale production have often been called trusts, businesses becoming large by virtue of horizontal or vertical combination, or both, are more properly thus referred to. Hence, the so-called trust problem is essentially one of business combination with the purpose or effect of diminishing competition between once independent firms.

The combination movement is often thought of as dating from the decade following the Civil War. However, it should be recognized that combinations or monopolies are not that young. Monopolies existed in ancient Egypt and Greece; they were common in the days of feudalism; mercantilistic states of the fifteenth and sixteenth centuries often granted exclusive privileges to business groups. Even where no such privileges were granted, the natural tendency for business men to join together was generally realized. At the very time in which *laissez-faire* government policies were beginning to flower, as Adam Smith remarked in 1776, in an oft-quoted phrase, "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." [1]

1. First Period of Combination: 1880–1893. Although combinations existed before 1880 in the United States, the first period of trust development may be said to begin with the forming of business trusts for combination purposes about 1880. Consolidations of railroad companies were not uncommon in the preceding years, and mergers existed in the industrial field; moreover, some price agreements and pools were found before 1880. But the decade of the eighties ushered in the more permanent and effective combinations which gave rise to state and federal government anti-trust laws at the close of the decade.

The case of the oil trust under Rockefeller leadership presents an interesting example of the growth of these early combinations. In 1867 John D. Rockefeller united several large refining companies into the partnership of Rockefeller, Andrews, and Flagler. This partnership was succeeded by the Standard Oil Company of Ohio in 1870, a corporation capitalized at $1,000,000 and controlling 10 per cent of the oil-refining business of the country. Within ten years, this company had combined with other producers so that it controlled about 90 per cent of the oil business. This position of dominance was gained in large part by virtue of discriminatory railroad rates and rebates, by competition which crippled those refiners and producers who refused to join the Standard "alliance" of companies, and by discriminatory use of pipe-line facilities under Standard control. In 1882, the Standard Oil Company of Ohio, and the other oil companies brought under its dominance, set up a business trust by which the common stocks of the companies were placed in the hands of nine trustees. With changes in form, this combination continued to

[1] *Wealth of Nations*, bk. I, chap. X.

dominate the industry until its dissolution in 1911. Its record is one of success, with large profits, monopolistic prices, and the obliteration of competition by fair means and foul.

Combinations were formed in other fields. Among the more important were the trusts formed in the lead, whiskey, sugar, cottonseed, and linseed oil industries. Other large combinations were formed about 1890. Of these, the more important were those in the tobacco, leather, cordage, and shipbuilding industries.

The growth of combinations was somewhat checked in the early years of the nineties. Several state courts held the trustee device illegal at common law on the ground that, where used to combine corporations, such device was either unlawful as a partnership of corporations — and hence beyond corporate powers — or contrary to public policy. Moreover, the depression of 1893 caused several combinations to fail, and for several years promotion of combinations practically ceased.

2. SECOND PERIOD OF COMBINATION: 1897–1903. With the return of a degree of prosperity in 1897, the combination movement proceeded, at first cautiously, and then with extreme rapidity. The trustee device was forsaken for other forms, especially the consolidated company and the holding company. With increasing earnings, demand for stocks increased. With a ready market available for financing their schemes and with some real economies of combination to be made here and there, promoters developed new and greater combinations in practically every field of enterprise. Dewing has aptly described this period in the following language:

> Every conceivable line of manufacturing had its trust. Conservative bankers, shrewd business men, and doctrinaire economists became infected with the virus of large-scale production. People condemned the trusts one moment and bought their securities in the next. It was the harvest-time of promoters. By the end of 1899, more than 130 consolidations of considerable magnitude had been organized, all for the sole purpose of suppressing competition and increasing the scale of production.[1]

During these few years, several combinations were promoted which have been important over the years. Nearly the entire tobacco industry in the United States was brought under the control of American Tobacco Company interests by 1901 through the Consolidated Tobacco Company, the American Tobacco Company, and other companies. In 1904 all these were consolidated and a new American Tobacco Company was formed. This combination, representing the fruition of monopoly efforts dating from 1890, brought under one management group nearly all the cigarette, smoking and plug tobacco, stogy, tinfoil, and licorice business, and a significant part of the cigar production.

In 1901, the United States Steel Corporation was organized as a combina-

[1] Dewing, A. S., *Financial Policy of Corporations* (New York: Ronald Press, 3d rev. ed., 1934), pp. 740–41.

tion of a number of steel combinations representing some hundred and eighty concerns which were once independent and approximately one half of the nation's iron and steel output. In 1902, the International Harvester Company was formed as a consolidation of five leading farm-machinery firms, and thereby about 90 per cent of production for domestic market was brought under a single management. Other large promotions occurring during this period include the Diamond Match Company in 1899; the American Agricultural Chemical Company in the same year; the American Can Company, the American Locomotive Company, and the Eastman Kodak Company, all in 1901; and the Corn Products Refining Company in 1902. One should not overlook the formation of the Standard Oil Company of New Jersey as a holding company in 1899 to take over the extensive oil monopoly built up in previous years. Another combination of note was the Northern Securities Company, organized in 1901 to control the Great Northern and Northern Pacific Railroads, two competing lines in the Northwest.

Although the number of combinations declined after 1902, occurrence of the depression of 1903 brought the promotion of new combinations to an abrupt halt; but the depression was more the occasion than the cause. Several causes might be noted. Perhaps, as some believe, the combination period came to an end because there was little or nothing left to combine. There was more to it than this, however. Investors and promoters were generally disillusioned about the profits to be made by combination. Perhaps the major number of combinations were ill-advised from the start, since the anticipated economies did not measure up to promoters' and investors' expectations. A careful study of costs and economic values was not generally made when a combination was promoted, and excessive prices were often paid to combine plants on the assumption that suppression of competition would bring large profits.

Another fundamental cause for the decline in the development of combinations was the revitalization of the law against such attempts to monopolize. Even though anti-trust laws were passed by the federal and state governments around 1890, several court decisions adverse to them left the status of this legislation unsettled and led promoters to believe that the laws could not reach them. The picture was changed by some court decisions after 1900 showing that the anti-trust laws had some real force, as well as by some modifications of the statutes themselves.

3. THIRD PERIOD OF COMBINATION: 1923–1929. Many combinations of various sorts took place in the twenty years following 1903. But their number and scope were not great enough to justify the assertion that combination was markedly accelerated. With a return to fairly normal conditions after the World War and the depression of 1920, promotion of business combinations again became tempting to promoters and an increasingly large group of speculators and investors.

In the industrial field, earlier combinations had dealt primarily with manufacturing and transportation companies. In the 1920's, industrial combinations more often involved companies operating in similar markets whereby the cost of marketing a product, as distinguished from the cost of manufacture, might be reduced. The rapid development of the chain store is an interesting case in point.

But what has made this period especially notable is the extent of consolidation or other combination outside of the industrial field. These were the years of the public-utility holding company and the development of billion-dollar public-utility empires. The holding-company device was also prominently employed in the banking and railroad fields. Moreover, large banking systems and public-utility operating-company systems were built up by process of consolidation.

The 1920's are interesting not only for the rapid growth of consolidation but also for the development of many large concerns through internal growth. Many enterprises, through reinvestment and financing of new additions and betterments by capital raised from all-too-willing investors, were able to develop to a point of relative dominance in some industries without resorting much, if any, to combination with other concerns.

This period of growth was brought to a sharp close by the depression of 1929. Although many combinations in the industrial field gave evidence of having been well and economically formed, public-utility, railroad, and bank combinations were too often formed upon rather weak financial bases. As might be expected, many of them have disintegrated. Moreover, after 1929, the political situation was not favorable for continued existence of large businesses, let alone the development of many new combinations. The strict provisions of the national public-utility holding-company regulations, punitive chain-store taxes, corporate income taxes, and the government's expressed intent to enforce the anti-trust laws were not conducive to rapid combination growth, even if economic possibilities have been present.

B. COMMON-LAW REGULATION OF TRUSTS

Combination for the purpose of suppressing competition was subject to regulation under the early English trade law and the common law long before control by statute was attempted. The earliest law respecting suppression of competition or practices injurious to fair competition is found in the English Law Merchant [1] of the eleventh to fourteenth centuries. The Law Merchant was simply a code of trade practices, largely growing out of decisions of staple and fair courts. Under it, such practices as engrossing (buying in quantity with the intention of selling again at a higher price), forestalling (buying goods before they had reached the market), and regrating (buying and selling again in the same market) were offenses punishable under common law.

[1] See *supra*, pp. 5–6.

Much of the early business regulation of England, either by courts or statutes, did not find its way into modern common law. This has been due in large part to enactments by Parliament, and to the fact that many business cases did not reach the King's Bench Courts, and so did not come down in the court records. But two rules of regulatory effect did get into modern common law and became a basis for some regulation of the trusts. These had to do with conspiracy to monopolize trade and agreements to restrain trade.

1. Conspiracy to Monopolize. The common-law doctrine making conspiracy to monopolize unlawful finds its roots in the public dislike of monopoly and the old judicial principle of conspiracy. Under the early English common law, only monopolies obtained from the Crown were held by the courts to be unlawful. But the law against other monopoly was invigorated by introducing the conspiracy doctrine. Conspiracy involved the joining together of two or more parties with the purpose of inflicting harm upon a third party. Thus the common law did not hit monopolies developed by the natural growth of an individual business; yet it did touch upon practically all attempts to monopolize, since such attempts almost invariably were carried on by means of a conspiracy.

Contracts made to effect a conspiracy to monopolize were not enforceable in the courts. Any party injured by such a conspiracy had a case for the collection of damages. Moreover, conspiracy was a criminal offense in the common law, punishable by fine or imprisonment.

While the conspiracy doctrine brought attempts to monopolize within the range of legal condemnation, the criminal penalties possible for guilty parties were not generally applied. As a matter of fact, where the common law was used against industrial combinations in this country, the conspiracy doctrine was seldom the basis for legal action. By far the greater number of cases by which common-law regulation was applied had to do with agreements to restrain trade.

2. Agreements to Restrain Trade. Not all agreements to restrain trade were unenforceable in the courts under the common law. Prior to the nineteenth century, the courts regarded all contracts with a purpose of suppressing competition, or contributing to such purpose, as unenforceable. In the latter part of the nineteenth century, however, they came to the position that only contracts in unreasonable restraint of trade should be outlawed.

Such contracts were not illegal in the sense that they could not be made. They merely could not be enforced at law. Hence the law of agreements to restrain trade did not stop the forming of combinations. It did, however, make many combination transactions risky and ineffective. If any participant in a combination plan should break away from an agreement, the group had no legal means of forcing him to live up to his agreement.

3. Weaknesses of the Common Law. As a method of protecting the public against the existence and abuses of monopoly, the common law had serious

shortcomings. The fact that agreements to restrain trade were not made illegal has been mentioned. So long as participants in a combination scheme live up to their obligations, or methods of enforcement outside the courts are found, there is little in the common law which would regulate the combination. And all too often it has been profitable for participants to abide by agreements made to suppress competition. Nevertheless, the unenforceability of these contracts has often led to the dissolution of combination agreements by those participating in them.

While combinations in restraint of trade might have been dissolved under the common-law principle of conspiracy to monopolize, actually this principle was not so used. Contracts involving agreements to restrain trade reached the courts as the result of the desire by interested parties to gain their enforcement. But if the conspiracy-to-monopolize doctrine was to be employed, it would have been necessary for some interested public authority to bring the suit.[1] This was not done. When public condemnation of combination grew so strong in the 1880's that action was demanded, the authorities found that they could more easily and successfully attack the charters of corporate members of the combination. Thus, the State of New York revoked the charter of the North River Sugar Refining Company in 1890 on the ground that the stockholders, by placing their stock in a trust, had caused the corporation to do an act contrary to public policy and to abandon its corporate duties.[2]

Even if the conspiracy doctrine had been rigorously applied, the common law would have been somewhat weak. In the first place, not all agreements to suppress competition might fall under the doctrine, for the essence of conspiracy is the acting in concert for purpose of damaging third parties. In the second place, the common law provided no definite program upon which the administrative branch of government might be required to operate, nor has it provided any facilities for continuous supervision of business practices.

Since the common law was practically limited to voiding agreements in restraint of trade, it provided for no punishment of those combining. And so long as members to an agreement were willing to live up to it, there was no way by which the public might be protected from its harmful or uneconomic results.

C. STATE ANTI-TRUST LAWS

As public opposition to the trusts crystallized and the shortcomings of the common law came to be realized, the state governments as well as the federal government attempted to break up these combinations by statutory enact-

[1] Lyon, L. S., Watkins, M. W., and Abramson, V., *Government and Economic Life* (Washington: Brookings Institution, 1939), vol. I, p. 255.

[2] *People v. North River Sugar Refining Co.*, 121 N.Y. 582 (1890). Other states did likewise. See *State v. Standard Oil Co.*, 49 Ohio 137 (1892); *State v. Nebraska Distilling Co.*, 29 Neb. 700 (1890); *Distilling and Cattle Feeding Co. v. People*, 156 Ill. 448 (1895).

ments. The constitutions of many of the states had long included declarations against monopolies, but these provisions seemed to have been designed to forbid the state governments themselves from granting monopoly privileges. Acting under their powers to legislate in the general welfare and to prescribe the conduct of corporations operating within the state, states passed anti-trust laws, the first such law being placed on the statute books of Kansas early in 1889.

In that year twelve more states enacted some kind of anti-trust law, either by statute or constitutional amendment, and by 1891 nineteen states had done so.[1] Since the passing of anti-trust legislation by the federal government in 1890 and 1914, the number of state laws has increased so that at present all but seven states have some prohibitions against combinations to restrain trade or attempts to monopolize.[2] In a few cases these prohibitions are included only in the state constitutions, although they are in general supported by special statutes.

1. PROVISIONS OF STATE LAWS. While the terms of state laws differ, the purposes of their provisions are surprisingly uniform. All arrangements, contracts, agreements, or combinations designed to restrain trade are made unlawful. Most states indicate that the actions condemned are those which would suppress trade with a view to increasing prices or reducing production. These laws likewise forbid any person to enter such an arrangement upon penalty of fine or imprisonment, or both. Typical penalties are fines from $500 to $5000 and imprisonment up to one year.

Almost all the states provide for forfeiture of the charter of a convicted domestic corporation, and ousting of a convicted foreign corporation. Some make officers of the corporation liable along with the corporation. A few provide that anyone injured by an unlawful combination may receive damages equal to three times the sustained loss.

2. VALUE OF STATE ANTI-TRUST LAWS. Most authorities seem to be agreed that the state laws have not had very great effect in stopping growth of combinations in restraint of trade or breaking up those existing. Few states have attempted to enforce them. Even where attempts have been made to do so, little has been accomplished except the ousting of a few corporations and levying fines against others. So far as meeting the threat to trade which some combinations have presented, the record of the states has not been impressive.

There are many reasons for the impotence of state anti-trust regulation. Perhaps the greatest single cause has been the inherent disability of state authorities where interstate activities are concerned. Big combinations have

[1] Curtis, R. E., *The Trusts and Economic Control* (New York: McGraw-Hill Book Company, Inc., 1931), p. 116. Authorities are in disagreement as to how many states had passed laws at this time. See discussion of the point in Seager, H. R., and Gulick, C. A., *Trust and Corporation Problems* (New York: Harper and Brothers, 1929), p. 342, note.

[2] Owens, R. N., *Business Organization and Combination* (New York: Prentice-Hall, Inc., rev. ed., 1938), p. 537. These states are Delaware, Nevada, New Jersey, Oregon, Pennsylvania, Rhode Island, and West Virginia.

often been nation-wide and are seldom found to be operating entirely within a state. Charters can be forfeited only by the state granting the charter. A Delaware corporation operating in Missouri can be ousted if it is engaging in any intrastate business in that state. However, there are many ways a corporation may do business in a state purely through channels of interstate commerce, and ousting the corporation does little to solve the problem. If all producers of a certain product are combined, the state cannot always oust them all, lest it take away from its citizens a product which cannot be furnished efficiently by a small independent. Nor does fining the corporation solve the fundamental problem much better. Fines have seldom been large enough to deter combination activities, and have come to be regarded as a fee for doing business. Where fines are large, the penalty really falls upon investors, most of whom are innocent of wrongdoing. Moreover, where the corporation is doing business not constituting intrastate commerce, the state may be unable to reach it at all.

The machinery of law enforcement in most states is not adequate to the task of meeting the combination problem. Enforcement is usually left to the attorney general, or at best to some commission with general supervision over corporate activity. Such agencies often have neither the time nor the inclination to enforce the law, especially in the face of the tremendous difficulties encountered. Furthermore, states seldom have the machinery for fact-finding which is so necessary to disclose the operations of the usual combination. Even if they had such a body, the interstate nature of combination activities might make it impracticable, if not impossible, to get complete and accurate information for law-enforcement officers to use.

D. THE FEDERAL ANTI-TRUST LAWS

When one considers the nature of the combination or trust problem, there can be no doubt that the federal government is the only organization capable of dealing with it. This was realized almost as soon as the states enacted their anti-trust laws and has been well confirmed by the experience of succeeding years. The federal government entered the field by the enactment of the Sherman Anti-Trust Act in 1890. The bill was passed in both houses of Congress with only one dissenting vote. After the political campaign of 1888, there had been no organized political opposition to curbing the existence of combinations designed to suppress competition and to raise prices and curb output. The delay until 1890 was occasioned because of disagreement as to how the trusts might be regulated and what sort of combinations should fall within the purview of the laws.

Additional important anti-trust legislation was not provided by the federal government until 1914.[1] Owing to some unfavorable decisions in the courts,

[1] Some legislation was passed before 1914. The Wilson Tariff Act of 1894 made unlawful combinations seeking to restrain competition or increase prices of imported goods. Other legislation was passed to expedite the enforcement of the anti-trust laws, but none of this was of any substantial importance.

the ambiguous wording of the Sherman Act, and the belief that the law had not been administered effectively, supplementary measures were passed. These are embodied in the Clayton Act and the Federal Trade Commission Act of 1914. The Clayton Act was drawn with the purpose of forbidding certain definite practices of monopolistic combinations. The Federal Trade Commission Act established an independent administrative commission with powers of investigation and authority to police trade practices so that the growth of monopolies might be prevented. While both are properly anti-trust laws, the operation of the Federal Trade Commission has been more in the direction of maintaining a certain plane of competitive behavior than in the actual curtailing of monopolistic combinations, and is treated in the next chapter. Nevertheless, one should not forget that the Commission has done much to thwart monopoly and has furnished the government with information for proceeding under the anti-monopoly laws. In a sense, too, regulation of competitive practices is also regulation of monopoly.

1. THE SHERMAN ACT, 1890. The Sherman Anti-Trust Act was not a complicated piece of legislation, containing only eight rather brief sections. The law made illegal "every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several states, or with foreign nations." It also declared that "every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor." Likewise, persons making a contract in restraint of trade were guilty of a misdemeanor.

Various penalties were provided. Persons guilty of conspiracy or attempts to monopolize, or agreements in restraint of trade, might be fined $5000, or imprisoned for a term of one year, or both. Property of any unlawful combination being transported across state lines was subject to seizure. Persons damaged by an act of a party guilty under the law were allowed threefold payment of sustained losses, as well as all costs of the suit.

Enforcement of the law was placed under the Attorney General of the United States and the district attorney in each district. Where infractions were found to exist, it was the duty of the Attorney General and his subordinates to bring suit in a federal court asking for enjoinment of the violation and the imposition of penalties.

2. THE CLAYTON ACT, 1914. In 1903, Congress established a Department of Commerce and provided for a Bureau of Corporations within it. The elaborate reports and extensive investigations of this research organization disclosed practices which were regarded as questionable. This work also lent emphasis to the wisdom of having a governmental body to search out violations of the letter and spirit of the anti-trust laws. The Clayton Act was designed primarily to strengthen the Sherman Act by specifically invalidating certain monopolistic practices.

The Clayton Act made it unlawful for persons to discriminate in price between different purchasers of commodities, where the effect was substantially to lessen competition or to tend to create a monopoly in any line of commerce. However, exception was made where such discrimination merely took into account differences in grade, quality, quantity, or cost, or where such discrimination is necessary to meet competition. Where the effect was substantially to lessen combination or to tend to create a monopoly, tying contracts and exclusive dealing agreements were also made unlawful. Although stock of other companies might be held by a corporation for investment or for forming legitimate subsidiary companies, acquisition of share capital of one corporation by another was outlawed if the effect was substantially to lessen competition or to tend to create a monopoly.

The Clayton Act also made unlawful the interlocking of directors or employees between two or more banks or trust companies whose deposits, capital, surplus, and undivided profits aggregated more than $5,000,000. This practice was also forbidden between two or more corporations in interstate commerce, any one of which had capital, surplus, and undivided profits totaling more than $1,000,000. Likewise, interlocking relationships between railway companies were restricted, the act forbidding the making of securities, supply, or construction contracts in an amount of more than $50,000 between two companies with such relationships, unless in accordance with competitive bidding as prescribed by the Interstate Commerce Commission.

A few enforcement changes were also made. Individual officers, directors, or agents of a corporation found guilty of an anti-trust law violation were deemed to be guilty as persons along with the corporation. Any person was given the right to sue for injunctive relief from action threatening damage by a combination violating the anti-trust laws. The law also included an interesting attempt to exempt certain activities of labor unions and agricultural organizations from the anti-trust laws. This will be discussed presently in connection with exemptions.

3. Other Anti-Trust Legislation. Most other anti-trust legislation has had to do with granting special exemptions. A few measures of some substantial importance to the anti-trust legislation may be mentioned. The Federal Trade Commission Act of 1914 has already been noted. The jurisdiction of the Commission is spread over activities to raise the plane of competition and to work in aiding in the dissolution of monopolistic combinations. It is authorized to enforce the sections of the Clayton Act relative to price discrimination, tying contracts, holding companies, and interlocking directorates. It is also empowered to make investigations of business practices and management and to investigate the results of decrees obtained by the Department of Justice under the anti-trust laws.

In 1936, Congress passed the Robinson-Patman Act, by which the price-discrimination sections of the Clayton Act were modified. This law narrowed

the exceptions allowed under the Clayton Act, made the test of illegality the destruction of competition between parties to the discrimination or their customers, rather than the line of commerce, and expressly outlawed various methods by which price discriminations were effected other than through selling prices.

Where federal laws forbid combinations in restraint of trade, or attempts to monopolize, they will be discussed in the present chapter. Where the question is one of business practices inimical to competition, it will be treated in the next chapter. The student should realize, however, that laws passed to break up monopoly and those intended to enforce certain competitive practices are not only exceedingly closely related, but should be regarded as parts of the broader problem of enforcing competition.

4. Exemptions from the General Anti-Trust Laws. In the course of some fifty years, numerous specific exemptions from the federal anti-trust laws have been provided by legislation. The Clayton Act contained a section exempting the organization of farmers and laborers from anti-trust prohibitions. On this point, section 6 of the law states:

> Nothing contained in the anti-trust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for the purpose of mutual help, and not having capital stock or conducted for profit, or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall any such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the anti-trust laws.

This section does not give these organizations the power to do anything they wish, but merely to engage in lawful activities and to be free, as organizations of competitors, from the federal anti-trust laws.

The Webb-Pomerene Act of 1918 also exempted export-trade associations. Provided that no restraint of domestic trade results, associations engaging solely in the export trade are allowed to exist and to operate without fear of the anti-trust laws. These associations are required to file information as to their organization, contracts, and operations with the Federal Trade Commission. Under the law, if the Commission finds that the result of a combination is to restrain trade and commerce within the United States, it may order modifications in its business practices.

When regulation of packers and stockyards was placed in the hands of the Secretary of Agriculture in 1921, these businesses were exempted from the operation of the regular federal anti-trust laws. Strictly speaking, this legislation does not exempt packers and stockyards from anti-trust laws, for the special regulation applied in 1921 is far more rigorous and definite than regulations against monopoly generally.

The Capper-Volstead Act of 1922 widened somewhat the exemptions applicable to agriculture already provided by the Clayton Act. By its provisions,

agricultural producers were permitted to form co-operative associations to process, handle, and market their products. The co-operatives had to be operated for mutual benefit, to restrict voting power of members to one vote per person, to limit dividends on membership capital to 8 per cent per year, and were not to deal in products of non-members to an amount greater than the business done for members.

Under the temporary National Industrial Recovery Act of 1933, in operation until 1935, all businesses operating under an approved code of fair competition were exempt from the operation of the anti-trust laws. However, the Recovery Act did provide that no code of fair competition was to be approved if it promoted monopolies.

Other exemption has been granted to the railroads when consolidation is authorized under the Transportation Act of 1920. Moreover, the Transportation Act of 1933 released the railroads from the anti-trust laws if any plan of co-operation was approved by the Federal Co-ordinator of Transportation. It is interesting in this connection to note that all this transportation legislation allowing combination has required that competition not be lessened unduly. Similar exemptions have been allowed to other transport and public-utility agencies where a combination is sanctioned by some appropriate federal commission. Likewise, certain banking combinations have been exempted where approved by the Federal Reserve System authorities, and interlocking relationships have been permitted where approved as being compatible with the public interest, rather than not destructive of competition.

E. JUDICIAL INTERPRETATION OF THE FEDERAL ANTI-TRUST LAWS

Although the Sherman Act and the other laws specifically forbidding combinations or conspiracies in restraint of trade may seem to be simple, their meaning has long been the occasion of debate and uncertainty. For fifty years, the courts have been interpreting them. While the meaning of the Sherman Act is somewhat clearer than it was, say, forty years ago, its exact definition is still somewhat in dispute. Over the decades, however, certain leading cases which reached the United States Supreme Court furnish grist for the answer to many such questions as: What is restraint of trade? What is a combination? Do all combinations which reduce the volume or vigor of competition fall under the ban of the laws? If businesses happen to combine for the purpose of reducing costs and incidentally curtail competition, are they outlawed? Is size evidence of restraint of trade? When does co-operative action merely enlighten individual competitors so that they can the better follow out their selfish interests, and when does it enable them to join with competitors in a single monopolistic policy?

The rôle of the courts has been of extraordinary importance in the develop-

ment of anti-trust regulation. Their interpretation of the laws has served not only to give them meaning for future use, but has thwarted effective enforcement at some times, and placed teeth in the law at others. For example, in the first case to reach the Supreme Court, that tribunal held in 1895 that a combination of sugar manufacturers controlling 98 per cent of the sugar-refining business did not fall under the Sherman Act because it was a combination in manufacture rather than in commerce.[1] The decision in this case disillusioned those who believed that the law might curb large industrial combinations, and the belief became prevalent that it had no real meaning.

Some vitality was given to the Sherman Act by decisions in cases involving railroad rate agreements in 1897 and 1898. In the Trans-Missouri Freight Association case, handed down in 1897, a closely divided Supreme Court held that an agreement between railroads whereby rates were fixed was a clear case of direct restraint of trade and was forbidden by the Sherman Anti-Trust Act.[2] A like decision was announced in the Joint Traffic Association case in 1898.[3] In this case, the Supreme Court, again in a closely divided opinion, reaffirmed the Trans-Missouri case and held that the Sherman Act was based upon sound constitutional grounds as a valid exercise of the interstate commerce power which did not take liberty without due process of law.

The first industrial combination, a pooling arrangement between six cast-iron pipe producers, was dissolved by a decision of the Supreme Court in 1899.[4] The Court held that while control of manufacturing was involved, the combination did not limit itself to such control, as had the sugar refiners, but had exerted an immediate and direct effect upon the selling of pipe.

The effectiveness of the law was broadened in succeeding cases. In 1904, the Supreme Court upheld the right of the government to dissolve a holding company which had brought about a combination of two large competing railroads.[5] When the huge oil and tobacco combinations mentioned above were found to be unlawful in 1911, the Sherman Act had reached a position where no one doubted its power to deal with monopolistic combination.[6] Although the Supreme Court refused to order the dissolution of the United States Steel Corporation, on the ground that its largeness was no offense,[7] the legal virility of the Sherman Act and its application to genuine combinations in restraint of trade since 1911 can hardly be questioned.

Questions pertaining to interpretation have sometimes served to hinder the effectiveness of the law, but perhaps a greater cause for this ineffectiveness,

[1] *U.S. v. E. C. Knight Co.*, 156 U.S. 1 (1895).
[2] *U.S. v. Trans-Missouri Freight Association*, 166 U.S. 290 (1897).
[3] *U.S. v. Joint Traffic Association*, 171 U.S. 505 (1898).
[4] *Addyston Pipe and Steel Company v. U.S.*, 175 U.S. 211 (1899).
[5] *U.S. v. Northern Securities Company*, 193 U.S. 197 (1904).
[6] *U.S. v. Standard Oil Co. of New Jersey*, 221 U.S. 1 (1911), and *U.S. v. American Tobacco Company*, 221 U.S. 106 (1911).
[7] *U.S. v. U.S Steel Corporation*, 251 U.S. 417 (1920).

where it can be claimed, has lain in lax administration. Unless law-enforcement agencies are genuinely desirous of dissolving combinations which threaten the freedom of competition and trade, suits are not likely to be brought. Even when they have been, there have been occasions when the failure of enforcement can be ascribed to insufficient evidence or poor pleading. For example, authorities are quite well agreed that if the prosecution had taken pains to show that the practical monopoly of sugar manufacture in the sugar trust case really carried with it the purpose and result of restraining trade, the adverse decision in that case might not have been handed down by the Court.

It would be desirable to take the leading cases in which the Supreme Court has dealt with the anti-trust laws and study the facts and decision in each instance in detail. This has been well done elsewhere, however.[1] For present purposes, it may be enough to summarize the factors that the Supreme Court has considered in interpreting the anti-trust laws. From an analysis of these factors, their real meaning can be obtained.

1. PURPOSE OF THE LAW TO PROTECT COMMERCE. As has been noted in connection with the sugar trust case, the Supreme Court has taken the position that the anti-trust laws can apply only to combinations which affect interstate or foreign trade.[2] If this meant that the law applied only to railroads and other agencies clearly operating in interstate commerce, its scope would be small indeed. But there are few large combinations in any field of enterprise which do not operate in interstate commerce or carry out policies which have a direct effect upon it.

When manufacturers pool their business with a division of markets or the fixing of price or output, such operations have a direct effect upon the freedom of competition in interstate commerce. Likewise, when there is combined under one corporation almost all the tobacco or oil production of the country, the necessary result is to restrict competition in the interstate marketing of these commodities. Furthermore, with the decisions under the National Labor Relations Act,[3] by which both small and large manufacturers, miners, and other producers are found to be in the flow of interstate commerce, the fact that the anti-trust laws are limited to the protection of interstate commerce ceases to have much of a definitive meaning. It should be noted in this connection that while the trade affected must be interstate or foreign, the persons threatening the freedom of commerce need not be in interstate commerce themselves. If they are in the flow of commerce, or if they do things which have a

[1] Jenks, J. W., and Clark, W. E., *The Trust Problem* (New York: Doubleday, Doran and Company, 5th ed., 1929), chap. 16; Seager, H. R., and Gulick, C. A., *op. cit.*, chaps. 19, 21, 22; Owens, R. N., *op. cit.*, chaps. 26–28.

[2] The fact that the anti-trust laws apply to commerce only was interestingly brought out in *Federal Base Ball Club v. National League*, 259 U.S. 200 (1922). In this case, the Federal Baseball Club of Baltimore sued the National League for damages under the anti-trust laws. The Supreme Court found against the Federal Club on the ground that baseball games were not commerce within the meaning of the law.

[3] See *supra*, pp. 42–45, and *infra*, pp. 785–87.

direct effect upon commerce, their actions may be brought within the federal law.

2. THE FORM OF THE COMBINATION. There has been a general belief that certain forms of combination are more likely to run afoul of the law than others.[1] Business men and many lawyers have believed that combinations of independent producers, by which co-operative action is attempted, are more likely to be found in restraint of trade than an outright consolidation of these producers. Some grounds have existed for this belief. In the early years of anti-trust law enforcement, successful prosecution was limited to pooling agreements and combinations effected through the use of a holding company.

In the dissolution of the American Tobacco Company, the Supreme Court negatived this view. This company and some of its largest subsidiaries were themselves in large part consolidations of numerous other companies. The Court did not limit itself to ordering divestment of stock ownership between the companies. It ordered dissolution even of some of the consolidated companies. In this case, the Court emphasized that the form of the combination was of "no moment" and that the law "embraced every conceivable act which could possibly come within the spirit or purpose of the prohibitions of the law, without regard to the garb in which such acts were clothed." [2]

3. ONLY UNREASONABLE RESTRAINTS OF TRADE ARE FORBIDDEN. In interpreting the law before 1911, the majority of the Supreme Court had held to the position that the anti-trust laws forbade every agreement, combination, or conspiracy in restraint of trade. In the Trans-Missouri Freight Association case, handed down in 1897, the majority of the Court held that the Sherman Act outlawed *all* restraints and monopolies directly affecting interstate commerce. Pointing to the language of the law, the majority declared that "the plain and ordinary meaning of such language is not limited to that kind of contract alone which is in unreasonable restraint of trade, but all contracts are included in such language, and no exception or limitation can be added without placing in the act that which has been omitted by Congress." [3] Four justices dissented from this position, holding that the law should have been construed to forbid unreasonable restraints of trade only. They pointed to the definition of unlawful restraints of trade under the common law and to the fact that only unreasonable restraints were held by it to be illegal.

The rule of reasonableness was not adopted by the Supreme Court until 1911, when the Standard Oil Company was ordered dissolved. But the notion that the Sherman Act outlawed all restraints of trade continued before 1911 to be objected to by a minority of the Court, and there is evidence that one of the majority justices in the Trans-Missouri case had by 1904 come to see the

[1] See testimony of W. L. Thorp, *Investigation of Concentration of Economic Power*, pt. 1, p. 112 (1939).

[2] *U.S. v. American Tobacco Co.*, *supra*, pp. 180–81.

[3] *U.S. v. Trans-Missouri Freight Association*, *supra*, p. 328.

error of the earlier decision.[1] The position of the majority had subjected the Court to some embarrassment. For years it had been regarded as good law for sales of a business involving good-will values to be accompanied by an agreement that the seller might not enter the business again in direct competition with the purchaser. Partnerships of two or more individuals previously in competition had been allowed where the effect was not unduly to stifle competition. Indeed, almost all business contracts have some suppressing effect upon the ability of members to compete. Moreover, there were those on and off the bench who believed that the strict application of the Sherman Act might atomize business to an extent not compatible with efficient public interest.

A rule of reasonableness was read into the anti-trust laws in the opinion explaining the decision in the Standard Oil case in 1911. Although the statement of the rule in this case had little if anything to do with the decision — for under any interpretation of the law the Standard Oil Company was held to be a forbidden combination in restraint of trade — the dictum did serve to lay the legal framework for an interpretation of the law which has prevailed to the present day. In this case the Supreme Court pointed out that the language of the law must be interpreted in the light of the "existing practical conception of the law of restraint of trade," and that it did not intend to forbid every contract which might have a restraining effect upon trade, but only those contracts which, as judged by a "standard of reason," unduly restrained trade.[2] While Chief Justice White, reading the opinion for the majority, tried to point out that the law had always been interpreted in this light, his mental gymnastics were not convincing to concurring Justice Harlan, who saw not only a reversal of previous decisions but an attempt at judicial legislation.

Even though the introduction of a rule of reason may be justifiable as bringing to the law a practical interpretation, it does place words in the anti-trust laws which were not there, and it makes the determination of reasonable or unreasonable restraints an element of uncertainty in every case. Whether a combination falls under the ban of the anti-trust laws has become a matter for determination of the courts in view of facts existing in certain individual cases. This construction has made it necessary for the courts to find standards of reasonableness. The remaining factors discussed in this section serve in part to do this.

4. Intent of Parties. In determining whether certain acts of combination restrained trade in opposition to the law, the Supreme Court early emphasized the importance of intent of the parties concerned. In the Addyston Pipe Pool case, the Court pointed out as evidence of unlawfulness the fact that the combination had a "direct, immediate and *intended* effect upon the subsequent contract to sell and deliver pipe." [3] In the Standard Oil case, it found

[1] See concurring opinion of Justice Brewer, in *U.S. v. Northern Securities Company, supra*, p. 361.

[2] *Standard Oil Co. v. U.S., supra*, p. 62.

[3] *Addyston Pipe and Steel Co. v. U.S., supra*, p. 243. Italics supplied.

a "*prima facie* presumption of intent and purpose to maintain the dominancy over the oil industry" as the result of the whole history of the company and the general policy of excluding competitors.[1] The element of intent was likewise pointed out in the American Tobacco Company case.[2] Intent of parties to suppress competition has been an important aspect of numerous other decisions.

Intent has been used to acquit combinations as well as to convict. Although the case did not turn on this finding alone, the Supreme Court found that the United States Steel Corporation had not intended to monopolize but had desired to effect economies associated with large size.[3] A co-operative selling agency whose members were independent producers of bituminous coal was upheld by the Court in 1933, partly on the finding that the association intended to remove certain well-recognized evils in the coal industry and not unduly to restrict competition.[4]

5. Overt Acts of Parties. Closely related to the factor of intent is the very important consideration of overt acts of parties to an accused unlawful combination. These two factors usually go hand in hand and overt acts attest to illegal intent. As the Supreme Court said in the American Tobacco Company case:

> Indeed, the history of the combination is so replete with the doing of acts which it was the obvious purpose of the statute to forbid, so demonstrative of the existence from the beginning of a purpose to acquire dominion and control of the tobacco trade, not by the mere exertion of the ordinary right to contract and to trade, but by methods devised in order to monopolize the trade by driving competitors out of business, which were ruthlessly carried out upon the assumption that to work upon the fears or play upon the cupidity of competitors would make success possible.[5]

The Court went on to enumerate the practices of the tobacco combination by which it had unfairly come to a position of dominance.

Unfair and suppressive acts were used as the basis for finding many combinations unlawful under the anti-trust laws. This was especially true of cases in the lower federal courts.[6] Only a few of these acts can be mentioned here. In many cases, dominant position has been gained by a combination by buying out competitors and forcing them to agree not to compete for long times in the future. At times, rather liberal payments have been made by a combination for a competitor's business. But even where this has been true, monopolistic groups have often been able to force sale by a competitor under threat of destructive competition. Trade wars have been promoted by certain groups

[1] *Standard Oil Co. v. U.S.*, *supra*, p. 75.

[2] *U.S. v. American Tobacco Co.*, *supra*, p. 182.

[3] *U.S. v. U.S. Steel Corp.*, *supra*.

[4] *Appalachian Coals, Inc., v. U.S.*, 288 U.S. 344 (1933).

[5] *U.S. v. American Tobacco Co.*, *supra*, pp. 181–82.

[6] See, for example, *U.S. v. Eastman Kodak Co.*, 226 Fed. 62 (1915); *U.S. v. E. I. DuPont de Nemours and Co.*, 188 Fed. 127 (1911); *Patterson v. U.S.* (National Cash Register case), 222 Fed. 599 (1915).

in order to force competitors to withdraw from the field. Buying up plants and then closing them down as a means of controlling supply have also indicated attempts to monopolize. When combination actions are undertaken and then attempts are made to cover up these operations through dummy corporations and competitors, the natural inference is that restraint of trade is intended. Then, there is the whole group of unfair competitive practices with which the Federal Trade Commission has come to deal, which may denote the development of a combination in restraint of trade.

There are cases, however, where a large company has been developed by the aid of acts designed to gain dominance for it, and yet where the courts have not held these acts grounds for finding the combination guilty of anti-trust law violations. The United States Steel Corporation had admittedly engaged from 1901 to 1911 in certain practices aimed at curtailing competition. Before 1907 it had led in obtaining co-operation among steel producers by pools, associations, and various trade meetings. For several years after 1907, the famous Gary dinners were used to effect a gentlemen's agreement in the trade. But six months before the government brought a suit under the anti-trust laws, these activities were abandoned. Finding that the abandonment was not in prophecy or dread of the suit, and that the corporation was not engaging in such acts at the time of the suit, the United States Supreme Court did not allow these acts to be taken as presumptive evidence of restraint of trade.[1]

The existence of overt acts does not make a conclusive case of restraint of trade. If such practices are being engaged in at the time of the suit, doubtless they would have great weight in determining the result. If, however, a combination is to be freed from the anti-trust laws merely because it has discontinued practices regarded as tending toward monopoly, the laws might be circumvented unless prosecution can be started while the combining or monopolizing is taking place. But this does not seem to be the necessary import of the United States Steel case. In this case, and in others where past overt acts have been overlooked, there were other reasons why the Court was unwilling to order dissolution. Where competition has not been stamped out and where the combination has appeared to be economically justified, some trusts have been looked upon as "good" trusts.

6. Mere Size Is Not an Offense. In the Northern Securities Company case, before the introduction of the rule of reason, the Supreme Court held that the mere existence of a large combination with power over a great part of trade constituted a "menace to, and a restraint upon, that freedom of commerce which Congress intended to recognize and protect."[2] Yet after the rule

[1] *U.S. v. U.S. Steel Corp.*, *supra*, pp. 444–45.

[2] *Northern Securities Co. v. U.S.*, *supra*, p. 327. Typical of early court opinion is the statement of a lower federal court in *U.S. v. Patten*, 187 Fed. 664 (1911). At p. 672 the court declared that "trade and commerce are 'monopolized' within the meaning of the federal statute, when, as the result of efforts to that end, such power is obtained that a few persons acting together can control the prices of a commodity moving in interstate commerce. It is not necessary that the power thus obtained be exercised. Its existence is sufficient."

of reason was adopted, its application brought into being the principle that mere size is not an offense under the anti-trust laws.

The first case in which the Supreme Court enunciated this principle was that in which it refused to find the United States Steel Corporation a combination in restraint of trade.[1] When the Steel Corporation was organized in 1901, it was in reality a combination of combinations in the steel industry and was certainly organized with a view to reducing competition. But competition still existed in the steel industry, and although the company had a place of leadership, the government was unable to prove that it had abused its power. In examining the case of the government against the United States Steel Corporation, the Supreme Court found, then, that despite the size of the corporation's business, competition existed in the industry, that monopolistic practices had been abandoned, that prices did not indicate monopolistic control, and that the corporation was not using its position to restrain the trade of competitors. This left, as evidence of unlawful combination, the element of size of the business. The Court refused to interpret the law as making "mere size an offense or the existence of unexerted power an offense." Moreover, it held that the public interest might be injured if the corporation were dissolved.

Two important principles stand out in the Steel Corporation case. The first is the very significant one that under a reasonable construction of the anti-trust laws mere size is not an offense. The second has to do with the introduction of the idea of a good trust. A good trust is apparently one which has abandoned its objectionable practices and which, at the same time, is efficiently conceived, so that breaking it up would actually cause a loss to the public. The notion that the public may have an interest in the maintenance of a large and efficient organization is so important that it might well be treated as a separate factor which the courts have come to recognize in anti-trust law enforcement.

In the years following the decision concerning the United States Steel Corporation, the Supreme Court has had a number of occasions to repeat its stand. There is evidence that this concept of size and "goodness" has been a basis for the courts' allowing the existence of enterprises which are economically and ethically defensible. In the International Harvester Company case, in spite of the fact that the company controlled 64 per cent of the harvesting-machinery business, the Court held that trade was not unduly suppressed and implied that it was not in the public interest to dissolve the company.[2] Similar conclusions were reached in 1936 in a case involving the manufacture of women's dresses.[3]

[1] *U.S. v. U.S. Steel Corporation, supra.* In 1916, a lower federal court decided in favor of the American Can Company on pretty much the same grounds as those used by the Supreme Court to uphold the United States Steel Corporation. In *U.S. v. American Can Co.*, 230 Fed. 859 (1916), the court showed a reluctance to disturb the organization of the American Can Company, merely because it was big or had been developed by questionable practices, since abandoned. The court frankly stated that it felt the company was an efficient organization doing an excellent public service.

[2] *U.S. v. International Harvester Co.*, 274 U.S. 693 (1927).

[3] *Filene's Sons Co. v. Fashion Originator's Guild of America*, 14 Fed. Supp. 353 (1936).

An interesting case was presented to the Supreme Court in 1933. In order to stabilize their business, one hundred and thirty-seven producers of bituminous coal operating in the Appalachian coal fields created a joint selling agency, known as Appalachian Coals, Incorporated. Each producer constituted the agency its exclusive sales agent. Thus, by means of the selling agency uniform prices and allocation of available business were obtained. The Supreme Court refused to dissolve this co-operative plan.[1] It pointed out that while the combined producers controlled 73 per cent of commercial production in Appalachian territory, creation of the joint agency did not harm competition unreasonably in the whole bituminous coal industry. Moreover, the Court held that through elimination of competitive evils the combination appeared to foster fair competitive opportunities.

7. EFFECTS UPON PRICE. One of the factors which has bearing upon the finding of anti-trust violation has been the effect of a combination agreement upon price. In the early cases on railroad rate agreements and the Addyston Pipe Pool, the Supreme Court emphasized that agreements to foreclose competition and fix prices were clearly forbidden by the Sherman Act. The importance of price-fixing by combination methods as an indication of violation was also pointed out in cases involving trade-association activities [2] and resale price maintenance.[3]

Price-fixing may present conclusive evidence of an unlawful restraint of trade, even though the resulting prices are reasonable. In a case in 1927, the Supreme Court held that a restraint of trade does not become reasonable merely because the prices so fixed are reasonable.[4] Pointing out that the Sherman Act was based upon the assumption that maintenance of competition is desirable public policy, the Court declared that the important thing is the restraint of competition and the power to fix prices, and that the reasonable price at one time may become an unreasonable price later.

The importance of price-fixing as denoting unlawful restraint of trade was again emphasized by the Supreme Court in 1940. In a case involving price-fixing activities by a combination of oil refiners, the Court held that the artificial fixing of prices by a combination of private parties cannot be justified under the anti-trust laws, even if such action seems desirable to remove competitive abuses or evils.[5] The Court pointed out that it had "consistently and

[1] *Appalachian Coals, Inc., v. U.S.*, 288 U.S. 344 (1933).

[2] See, for example, *American Column and Lumber Co. v. U.S.*, 257 U.S. 377 (1921). At p. 409 the Court said, "These quotations are sufficient to show beyond discussion that the purpose of the organization, and especially of the frequent meetings, was to bring about a concerted effort to raise prices regardless of cost or merit, and so was unlawful...."

[3] In *Dr. Miles Medical Co. v. John D. Park and Sons Co.*, 220 U.S. 373 (1911), the Supreme Court condemned resale price contracts as involving a restraint of trade, primarily because of an attempt to fix dealer prices of an article which was in the channels of commerce. This doctrine has been somewhat modified. See *infra*, pp. 454–56.

[4] *U.S. v. Trenton Potteries Co.*, 273 U.S. 392 (1927).

[5] *U.S. v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

without deviation adhered to the principle that price-fixing agreements are unlawful per se under the Sherman Act," and that the reasonableness of the prices so fixed is of no legal importance, since "those who fixed reasonable prices today would perpetrate unreasonable prices tomorrow. . . ." [1]

8. EXEMPTIONS AND THE LAW. When Congress has exempted certain activities from the action of the anti-trust laws, questions have been raised as to the extent and meaning of these exemptions. As was indicated above in the survey of the laws, Congress has at one time or another exempted labor unions, agricultural associations, export combinations, and railroads, as well as those businesses covered by National Industrial Recovery Act codes, and packers and stockyards to which special legislation has applied. Because railroad, banking, and packing-company combinations and stockyards have been placed under special regulation, as have export associations, the real problems of what exemption means are most usually met in the fields of labor unions and agricultural associations.

It will be recalled that labor unions and agricultural associations were exempted from the anti-trust laws by the Clayton Act of 1914. This act merely stated that the anti-trust laws were not to be construed to forbid the existence and operations of these organizations or their members in "lawfully carrying out the legitimate objects thereof." But the Clayton Act did not grant entire exemption. As the Supreme Court pointed out in a case involving labor unions in 1921, it did not exempt organizations or their members "from accountability where they depart from . . . normal and legitimate objects and engage in an actual combination or conspiracy in restraint of trade." [2] Thus, so far as the exemptions under the Clayton Act are concerned, these organizations were removed from the anti-trust law only to the extent of the right to combine and the right to carry on activities which do not unreasonably restrict interstate commerce.

Agricultural associations were granted additional exemption under the Capper-Volstead Act of 1922. It should be noted that activities of these associations were exempt so long as they were formed in conformity with legal requirements, and so long as the Secretary of Agriculture found no monopolizing or restraint of trade which caused agricultural prices to be unduly enhanced. Other agricultural legislation, including the Agricultural Adjustment Act of 1933 and the Agricultural Marketing Agreements Act of 1937, allowed co-operative organizations to market produce without being completely subject to the anti-trust laws. The United States Supreme Court has insisted, however, that laws exempting agricultural associations do not authorize any combination or conspiracy in restraint of trade that these producers may see fit to devise.[3] Although actions specifically exempted by law do not

[1] *U.S. v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 221 (1940).
[2] *Duplex Printing Press Co. v. Deering*, 254 U.S. 443, 469 (1921).
[3] *U.S. v. Borden Co.*, 308 U.S. 188 (1939).

fall under the ban of the anti-trust laws, conspiracies with other than purely agricultural groups to maintain artificial and non-competitive prices are held to be unlawful.

The exact meaning of the exemption of labor unions from the anti-trust laws has been subject to uncertainty as the result of court decisions. The principle seems to be that unions are not forbidden to take steps to improve hours, wages, or working conditions, but they may not act so as to place unreasonable restraints upon interstate commerce, nor may they use methods deemed to be unlawful.

The application of this principle and the apparent change wrought in its construction in 1941 may be illustrated by a few cases. In attempting to organize the Duplex Printing Press Company, the machinists' union some years ago called a strike against a manufacturer and attempted a secondary boycott by inducing printers not to use presses manufactured by the Duplex Company and by urging truckers not to haul them. The United States Supreme Court held that the placing of a secondary boycott upon the trade of other producers constituted an unreasonable restriction of interstate commerce and was hence unlawful under the anti-trust laws.[1] In another leading case, the Supreme Court found that an attempt by coal miners to hinder the production and distribution of non-union coal was an unlawful interference with interstate commerce.[2]

In a case decided in 1927, the Supreme Court, with three justices dissenting, applied the anti-trust laws to union activity designed to force an employer to use union labor.[3] The International Stone Cutters' Union had ordered members of its locals to refuse to work on stone on which non-union cutters had been employed. While the Supreme Court did not deny that the ultimate purpose of the stone cutters — unionization — was lawful, it did find that causing loss or reduction of business of companies quarrying and fabricating stone by concerted action was unlawful.

On the basis of such court decisions, Assistant Attorney General Thurman W. Arnold announced in 1939 the policy upon which the Department of Justice would proceed against union activity.[4] He stated that practices which have "no reasonable connection with such legitimate objectives as wages, hours, safety, health, undue speeding up, or the right of collective bargaining" are punishable under the law. In this connection he noted five union practices which he felt to be against the law. They are: (1) unreasonable restraints designed to prevent use of cheaper material, improved equipment, or more efficient methods; (2) unreasonable restraints designed to compel the hiring of useless and unnecessary labor; (3) unreasonable restraints designed to enforce

[1] *Duplex Printing Press Co. v. Deering, supra.*

[2] *Coronado Coal Company v. United Mine Workers*, 268 U.S. 295 (1925).

[3] *Bedford Cut Stone Company v. Stone Cutters' Association*, 274 U.S. 37 (1927).

[4] *New York Times*, November 20, 1939, p. 1.

systems of graft and extortion; (4) unreasonable restraints designed to enforce illegally fixed prices; (5) unreasonable restraints designed to destroy an established system of collective bargaining (by this is meant the practice of one union making war upon another by striking against employers who deal with that union).

The program of enforcement of the anti-trust laws against union activities has had some interesting results in the United States Supreme Court. In 1939, the Court upheld the government when it charged that a labor union could not lawfully combine with milk distributors to prevent milk from being shipped into Chicago by parties who refused to fix milk prices.[1] But in a surprising case handed down early in 1941, the United States Supreme Court did not support the government and also reversed the implications of several earlier cases. In this case, the Court held that, if a labor union struck against an employer and boycotted his products because he had hired workers from a rival union, such action was exempted from the anti-trust laws by the Clayton Act.[2] It took the attitude that a jurisdictional dispute between labor unions and a boycott arising from it were elements of a controversy concerning terms and conditions of employment and were exempted by the Clayton Act.[3]

The present status of the anti-trust laws as applied to labor apparently is that labor is not bound by them unless it joins with non-union groups for the restraint of trade. Those very serious restraints of trade which arise from jurisdictional disputes and strikes to enforce any kind of strictly union policy appear to be outside the scope of the laws. Thus, most of the restraints which Assistant Attorney General Arnold felt to be outlawed now seem to be lawful. Clearly, such an interpretation of the anti-trust laws leaves a large breach in the restraints upon interstate commerce which those laws were designed to remove.

9. Interpretation of the Laws: Conclusions. Critics have long pointed to the federal anti-trust laws as an example of legislation which cannot be given any definite meaning. Business men have objected to the laws because they claim that they never know until a particular case has been decided whether certain actions are unlawful or not. As a matter of fact, as the anti-trust laws have been interpreted, there may well be question as to their applicability in special cases. Although the existence of a restraint affecting interstate commerce is often difficult to understand, the problem is made all the more difficult by the fact that only *unreasonable* restraints are forbidden. But the purposes of the anti-trust laws are not so difficult to comprehend, nor are most of the factors affecting reasonableness, discussed above.

[1] *U.S. v. Borden, supra.* [2] *U.S. v. Hutcheson*, 85 Law. Ed. (Adv. Sheets) 422 (1941).

[3] The Court took judicial notice of the desire of Congress to remove labor disputes from the realm of federal government restrictions by the Norris-LaGuardia Act which limited the power of courts in granting injunctions against union activity. The majority held that such legislation indicated that Congress desired a policy less restrictive of union actions. The minority pointed out, however, that such a policy was not stated in the anti-trust laws and that the majority was undertaking to "legislate where Congress has refused to do so."

Perhaps no better summary of the meaning of the anti-trust laws can be found than that given by a former President, legal scholar, and Chief Justice of the Supreme Court. Writing in 1914, former President William Howard Taft said of the anti-trust laws:

> It is possible for the owners of a business of manufacturing and selling useful articles of merchandise so to conduct their business as not to violate the inhibitions of the anti-trust law and yet to secure to themselves the benefit of management and of production due to the concentration under one control of large capital and many plants.
>
> If they use no other inducement than the constant low price of their product and its good quality to attract custom, and their business is a profitable one, they violate no law.
>
> But if they attempt by a use of their preponderating capital and by a sale of their goods temporarily at unduly low prices, to drive out of business their competitors, or if they attempt, by price-controlling contracts with their patrons and threats of non-dealing except upon such contracts, or by other methods of a similar character, to use the largeness of their resources and the extent of their output compared with the total output as a means of compelling custom and frightening off competition, then they disclose a purpose to restrain trade and establish a monopoly and violate the act.[1]

In spite of President Taft's concise and clear statement, there are necessarily matters which are not capable of exact classification. Reasonable persons could take different points of view in some cases on questions of use of power to restrain trade and intent to monopolize. Where this is true, obviously the legal and economic philosophies of those who sit upon the bench will have much to do in determining exactly what the anti-trust laws mean.

F. TRADE ASSOCIATIONS AND THE LAW

One of several special issues of anti-trust policy has had to do with the proper activities of trade associations. Although organization of business men on a trade basis has existed at least since 1850, new impetus to this form of combination came in 1912 with the publication of a book entitled *The New Competition*, by Arthur J. Eddy, a Chicago corporation lawyer. Mr. Eddy's thesis was that competition could be made more free and open if business men could have information about the price and production policies of competitors. This idea was adopted by many trade associations, and compilation and dissemination of trade data became one of their principal functions. In addition, trade associations have generally engaged in co-operative research, advertising, and lobbying, and have done much to encourage uniform accounting methods, codes of business ethics, and size and quality standards.

Under government aid and encouragement, trade associations grew rapidly during and after the World War. The Department of Commerce co-operated with them in compiling business statistics, and the Federal Trade Commission

[1] *The Anti-Trust Act and the Supreme Court* (New York: Harper and Brothers, 1914), pp. 126–27.

worked with them in formulating business-practice codes. The heyday of the trade association came with the enactment of the temporary National Industrial Recovery Act of 1933. In forming the codes of fair competition under this law, the trade associations in the various industries performed the principal task of drawing up the codes and furnishing the government with data and personnel for making them workable.

There are some seven thousand trade associations in the country; more than twenty-four hundred of these are national or international in scope.[1] The trade association is frankly a device to obtain co-operation among business men who are generally in competition with each other. Since it can hardly be expected that the anti-trust laws were devised to forbid all such co-operation, the problem of trade-association activities is primarily to divide the unlawful activities from the lawful. Obviously, the trade association can be used as a means for working a destruction of competition. Just as obviously, it can be used to sharpen competition and to reduce wastes to society by spreading business information.

1. Lawful Activities of Trade Associations. Scrutiny of trade-association activities for anti-trust law violations has been pretty generally limited to those matters by which the degree of price competition in an industry might be affected. Co-operation for advertising, research, business ethics, and standardization of size and grade has not been the basis for violation of the anti-trust laws. It is in the realm of price and production statistics and policy that such violations have come.

The scope of permissible activities is given in several cases where trade-association programs were upheld. One of the first of such cases was concerned with the Maple Flooring Manufacturers' Association.[2] This trade association, among other things, distributed information on flooring inventories of manufacturers, current production, shipments, costs, freight rates, and prices in actual sales. It was attacked as being in effect a combination the purpose of which was to restrain trade. The Supreme Court found in favor of the trade association, holding that the dissemination of information by it did not constitute violation of the law. The Court found no restraint of trade from the mere fact that dissemination of information enabled individual producers to "stabilize prices or limit production through a better understanding of economic laws and a more general ability to conform to them, for the simple reason that the Sherman Law neither repeals economic laws nor prohibits the gathering and dissemination of information."[3] The Court insisted that:

> We decide only that trade associations or combinations of persons or corporations which openly and fairly gather and disseminate information as to the cost of their product, the volume of production, the actual price which the product has brought in past transactions, stocks of merchandise on hand, approximate cost of

[1] Owens, R. N., *Business Organization and Combination*, p. 478.

[2] *Maple Flooring Manufacturers' Assoc. v. U.S.*, 268 U.S. 563 (1925).

[3] *Ibid.*, p. 584.

> transportation from the principal point of shipment to the points of consumption as did these defendants and who, as they did, meet and discuss such information and statistics without however reaching or attempting to reach any agreement or any concerted action with respect to prices or production or restraining competition, do not thereby engage in unlawful restraint of commerce.[1]

A like decision was reached in a case involving the Cement Manufacturers' Protective Association in 1924.[2] In answer to the complaint that dissemination of production and sales information tended to produce an unlawful restraint of commerce, the Supreme Court failed to find a basis for illegality. The Court pointed out that while the natural effect of wider and more scientific knowledge of business conditions might work toward a stabilization of price and production, there was no evidence of concerted action to control policies of individual members of the association.

2. UNLAWFUL ACTIVITIES OF TRADE ASSOCIATIONS. The activities of many trade associations have been held to constitute an unlawful combination in restraint of trade. The program of the American Hardwood Manufacturers' Association resulted in such a decision.[3] In this case, however, more than mere dissemination of information was attempted. Weekly reports were required of each member and the association audited these reports to insure complete accuracy. Information published by the association identified every member's price and production policies so that he knew exactly what every other member was doing. Market letters were sent out by the association suggesting restriction of output and maintenance or increase of prices. By exposing members who were engaging in price-cutting tactics and by holding meetings at which future price and production policies were discussed, the association was actively engaged in fixing uniform price and production practices for the trade. Hence, the Supreme Court found that the association was not only spreading information for its members but was restraining interstate commerce by concerted action to curtail production and increase prices.

Similar conclusions were reached by the Supreme Court in 1923 with a like plan of the Linseed Crushers' Council, a trade association of linseed oil producers.[4] This association had gone even farther than the Hardwood Association and had levied fines on members for non-attendance at meetings, had forced members to explain departures from published prices, and had put recalcitrants "on the carpet." Likewise, practices of the Sugar Institute, a trade association of sugar-refining companies, whereby attempts were made to fix prices, were enjoined by a decision of the Supreme Court in 1936.[5] In this case the Court did not object to dissemination of price information; what was found to be objectionable was the machinery which the association had to

[1] *Maple Flooring Manufacturers' Assoc. v. U.S.*, 268 U.S. 563, 586 (1925).
[2] *Cement Manufacturers' Protective Assoc. v. U.S.*, 268 U.S. 588 (1925).
[3] *American Column and Lumber Co. v. U.S.*, 257 U.S. 377 (1921).
[4] *U.S. v. American Linseed Oil Co.*, 262 U.S. 371 (1923).
[5] *Sugar Institute, Inc., v. U.S.*, 297 U.S. 553 (1936).

enforce adherence by members to prices and terms of sale announced in advance.

3. TRADE ASSOCIATION ACTIVITIES: CONCLUSIONS. The legal position of trade associations under the anti-trust laws is not too difficult to comprehend. The Supreme Court has shown a willingness to allow full interchange of information between members, even if individual members, acting independently and in their own interest, should use this information to bring their price and production policies in line with others in the industry. A trade-association program becomes unlawful when the association undertakes measures to enforce or secure compliance of members with a unified price or production policy through concerted action. The element of control through combination, where the individual producer is pressed to keep in line, is what seems to make for invalidity.

G. RESALE PRICE MAINTENANCE AND THE ANTI-TRUST LAWS

Resale price maintenance is the practice of producers selling an article to a wholesaler or retailer with the proviso that such article is not to be sold below a certain specified price. As such, it represents a *vertical* price-fixing combination. Since fixing of resale prices has been dealt with as a matter of fair competition, as well as in connection with the anti-trust laws, it may well be discussed in both the present and the following chapters. Because resale price maintenance has been given legal standing in state fair trade laws, it will be discussed more fully below.[1] The present treatment will merely point out its relationship to anti-trust regulation.

1. RESALE PRICE MAINTENANCE UNDER THE ANTI-TRUST LAWS. One of the most important cases involving resale price maintenance to be decided under the anti-trust laws was the Dr. Miles Medical Company case of 1911.[2] This company attempted to fix resale prices of its medicines by entering into contracts with jobbers and wholesalers who agreed not to sell to any retailer unless the retailer in turn agreed to sell at prices fixed by the company. The case was brought by the Medical Company to enjoin a wholesaler from interfering with the operation of these contracts. The Supreme Court found these contracts to be in restraint of trade, pointing out that a producer, having sold articles at a price satisfactory to himself, cannot undertake to control subsequent competition in the good.

Similar arrangements to control resale prices of patented goods were held to be an unlawful restraint of trade for like reasons in 1913.[3] Maintaining prices through a system of licenses whereby the purchaser was only licensed to use a patented article and the selling price was the royalty paid for use was

[1] See *infra*, pp. 489–97.

[2] *Dr. Miles Medical Co. v. John D. Park and Sons Co.*, 220 U.S. 373 (1911).

[3] *Bauer v. O'Donnell*, 229 U.S. 1 (1913).

also found unlawful.[1] Likewise, resale price maintenance under copyrights has been turned down by the Supreme Court.[2]

When the Colgate Company undertook to fix resale prices by persuasion, the Supreme Court found no unlawful restraint of trade.[3] The company used no contracts or other agreements to establish resale price maintenance. Instead, it circulated price suggestions to dealers and asked for their co-operation in maintaining these prices. It took pains to investigate whether dealers were charging these prices. If a dealer was not, the company merely refused to sell him additional stocks, usually giving some specious excuse for not so doing. The Supreme Court held that individual manufacturers or wholesalers in private businesses have a right to deal or refuse to deal with whomever they please. Since the company was not binding its dealers to sell on specified terms, its later refusal to deal was held not to constitute any unlawful restraint of trade.

The position of resale price maintenance under the anti-trust laws is made clearer by noting a case arising under the Federal Trade Commission. The Beech-Nut Packing Company followed the general outline of the Colgate Company resale price maintenance policy. But the Beech-Nut Company announced in advance its refusal to deal with price-cutters, and went to some pains to keep an index of those dealers who did not charge suggested prices. The Supreme Court held that this plan included more than mere co-operation by request, since dealers knew exactly what the penalty was to be, and that the result was suppression of competition as effectual as if outright agreements were made.[4]

2. Present Suspension of Anti-Trust Laws. By virtue of the Tydings-Miller Act of 1937, operation of the anti-trust laws was suspended where resale price contracts are made pursuant to provisions of state fair-trade laws. By these state laws, special legislative authority was granted to sellers of branded merchandise to fix resale prices by contract. The federal law merely allows these contracts to be effective in interstate commerce without danger of running afoul of the anti-trust laws. Hence, where enabling state laws are found, the resale price maintenance problem as an infraction of the anti-trust laws does not exist at present. Whether this aspect of anti-trust enforcement will ever be in force again will depend upon the effectiveness of consumer reaction to resale price maintenance, especially if the resulting prices tend to be materially higher than they were before 1937.

It should be emphasized that the Tydings-Miller Act and the various state fair-trade acts only legalize vertical price-fixing. Should agreements be made to fix prices of similar products in competition with each other, the anti-trust

[1] *Straus v. Victor Talking Machine Co.*, 243 U.S. 490 (1917).
[2] *Bobbs-Merrill v. Straus*, 210 U.S. 339 (1908).
[3] *U.S. v. Colgate and Co.*, 250 U.S. 300 (1919).
[4] *Fed. Trade Com. v. Beech-Nut Packing Co.*, 257 U.S. 441 (1922).

restrictions would clearly be valid. Whether resale price maintenance can be successful without some degree of horizontal price agreement is open to question. Evidence is easily found that when one manufacturer of a branded product in general competition with other goods refuses to fix his resale prices, the success of competitors fixing prices by contract is endangered.[1] Because of this situation, it would seem altogether natural for those manufacturers wishing to keep their resale contracts to take appropriate action to influence other manufacturers to use them. Moreover, when goods are generally competing, the fixed prices would have to be in line so that consumers might not be influenced too much by price, and so that dealers might not find it so advantageous to cut prices.

While collusive tactics may not be employed in connection with the fixing of resale prices, there is obviously tremendous pressure to engage in activities clearly forbidden by the anti-trust laws. At least, law enforcement agencies should not overlook the fact that only vertical price agreements are made valid and that horizontal agreements may easily accompany resale price maintenance.

H. PATENT MONOPOLIES AND THE ANTI-TRUST LAWS

In order to encourage invention and the advancement of the arts and sciences, inventors are allowed by law to have the exclusive use or control of patented devices. The patent-holder may assign his patent rights as he chooses and may attach such conditions to the use of the patents as he wishes. In other words, to the extent of the matter covered and for the life of a patent, the patent laws confer an individual monopoly on the holder.

If control is exerted by the individual acting alone over matters directly pertaining to the patent, administration of patent rights involves no question of violation of the anti-trust laws. Questions arise when the patent right is used as a means of restraining trade beyond the lawful power of the patentee, or when patent-holders join together in doing something in concert which restrains trade. Use of patents has most generally fallen under the jurisdiction of the anti-trust laws when it forms a basis for resale price maintenance, enforcement of tying contracts, unlawful extension of control, or combination of patents under patent pools.

1. PATENTS AND RESALE PRICE MAINTENANCE. The practice of fixing resale prices as an aspect of contracts for the use of patented articles has already been dealt with in the discussion above. Until the operation of the anti-trust laws was suspended as applied to resale price maintenance, the Supreme

[1] Note, for example, the news item in the *New York Times* for December 13, 1939, at p. 28. It discloses that when the producer of one brand of whiskey threatened to withdraw his resale price contracts, great consternation was felt in the industry as to what might happen to the prices of other producers. Such a situation would seem to make it difficult for other producers not to put pressure on the producer dropping his contracts to replace them.

Court had generally held that a patentee could not control the resale price of a patented article. He had full power to fix the price at which he might sell the patented good, and he had the exclusive right to determine who might sell it in the first instance; but once he had sold it at a price satisfactory to himself, the courts have held that his patent right did not extend to the fixing of resale price by a purchaser.

2. Patents and Tying Contracts. While a more extended discussion of tying contracts is reserved for the next chapter, the relationship of this kind of competitive restriction to patents may be noted at this point. A tying contract is a contract of sale or lease by which the seller or lessor binds the buyer or lessee, in return for the privilege of getting a certain good, to purchase or rent other articles. If a patented article is subject to a fairly inelastic demand, withholding its sale, except upon such condition, may be an effective means of selling a good for which the demand is fairly elastic.

Before the Clayton Act was passed in 1914, tying contracts were held to be legal.[1] The position of the Supreme Court was that such a condition of sale of patented articles was a valid result of the control vested in a patentee. If a patent-holder had exclusive use or control of an article, he could sell the article upon such terms of sale as he desired.

Under the Clayton Act, tying contracts were specifically prohibited, whether used with patented or unpatented goods. Because of this provision, the courts have held that tying clauses are unlawful as involving a restraint of trade.[2] It seems perfectly reasonable to assume that tying contracts could have been held unlawful under the Sherman Act. All the Clayton Act did was to define this practice as one tending toward monopoly and hence unlawful. Consequently, the later law merely did by legislation what might have been done by judicial interpretation.

3. Extension of Control Under Patents. The monopolistic rights which patent-holders enjoy do not justify the extension of the monopoly control to matters not immediately concerned with the patents. The fixing of resale prices and the making of tying contracts in connection with patents are really cases in which patent-holders have used their monopoly powers to extend their control beyond the exclusive rights granted under the patents. But the unlawful extension of power under patents may go much further. For example, in 1940 the United States Supreme Court found that a company which owned patents for a good had used the patent monopoly as a means of building up a combination and controlling prices.[3] This company, the Ethyl Gasoline Corporation, producing under patent a fluid to increase the octane rating of

[1] See *Henry v. A. B. Dick Co.*, 224 U.S. 1 (1912), and *U.S. v. United Shoe Machinery Co.*, 247 U.S. 32 (1918). Both cases were brought under the Sherman Act.

[2] See *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*, 243 U.S. 502 (1917); *United Shoe Machinery Co. v. U.S.*, 258 U.S. 451 (1922); and *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

[3] *Ethyl Gasoline Corporation v. U.S.*, 309 U.S. 436 (1940).

gasoline, had not only controlled gasoline-selling policies of refiners, but had forced gasoline jobbers into contracts by which jobbers' prices were fixed and competition between jobbers was suppressed. The Supreme Court pointed out in the case involving this practice that such contracts or combinations, which were used to obstruct the free flow of interstate commerce, were in violation of the Sherman Act, even in the case of a patented article, after the article is sold by the patentee or his licensee. In other words, the power of the holder of a patent does not extend to the right to restrain trade in any way, after the patented article has left the hands of the patentee or the person producing it under license.

4. PATENT POOLS. As the number of patents has increased in many lines of industry, producers have found it generally advisable to pool patents. By doing so all producers of a certain commodity may obtain the latest mechanical devices without danger of patent infringement and the costly suits which arise. Since so many goods involve a number of patents, and an individual producer seldom has all the needed patents, the system of pooling patents often works to the advantage of all patent-holders.

Patents may be pooled in several ways. Patent-holders may work out cross-licensing agreements on a reciprocal basis, or they may assign the patents to a trustee or a corporation which is authorized to issue licenses for the use of patents. Patents are also pooled sometimes by giving powers of attorney to a central administrative association, which in turn licenses users.

Patent pools have grown up in many industries. Patents have been pooled in the automobile industry through a cross-licensing agreement of members of the Automobile Manufacturers Association since 1914. In 1938, there were nearly eleven hundred patents covered by these agreements.[1] Of course there were many additional patents not placed in the pool. The Radio Corporation of America has been an agency whereby many radio and other communication patents have been pooled. Patents have also been pooled in such industries as hosiery, aviation, oil refining, and motion pictures, to mention only a few.

The legal status of patent pools depends upon whether the patents are pooled primarily to limit competition or for the purposes of increased efficiency and decreased patent litigation. For example, a pool of patents held by manufacturers of enameled ironware was formed in 1910. The manufacturers agreed not to sell except at certain fixed prices and not to deal with jobbers except those who resold at prices fixed by the pool. The United States Supreme Court found this arrangement to be a combination in restraint of trade in violation of the Sherman Act, since these agreements were hardly necessary to protect the use of a patent, but were designed to restrain competition in the industry.[2]

[1] *Investigation of Concentration of Economic Power*, pt. 2, p. 292 (1939).

[2] *Standard Sanitary Mfg. Co. v. U.S.*, 226 U.S. 20 (1912). Other cases in which a like result was reached include *U.S. v. New Departure Mfg. Co.*, 204 Fed. 107 (1913), and *U.S. v. Motion Picture*

Perhaps the leading cases in which patent combinations were held to be lawful were the United Shoe Machinery and the Standard Oil cases. In the United Shoe Machinery case,[1] the company had gained control, partly through consolidation with other shoe-machinery producers, of patents covering practically every basic operation of shoe manufacture. As a result, while other shoe machines were built the United had under its control the manufacture of every important kind of machine used in certain fundamental shoemaking processes. It was attacked as being a monopoly in restraint of trade, but the Supreme Court, in a close decision, refused to order its dissolution. The ground for upholding the combination was that it represented a combination of supplementary, rather than competing, patents. The Court claimed that competition would not be increased if the combination was broken up, for the machines for which patents were held were not in competition with each other. And if seven or eight companies held these patents, the monopoly aspect of the patent privilege would mean that competition would not be enhanced.

Another interesting case of a legal patent pool is supplied by the Standard Oil of Indiana decision.[2] In 1920 and following, several prominent oil companies [3] worked out an agreement by which certain patents used in refining might be shared. This cross-licensing combination was organized for the purpose of avoiding patent litigation. The government moved for the dissolution of the combination on the ground that it was in restraint of trade. The Supreme Court found that the companies made no attempt to restrain trade, in that the advantages of the combination were open to all upon reasonable terms; that the companies concerned were in real competition with each other; and that there had been no attempt to fix prices or do anything else beyond the agreement to pool patents. The Court consequently upheld the pool as a proper case of patent co-operation without evidence of restraint of trade.

From the examples noted here, it appears that a patent pool may or may not be unlawful under the anti-trust laws, depending upon what it does. If it suppresses competition by price or production agreements, or by conspiracy against those outside the pool, then it is illegal. If it is made up of complementary, as distinguished from competing, patents, no question of violation exists. And if it does not stamp out competition, by fact or deed or intent, but is formed for co-operative purposes in avoiding patent litigation and sharing of patent benefits, it is a perfectly legal arrangement.

Patents Co., 225 Fed. 800 (1915), appeal denied by the United States Supreme Court at 247 U.S. 524 (1917).

[1] *U.S. v. United Shoe Machinery Co.*, 247 U.S. 32 (1918). See also *U.S. v. Winslow*, 227 U.S. 202 (1913).

[2] *Standard Oil Co. (Indiana) v. U.S.*, 283 U.S. 163 (1931).

[3] Besides the Standard Company, the more important other participants were the Texas Company, the Gasoline Products Company, and the Standard Oil Company of New Jersey.

I. PACKERS AND STOCKYARDS

For some years prior to 1920, the practices of leading meat-packers had been subject to increasing public disapproval. Five large packers, Armour, Cudahy, Morris, Swift, and Wilson, had contrived in many ways to exercise control over the purchase of livestock and the sales of meat products. As early as 1905, the government had succeeded in getting an injunction against the packers for practices found to be in restraint of trade.[1] These practices included agreements not to compete with each other in livestock markets, to manipulate prices so that livestock would be shipped and then forced to be sold at a low price upon reaching the market, and to fix prices and quantities of meat products offered for sale. Railroad rate discriminations had been obtained by the packers. The National Packing Company was formed by the packers as a packing and sales concern controlled by three of the large packers. The Supreme Court had no difficulty in finding these practices in unlawful restraint of trade.

But the anti-trust case of 1905 did not end attempts by packers to place restraints upon competition. An investigation by the Federal Trade Commission in 1919 showed that most of the collusive practices forbidden in 1905 continued to exist.[2] In addition, the packers had extended their control over the stockyards so that they governed activities and facilities there, and they had acquired control of marketing of many meat substitutes, such as eggs, dairy products, and vegetable-oil compounds. As a result of the Commission's investigation, showing virtual monopoly and questionable competitive practices, Congress came to the conclusion that special legislation providing continuous supervision was needed in the industry. Consequently the Packers and Stockyards Act was passed in 1921.

1. PACKERS AND STOCKYARDS ACT OF 1921. So far as the packers are concerned, this law is a sort of Clayton Act for the industry, specifying certain unlawful monopolistic practices and providing for supervision by the Secretary of Agriculture. The regulation of stockyards is placed upon a different basis, the stockyards being regulated in the manner of public utilities.

Under the law, certain practices of those engaged in the meat-packing and allied businesses, where the business is in the flow of interstate commerce, are made illegal. These include the following:

(1) Engaging in any unfair, unjustly discriminatory, or deceptive device;

(2) Making or giving any undue or unreasonable preference or advantage to any person or locality;

(3) Selling or transferring any article from or to any packer for the purpose of apportioning supply and restraining trade;

(4) Engaging in any course of business or doing any act for the purpose of manip-

[1] *U.S. v. Swift and Co.*, 196 U.S. 375 (1905).

[2] Federal Trade Commission, *Report on the Meat Packing Industry* (1919).

ulating or controlling prices in commerce, or creating a monopoly in buying or selling;

(5) Combining with other persons to apportion territory, apportioning purchases or sales, or manipulating prices.

The law further provides that when the Secretary of Agriculture has reason to believe that the act is being violated, he shall issue a complaint, and, after hearing, may issue a cease and desist order. This order is to be final and conclusive unless set aside upon appeal to a federal court. When approved by a federal court, the order acts as an injunction against the packer concerned, and disobedience is punishable by fine or imprisonment, or both.

Stockyards operating for compensation as a public market in interstate commerce are subject to regulation of the public-utility type. Dealers and others using stockyard facilities must be registered with the Secretary of Agriculture. Stockyard owners and market agencies (persons buying and selling on a commission basis and persons furnishing stockyard facilities) are subject to the duty of furnishing reasonable stockyard services upon reasonable request, and must charge just, reasonable, and non-discriminatory fees for their services. They must file their schedule of charges with the Secretary of Agriculture and publish them for public inspection. Changes in charges must be filed with the Secretary and can be made only after ten days' notice. The Secretary is given the authority to suspend operation of any schedule of charges, and, after hearing, may issue an order prescribing lawful charges. Departure from published rates is unlawful and, along with any other infraction of the law, is made punishable by fine or imprisonment.

The law provides that every packer, stockyard owner, market agency, and dealer must keep accounts, reports, and memoranda disclosing all transactions involved in his business. If the Secretary of Agriculture finds these documents to be misleading or inaccurate, he may prescribe the manner and form by which they shall be kept.

2. Administration and Results. The Packers and Stockyards Act has been upheld by the Supreme Court in two leading cases. In one case, the constitutionality of stockyards regulation was attacked on the grounds that buying and selling of livestock at a stockyard was not interstate commerce. In an important decision widening the meaning of the interstate commerce clause, the Supreme Court held that packing and stockyard operations were in the flow of commerce between producer and retailer or consumer and were subject to regulation by Congress.[1] In the other case, the power of the Secretary of Agriculture to fix charges of commission men was challenged on the ground that these were charges for personal service and not rates for employment of property affected with a public interest. The Supreme Court held that since the business was one affected with a public interest, the fact that

[1] *Stafford v. Wallace*, 258 U.S. 495 (1922).

compensation for services, rather than for use of property, was involved had no bearing on the case.[1]

As a general matter, the regulation of stockyards has been carried out much like the administration of control by state and federal commissions over public utilities. Reasonable rates for the various services involved in stockyard operation have been prescribed by the Secretary of Agriculture from time to time. In this connection, it is interesting that the Secretary has used the technique for setting rate levels which is used in the public-utility field. He has determined the fair value of facilities employed by an agency by computing cost of reproduction new less depreciation. He has allowed a fair rate of return on this value (usually 6 per cent) in addition to operating expenses, and he has been upheld by the Supreme Court in doing so.[2]

In administering the law, the Secretary of Agriculture has encouraged self-regulation through adoption of fair-practice codes and has placed the authority granted to his office behind these codes. While this administration has probably not stamped out all the questionable practices which have grown up in the packing industry, the results have been successful enough so that public resentment against the industry has declined greatly and relatively few cases of abuse are now found. In administering the control of packers, the Secretary has been helped by a consent decree obtained by the government against the packers in 1921.

7. CONCLUSIONS: THE TRUST PROBLEM

In the previous chapter, the decline of competition in American industry was noted. If the anti-trust laws were designed to restore competition through legal action, they must be regarded as having been ineffective. While the decline of competition might have come by emergence of large firms without combination, that is, by natural development, there is adequate evidence that some of the loss in competitive vigor has come through combination in some form or other.

It is hardly open to doubt that a trust problem still exists. While the law has been fairly effective in smashing a few of the larger monopolistic combinations, it has certainly not been able to enforce competition. There are many ways by which this can be explained. The law itself may be blamed. Law-enforcement officers have not always understood its meaning, and they have had to rely on the tedious process of judicial interpretation to obtain knowledge of this meaning. The penalties under the law have not been serious deterrents. Courts and juries have hesitated to send violators to jail, and fines have never proved to be embarrassing to the corporation involved. Even when combinations have been ordered dissolved, genuinely competitive conditions

[1] *Tagg Bros. and Moorhead v. U.S.*, 280 U.S. 420 (1930).

[2] *Denver Union Stockyard Co. v. U.S.*, 304 U.S. 470 (1938).

have not often followed. For example, when the Standard Oil combination was ordered dissolved in 1911, stockholders in the holding company were given pro-rata shares in the underlying companies. Through co-operation by those who previously controlled the holding company, the companies resulting from the dissolution were managed pretty much as before.

The legal infirmities of the anti-trust laws, whereby "good trusts" might be saved and largeness became no offense, also account for a decline of competition in spite of the statutes. Furthermore, apathy of law-enforcement officers to the anti-trust laws, especially in the years after the World War, is also a factor of importance in explaining their ineffectiveness. When the number of instances in which the anti-trust laws might have applied is considered, the number of cases in which the government has proceeded against combinations is strikingly few. The desire not to disturb business in periods of prosperity or of preparation for national defense, or labor unions at any time, and the wish to satisfy pressure groups, are political elements which furnish background for understanding inadequacies of enforcement of the existing laws.

1. Social Aspects of Large Combinations. The existence of combinations of a size large enough to impair the effectiveness of competition raises questions as to the desirability of competition. In the public-utility field the inherent advantages of monopoly have been recognized. Indubitably in other fields of enterprise, the large combination, or even monopoly, may be justified upon grounds of economies of size and elimination of wastes of competition. There may be certain industries, too, such as those exploiting natural resources, where competition may lead to waste of things which society should conserve. This may be particularly true in the oil, gas, and coal industries.

On the other hand, large combinations may tend to keep the economic system from operating effectively. If prices are kept at inflexible levels or are fixed to bring in monopoly profits, capital and labor resources may not be utilized efficiently, because the constant pressure of competing producers and competing buyers is likely to be required to force operations at lowest cost and production of goods most wanted by purchasers.

If large combinations do have economic advantages in certain fields of enterprise, it may be well to allow them to continue, *if* the lower costs of large size can be passed on to consumers. This is a problem for government policy. If the stimuli of competition are to be removed, the only alternative seems to be to place safeguards in the form of government controls in the industry. This need not mean wholesale control of industry, since many businesses have economic characteristics which tend to keep them small. Businesses which produce goods not susceptible of standardization, and in which the market is small, materials perishable or too heavy to transport efficiently, labor the chief element, or management exceedingly difficult, may be so limited in size that competition is not likely to be threatened.

2. TRUST POLICY AND THE GOVERNMENT. If the complete enforcement of competition outside the field of businesses affected with a public interest were desired, the government would seem to have the power to obtain it. This would mean a much more restrictive law and a much more vigorous enforcement than have been the case. In effect, the law and its enforcement would have to be drawn so as to obtain the virtual atomization of industry. Each industry would have to be broken up into such small units that competition would be the natural result, and attempts of these units to co-operate in any way would have to be forbidden or regulated.

As a matter of fact, there are those who believe that the proper government policy is rigorous enforcement of an anti-trust law which would restore competition by making business units small and independent.[1] The attitude of this group is that competition is necessary for the maintenance of a free capitalistic system, and that unless competition is enforced totalitarian controls will result. Some in this group would admit that where economies of combination or monopoly are so great as to be in the social interest, legal monopolies might be allowed, but believe that these should be kept within as narrow limits as possible. Some of those who subscribe to this view declare that an arbitrary limitation must be placed upon size, the percentage possibly varying with the industry, but being small enough to insure competition.

An alternative policy is to give up anti-trust law enforcement as such and to substitute self-regulation of industry along the pattern of the codes under the National Industrial Recovery Act. This self-regulation would involve provisions dealing with price and production policies of all kinds, and would be a recognition that competition is no longer practical or desirable. To protect the public interest, however, such schemes of so-called self-regulation would seem to necessitate government supervision of the content of codes, and perhaps extensive government regulation as a part of the codes themselves.

Another possible policy is to keep the anti-trust laws much as they are, but to set up means for determining whether a combination is in reasonable or unreasonable restraint of trade. If believed to be wise, some definition of reasonableness might be determined by a commission in view of the facts in each case of combination; apparently the concept of reasonableness would be dependent upon the social good. If a combination could effect economies, took no advantage of its position to exploit consumers, and engaged in no practices regarded by business to be unfair, it might be a reasonable combination. This kind of policy would be similar to that now followed, except that the determination of reasonableness would be left to a commission rather than to the courts, and social welfare would become a definite hallmark of reasonableness.

[1] See, for example, the discussion of the ideas of former Justice Brandeis in Mason, A. T., *The Brandeis Way* (Princeton: Princeton University Press, 1938), and the attitude of the Federal Trade Commission in *Investigation of Concentration of Economic Power*, pt. 5, pp. 1647–56 (1939).

It has occasionally been suggested that the concept of businesses affected with a public interest be extended to all fields of business in which effective competition has become impracticable. In other words, by this policy monopoly or quasi-monopoly would be tolerated or encouraged. To protect the public, however, these industries would be subject to regulation of prices and service by some government agency, much in the way railroads are regulated by the Interstate Commerce Commission. This would mean widespread extension of government control. While it may be an ultimate solution, it would present tremendous problems of administration. The difficulty of solving price- and service-regulation problems has already been noted in the chapters on railroads and public utilities. If this sort of control were extended to many more businesses, the job of continuous supervision of several thousand firms would be exceedingly complex.

Another possible approach is one which has been gaining favor among certain governmental officials.[1] This is based upon the belief that there is no single standard of competitive behavior suitable to all industries alike, and that the anti-trust laws should undertake an industry-by-industry approach. This policy would admit that free and complete competition can hardly be obtained in all industries, and that even if industries could be atomized, the diseconomies resulting might not be in the social interest. The foundation of this suggested policy is to make a realistic study of each industry and, on the basis of the economic situation in the industry, decide what degree of competition is feasible or economically and socially desirable. Where it does not seem wise to require free competition, the industry would be placed under some kind of government supervision, to an extent necessary to protect the public. In industries in which competition can be restored by removing artificial restraints without loss of economies of size or combination, competition would be enforced through strict application of anti-monopoly or anti-combination laws.

In view of the economic nature of the forces behind the present decline of competition, as discussed in the previous chapter, the last approach seems to have much in its favor. Competition has not declined simply because grasping combinations by fair means or foul have driven the independents out of an industry. Underlying economic developments and the economic forces which have determined size have been influential. A return to traditional free competition would surely necessitate atomization of business. That the breaking of business into small enough units to insure competition would hinder productive efficiency is hardly open to doubt. If this be the case, as it seems to be, then abandonment of the single standard of free competition has much in its favor.

[1] See article by J. H. Crider, in the *New York Times*, October 30, 1939, p. 23. From statements made by such officials as Leon Henderson (S.E.C.), Jerome Frank (S.E.C.), and Thurman Arnold (Assistant Attorney General), the setting up of an anti-trust law on the industry-by-industry approach is indicated as favored in some government quarters.

On the other hand, the industry-by-industry approach necessarily involves increased government supervision of business. Nevertheless, this approach does not require regulation of all business along the pattern of public-utility control. Many industries would be left as they are, for if competition is found to be desirable in a particular industry, about all government need do is to remove monopolistic restraints. In industries in which the firms are few and relatively large, and in which this is found to be economically desirable, a program of regulation might need to do no more than to investigate and to supervise in a general way. Protection of the public might well be of enough concern to the industry and enough seeds of competition might remain to make detailed regulation unnecessary. Other industries in which a single firm or a very few firms dominate might have to be placed under regulation similar to that now imposed on businesses affected with a public interest.

Of course, another alternative, and one which has something to be said for it, is to leave the anti-trust laws as they are. Admittedly, the present laws have not been very effective either in restoring competition or regulating competition. But they do furnish a basis for prosecution of unreasonable restraints of trade. Flagrant cases in which the public interest is disregarded may be brought under the anti-trust laws without much trouble. Moreover, their meaning has been greatly clarified over the years, and a willing enforcement agency can find much in them to thwart unreasonable combination. Furthermore, even though competition may be diminished by business growth and other economic developments, this is not in itself proof that society is being harmed so much that more drastic measures are necessary.

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CHAPTER

20

REGULATION OF COMPETITIVE PRACTICES

IN THE previous chapter, regulation to prevent monopolistic combinations was discussed. This type of control has been designed to force the breaking up of such combinations *after* they have been formed, and when they are found to be against public policy as expressed in the anti-trust laws. In doing so, however, the government has often discouraged the formation of new combinations which might be contrary to law.

Another field of regulation to maintain competition in industries not affected with a public interest is that of competitive practices. Originally the purpose was to prevent those practices which stifled fair competition and led to monopoly. While this purpose is still very important, the scope of these laws has been broadened to include regulation aiming at protection of business men and consumers against practices which are thought to be unfair or harmful This development is well exemplified in the growth of jurisdiction and action of the Federal Trade Commission. Starting from the job of protecting honest and fair business men from their unscrupulous or unfair fellows, the Commission has become a guardian of the consumer as well. Thus it has developed an approach somewhat similar to that of the Pure Food and Drug Administration. Yet even though the consumer is included along with the business man in the protective sphere of the law, this type of regulation can be characterized as regulation to promote fair competition. Whether individuals are producers, sellers, or buyers, they may be adversely affected by unfair competition.

A. REGULATION UNDER COMMON LAW

Standards of competitive behavior have been affected somewhat by several principles of common law. Coincident with the development of economic

liberalism, the courts evolved several legal concepts which aimed at the protection of private property and the freedom of competitive activity.

Perhaps the common-law doctrine having most regulatory force in this direction has been the allowance of damages in cases of "palming off." This is the practice whereby a seller represents to a buyer that a product is that of a competitor when such is not the case. Such action was deemed by the courts to be an invasion of the property rights — good-will or trade-name — of the competitor, and as such to be a cause for the collection of damages and the issuance of an injunction against the trespasser. This action has also been regarded by the courts as a practice of deception upon the buying public.[1] The common law made misappropriation and misrepresentation the essence of the offense, whether it was accomplished by word of mouth, by advertising, or by simulation of labels, packaging, color, form, or appearance of goods.

Another actionable offense at common law has been the misappropriation of trade secrets or other intangible trade values. This offense differs somewhat from palming off in that the seller makes no attempt to identify his competitor with the article, but, while plainly marking the product as produced by himself, appropriates trade secrets or other intangible trade values of the competitor. The courts have accepted imitation as inherent in a competitive system, and under the common law it could not be enjoined unless based upon a trade secret obtained through fraud by inducement of employees to violate a trust. Thus, if a seller obtained knowledge of certain confidential information or secret processes by fraud or by inducing an employee of a competitor to disclose such secrets, he might be enjoined from using them to the disadvantage of the original owner. Mere imitation, without palming off or infringement of trade-name, has not often been stopped by the courts unless based upon knowledge unlawfully obtained. However, in one case where a news service appropriated news of another service and sent it out as its own, the United States Supreme Court prohibited the practice.[2] While this case might be used as a common-law precedent for prohibiting imitation generally, the courts have not done so.

Under the common law, malicious interference with competitors might also be restrained and suits for damages entertained. Where a seller attacks the reputation of a competitor or the integrity of a competitor's products as a means for selling his own, such interference may be actionable. As a general rule, for an aggrieved competitor to obtain redress, he has been forced to prove that a false statement has been made willfully to injure the reputation of his business or product and that the utterance has caused him a definite loss. Because proof on these points could not always be obtained, the common-law principle has not been too helpful in the regulation of competition.

[1] Handler, Milton, "Unfair Competition," 21 *Iowa Law Review*, pp. 175–262 (1936), at p. 183.

[2] *International News Service v. Associated Press*, 248 U.S. 215 (1918).

Where malicious interference resulted from threats or physical violence against a competitor or his customers, the common law allowed redress as a means of avoiding a wrong to the injured party. In cases such as these, proof of interference has not been so difficult to establish, and the regulatory effect of the common law has been greater than in cases of defamation of a competitor's reputation.

Occasionally, under the common law, misbranding or false advertising has been held to constitute unlawful competition. The courts have ruled that a competitor may not sue to prevent a fraud against the public, although a purchaser may sometimes sue for redress if he is defrauded.[1]

As an instrument for enforcing a level of fair competition, the common law leaves much to be desired. Often malicious intent must be proved. Usually specific damage must be shown by a competitor or a purchaser. Moreover, resorting to judicial process to remove instances of unfair competition is not satisfactory. Suits for individual cases are so expensive that many unlawful activities will not be prosecuted. Actions deceptive or harmful to buyers, even where unlawful under the common law, may not be contested at all unless a seller is damaged.

Furthermore, the scope of unlawful competitive activity has been very limited under the common law. Deceptive practices which harm the public rather than a competitor were clearly not actionable law. Even where the common law has applied, it has served only to bring adjudication of particular controversies and the levying of damages in individual cases; it has not been an effective instrument for prevention. Thus, the common law lacks breadth to cover the whole area of that which society may believe to be fair competition; it has proved to be an expensive and annoying means of forcing compliance with the law; and it has been deficient in not furnishing supervision by which unfair competition might be prevented

B. THE FEDERAL TRADE COMMISSION

Dissatisfaction with the common law as an instrument of regulation of competitive standards, and disillusionment with the anti-trust laws as a means of halting the growth of monopolistic combinations, led to popular demand for an administrative commission to regulate competition under special statutory authority. For these purposes, the national government established the Federal Trade Commission in 1914. At about the same time, many states created agencies to supervise regulation of competitive practices and established statutory standards of fair competition. In general, while these statutes and their administration show some differences, the state laws so closely parallel the federal law that discussion of the work of the Federal Trade Commission will be adequate for the purposes of this text. Moreover, the increasing activity

[1] Handler, Milton, *op. cit.*, pp. 193–95.

and scope of regulation of the Federal Trade Commission have tended to make the federal government dominant in almost all phases of regulation except that of local business.

1. THE JURISDICTION OF THE COMMISSION. The regulatory jurisdiction of the Federal Trade Commission is divided into three principal parts. One has to do with regulation of specific monopolistic practices which the statute forbids; these practices are those which the lawmakers believed to be most closely related to the development of monopolistic combinations. Another portion of the jurisdiction is concerned with the prohibition of unfair methods of competition and deceptive trade practices. The Commission is further charged with certain investigatory activities which have often had exceedingly important regulatory effects. These subjects are discussed in the following subdivision.

The Federal Trade Commission draws its authority principally from the Clayton Act and the Federal Trade Commission Act of 1914. The price-discrimination provisions of the former law were materially changed by the Robinson-Patman Act of 1936, and the scope of the Commission's jurisdiction over unfair competition was broadened by an amendment to the Federal Trade Commission Act in 1938.

The principal authority conferred on the Commission by the Federal Trade Commission Act is the provision of section 5 by which unfair methods of competition, and unfair or deceptive acts or practices in interstate commerce, are made unlawful and subject to supervision by the Commission. It is worthy of note that until 1938 only unfair methods of competition were forbidden. By legislation added in 1938, false advertising of food, drugs, devices, or cosmetics was made unlawful as an unfair or deceptive act under section 5.

The Federal Trade Commission Act also gives the Commission sweeping powers to conduct investigations of business, either on its own initiative or at the request of the Attorney General, the President, or either house of Congress. In making these investigations the Commission may require both regular and special reports from businesses using the channels of interstate commerce.

Much of the authority of the Commission comes from the Clayton Act. Section 2 of this law, as amended by the Robinson-Patman Act of 1936, forbids certain price discriminations between purchasers, and provides that the granting as well as the receipt of such discriminations shall be unlawful. Section 3 makes it unlawful for any person engaged in interstate commerce to sell goods or fix a price therefor on the condition that the purchaser shall not use or deal in the goods of a competitor, if the effect of such an arrangement is substantially to lessen competition or tends to create a monopoly in a line of commerce. Sections 7 and 8 forbid certain intercorporate relationships. Section 7 forbids one company to acquire the stock of another where both companies are engaged in interstate commerce, and where the result is to restrain commerce in any section or community and to tend to create a monopoly in any line of commerce. Purchase of stock solely for investment or to establish sub-

sidiaries for carrying on immediate lawful business, where the effect is not substantially to lessen competition, is permitted. Likewise, purchase by common carriers, subject to the Interstate Commerce Commission, is not outlawed where necessary to acquire feeder or branch lines, or to extend lines. Section 8 provides that interlocking directorates may not be held between industrial corporations any one of which has capital, surplus, and undivided profits of more than $1,000,000, if elimination of competition would result.

2. How the Commission Works. The work of the Federal Trade Commission naturally falls into two main classifications: general investigation of economic conditions, and enforcement of the law against certain competitive practices. As noted above, the Commission has power to make investigations of business practices generally, on its own motion or on request of the proper authority. It also may make special investigations in carrying out any part of the law against unfair competition. Thus its investigatory work may be regulatory in effect by disclosing certain questionable practices, or may be the basis for action by the Commission itself or by the Department of Justice, or may furnish a background for new legislation.

The Commission's procedure is interesting as an example of government control in a complicated field. Upon application of any interested party showing the facts of an alleged violation, or on its own initiative, the Commission examines the case to determine whether the practice complained of is within its jurisdiction. If so, the case is docketed as an application for a complaint. At this point it is investigated by a Commission examiner, who recommends some course of action: that the charge be dismissed, that a stipulation be entered into, or that a complaint be entered.

With the examiner's report before it, the Commission decides upon its course of action. If it feels that the law has been violated but that the practice is not inherently fraudulent or vicious, it may offer to settle the case by stipulation. A stipulation is simply a settlement based upon an admission of facts by the offender and the promise to cease from the practice complained of. This saves the offender the expense of further proceedings and possible unpleasant publicity, and is especially advantageous for minor or unintentional infractions. If the stipulation is refused, the case moves to the complaint stage.

If the Commission decides to issue a complaint, hearings are usually held before a trial examiner with the legal staff of the Commission acting on behalf of the public. The trial examiner issues a report on the basis of these hearings. He draws up a statement of facts and recommends either dismissal of the complaint or the issuance of a cease-and-desist order; the accused parties are allowed to file exceptions to his findings. After study of the so-called proposed report and the exceptions, the Commission issues its own report. If it finds the charges to be supported and the alleged action to be unlawful, it issues an order requiring the accused party to cease and desist from such action. If the ac-

cused company does not contest the order by appeal to the courts within sixty days, it becomes final and later violations involve a fine of $5000. On the other hand, if the company appeals to the federal courts, and the latter find the order inconsistent with the law or grounded upon findings not supported by evidence, they may modify it or set it aside. It should be noted that even in cases of disobedience to a final and uncontested order, the Commission does not levy a fine; this can be done only by the courts upon application of the Commission.

There is still another variation in the procedure of the Commission. Should several informal complaints be presented to it on similar matters which seem to affect the practices of an industry, it may call a trade-practice conference of members of the industry. But it usually requires that the interested members request the conference and that a majority of the industry be represented. Trade practices are discussed at the conference and, with the advice of the Commission, an industry may draw up a code of fair practice. Any part of this code which falls under the fair-trade jurisdiction of the Commission may be enforced by it. Usually, where applications for complaints are satisfied by the adoption of such a code, and offending members of an industry agree to comply with it, the proceedings are dropped.

The trade-conference device is an interesting and advantageous kind of administrative procedure. Through the spur of self-regulation, an industry may be able to eradicate many questionable practices as the result of a single conference. Hence, instead of having to wait for a number of individual cases to be brought before the Federal Trade Commission, members of the industry may more easily and quickly find out what the proper interpretation of the law of unfair competition is. To the extent that the code resulting from a trade conference leads to its wide acceptance, the Commission itself is saved the time and trouble of prosecuting a host of isolated infractions.

3. Relation to Anti-Trust Law Enforcement. A word may be said of the relation of the Commission's work to enforcement of the anti-trust laws. To some extent, the Commission has served to fill some gaps found in such enforcement by the Department of Justice. It has furnished a means of rather continuous supervision of business. The monopolistic practices forbidden by the Clayton Act are placed under the joint jurisdiction of the Commission and the Department of Justice. Proceedings may be begun by either, and both have found it advantageous to co-operate in applying the law.

The investigatory activities of the Commission have been invaluable in helping the Department of Justice to seek out and prosecute combinations in unlawful restraint of trade. Moreover, by controlling practices which often lead to monopolistic power, the Commission has contributed much to making such prosecutions by the Department unnecessary.

C. INVESTIGATORY ACTIVITIES OF THE COMMISSION

The investigatory activities of the Federal Trade Commission over the last several decades have been so numerous and broad that one can hardly discuss them adequately here.[1] The investigation of the public-utility holding companies was published in ninety-five volumes totaling nearly sixty thousand pages. The report on chain stores was transmitted to the Senate in thirty-three factual volumes and a final volume covering conclusions and recommendations. Other important general investigations include reports on the agricultural implement and machinery industry, the causes of decline in agricultural income, co-operative marketing, open-price trade associations, the motor-vehicle industry, the petroleum industry, and the use of basing-point methods in fixing prices. In all, some hundred and fifteen general investigations have been made by the Commission.

In addition to these general investigations, usually undertaken at the request of Congress, the Commission has studied certain features of a large number of industries, with a view to finding the extent of questionable competitive practices. For example, from 1932 to 1938 the Commission made such inquiry into one hundred and thirty-four situations where acquisitions or mergers had taken place.[2]

The regulatory effect of these investigations has already been noted. Disclosure of questionable circumstances often leads to their modification without resort to legal process; investigation may also furnish data upon which prosecution can be based. The facts disclosed by the Commission, and the recommendations for new legislation made, have been useful in drafting new statutory controls. Indeed, in weighing the work of the Federal Trade Commission especially, and with government commissions generally, the elements of publicity and knowledge arising from their investigations are often underestimated.

D. REGULATION OF SPECIAL MONOPOLISTIC PRACTICES

By virtue of the authority found in the Clayton Act, several special monopolistic practices have been treated by the Federal Trade Commission, as well as by the Department of Justice. These practices are specifically prohibited by statute. As such, they differ from those methods of unfair competition or fraudulent devices outlawed by section 5 of the Federal Trade Commission Act. The latter practices are not clearly defined in the statute, and the Commission is left to place a given practice within or outside of the legal principles

[1] For complete information about these investigations, the reader is referred to the annual reports of the Federal Trade Commission and to the reports of the investigations themselves. A list and brief summary may be found in *Investigation of Concentration of Economic Power*, pt. 5 A, pp. 2373-2417 (1939).

[2] See *Investigation of Concentration of Economic Power*, pt. 5 A, p. 2373.

stated. But with those practices forbidden by the Clayton Act the elements of unlawfulness are more clearly defined.

Furthermore, the matters outlawed by the Clayton Act are more closely related to the problem of combinations in restraint of trade. Those things forbidden by the Federal Trade Commission Act are generally connected with the ethical plane of competitive activity rather than practices tending to monopoly. While this distinction can often be made, there are cases where a practice may tend toward monopoly and at the same time be an unfair method of competition. For example, in its conclusions on the use of basing points, the Federal Trade Commission found them to be a device tending to create a monopoly in opposition to certain features of the Clayton Act, and also a means of unfair competition.

1. PRICE DISCRIMINATION. One of the specific practices forbidden by the Clayton Act of 1914, as amended by the Robinson-Patman Act of 1936, was discrimination in price by a seller between different purchasers of commodities of like grade and quality, where any of the purchases involved were in interstate commerce, and where the effect was substantially to lessen competition. Because the original provision of the Clayton Act has been materially changed by the amendments of the Robinson-Patman Act, it may be well to note the meaning of the original law before undertaking an analysis of the amendments.

a. Price discrimination under the original section. Under the original section 2 of the Clayton Act, price discriminations made by sellers in interstate commerce were forbidden (1) where such differences were not based upon variations in grade, quantity, quality, selling or transportation costs, or the necessity of meeting *bona-fide* competition; and (2) where the effect of such discrimination was substantially to lessen competition or to tend to create a monopoly in any line of commerce.[1] The original section also reserved to sellers the right to select their customers as they wished unless the purpose of doing so was to restrain trade.

Section 2 was aimed at destructive price-cutting among competing sellers, as well as the favoring of one buyer over another, where the purpose was monopolistic. Note that it did not compel sellers to charge all buyers the same price. Besides the justifiable causes for variations allowable under the law, the sales had to be in interstate commerce, and, until 1929, the courts held that the discrimination must injure sellers rather than buyers.[2] Since most of the evils of price discrimination arose from that between buyers, the corresponding provisions of the Clayton Act became a dead letter for a time.

[1] A "line" of commerce is a portion of a trade or industry on the same level of competition. Thus, drug retailers and drug wholesalers are in the same industry, but since they do not compete directly with each other, they are not in the same line of commerce. A line of commerce would be presented by retailers of the same kind of drug, or manufacturers of a certain product, or wholesalers in the same field.

[2] *Mennen Co. v. F.T.C.*, 288 Fed. 774, cert. denied, 262 U.S. 759 (1923), and *National Biscuit Co. v. F.T.C.*, 299 Fed. 733, cert. denied, 266 U.S. 613 (1924).

In 1929, however, application of price discriminations to lessening of competition between purchasers was made effective in a case decided by the United States Supreme Court.[1] The Court held that the action of a can company in selling tin cans at a lower price to one food-packer than to others had a tendency to create a monopoly in the packing industry, and was within the prohibition of the Clayton Act.

While the Van Camp case gave the Federal Trade Commission increased power to proceed against price discrimination, the provisions of section 2 of the Clayton Act were still open to objection by certain parties. Independent retailers had been alarmed at the amazing growth of chain stores after the World War. Believing that their rapid increase in the grocery, drug, tobacco, and other fields was due in part to unreasonably advantageous price concessions from manufacturers and wholesalers, the independent retailers pushed for an amendment of section 2 which would prevent these discriminations. As a result, Congress directed the Federal Trade Commission in 1928 to make a study of the development of chain stores. The Commission made its report in 1934.[2]

As was expected, the report disclosed many instances where advantageous prices helped the chain stores to undersell their independent competitors. A number of preferential practices were described. Price concessions for volume purchases were common, these discounts often bearing no relation to costs and sometimes being refused to groups of independent retailers who pooled their purchases. Special promotional allowances were often made; these included allowances for advertising, counter display, and dressing of windows. Allowances for services performed by the purchaser were also made. The most widely practiced of these were concessions made for brokerage and sales commissions where the chain-store organization dealt directly with manufacturers, rather than through customary middlemen with whom independent retailers dealt.

Some of the price concessions granted to chain-store organizations have been justifiable as representing definite savings to the manufacturer or savings due to elimination of certain middlemen. Other concessions have been based upon the superior bargaining power of the large chain-store organization. Being a large and consistent buyer, the chain store has had extraordinary power in forcing sellers to quote lower prices than they found it necessary to quote to others. Irrespective of the basis for these price discriminations, they were generally believed to be beyond the powers of the Federal Trade Commission under the original section 2 of the Clayton Act. While some doubtless were, the interpretation given this section by the Van Camp decision in 1929 probably placed many of them under the jurisdiction of the Federal Trade Commission. Because of the Robinson-Patman amendments of 1936, the question

[1] *Van Camp and Sons Co. v. American Can Co.*, 278 U.S. 245 (1929).

[2] Federal Trade Commission, *Final Report on the Chain Store Investigation*, Sen. Doc. No. 4, 74th Cong., 1st Sess. (1934). This report was preceded by thirty-three volumes of factual data.

of the effect of the new interpretation placed on the old law is not now significant.

These amendments were designed to fill the gaps existing in the original price-discrimination law. They were also to serve as a means for curtailing the growth of the chain store and for preserving the independent retailer and wholesaler. The dominant motive was the fight against chains and other large sellers. This being so, the student of price discrimination should regard the amendments from the point of view of their effect upon the economies of the chain type of marketing.

b. Price discrimination under the Robinson-Patman Act. The Robinson-Patman amendments to section 2 made material changes in the scope and effectiveness of price-discrimination regulation. The changes may be summarized as follows:

(1) Price discrimination is forbidden which harms competition between sellers, between sellers and buyers, or between buyers. Proof of injury to a line of commerce is no longer necessary.

(2) Differences in price can only be made as follows:
   (*a*) To the extent of genuine differences in the cost of manufacture, sale, or delivery (however, where large buyers are few and quantity discounts would be unjustly discriminatory or promotive of monopoly, the commission may fix maximum discounts);
   (*b*) In response to changing conditions affecting the market for or the marketability of goods concerned, such as imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned; or
   (*c*) Where necessary in good faith to meet an equally low price of a competitor.

(3) Allowances made by the seller for services performed by a purchaser are forbidden, unless proportionately equal allowances are offered to all buyers.

(4) Allowances made by the seller for brokerage are prohibited, where payments are not made to the person actually performing such service and where the broker is not independent of the purchaser. Hence, making price concessions under the guise of brokerage, even through a firm under the control of the purchaser, is prohibited.

(5) Changes were made in the penalty and enforcement provisions:
   (*a*) Violation of the law is made a criminal offense with punishment ranging from fines to imprisonment;
   (*b*) The buyer, as well as the seller, may be found guilty if he "knowingly" receives a discrimination or induces a seller to grant a discrimination;
   (*c*) A bill of particulars charging a person with a violation is taken to be presumptive evidence of guilt and places the burden for proving innocence upon the accused. (This is not as unfair as might be supposed, for generally the accused parties are the only ones who have full information as to the extent and reasonableness of an instance of differential pricing.)

The above summary is adequate to indicate the administrative task placed upon the Federal Trade Commission. The law still applies to sales which

affect interstate commerce, and injury to competition must be proved. Right to select customers, in absence of a purpose of restraining trade, is still granted sellers. Proof of application of the law may have been made somewhat easier, since the Commission now must show only that the parties are engaged in interstate commerce and that the practice complained of has tended to harm competition between directly interested persons. Prior to 1936, the Commission had to prove that competition in a line of commerce was substantially lessened. Where this must be proved, the courts had taken the position that the industry generally must be affected, or at least a large part of it, and that a price discrimination affecting only a few competitors was not within the prohibitions of the law.[1] Such proof has been found difficult, but the Robinson-Patman Act makes injury to any party concerned an adequate basis for prosecution.

Where much administrative difficulty comes is in the matter of lawful price discriminations. Price differences based upon cost are generally lawful. But the determination of the cost of serving one buyer over another is extremely difficult; detailed and elaborate cost studies must be made by the Federal Trade Commission and by the seller. Even with an elementary understanding of the nature of overhead and joint costs, the student should have no trouble in seeing the problem involved. As a matter of fact, the Commission has pointed out that its investigations under the Robinson-Patman Act are more expensive and time-consuming than those under any other part of its jurisdiction.[2]

In connection with price discounts based upon quantity, the Federal Trade Commission is given an interesting power. If a competitive situation is such that purchasers in large quantities are so few that quantity differentials would be unjustly discriminatory or promotive of monopoly, the law provides that the Commission may fix maximum quantity limits upon which discounts can be given. Thus, although quantity discounts can be justified by cost differences, they may be limited by the Commission so that a few large purchasers may not obtain an undue advantage. This provision clearly illustrates the philosophy and purpose of the Robinson-Patman amendments. It indicates that their framers were interested in curtailing size and encouraging freedom of business opportunity, even if the large businesses could, from an economic point of view, justifiably receive price discounts larger than those received by the mass of their competitors.

Restrictions upon unearned brokerage and allowances for services of one kind or another have led to much controversy. Chain-store organizations and other mass distributors have customarily dealt directly with manufacturers. Under the present law, they may not be granted an allowance in lieu of the

[1] See, for example, *Ladoga Canning Co. v. American Can Co.*, 44 Fed. (2d) 763, cert. denied, 282 U.S. 899 (1930).

[2] Federal Trade Commission, *Ann. Rep.* (1939), p. 6. The Commission noted in its 1940 report (p. 31) that eight hundred and fifty-three investigations had been instituted under the Robinson-Patman Law and six hundred and thirty-four had been completed.

brokerage which would have to be added to the cost of dealers buying through a commission house. While this device has been used in the past for granting unfair price concessions to large buyers, and has placed independent retailers at a disadvantage from an economic point of view, if the mass distributor in effect saves the cost of brokerage by being able to deal directly, he should be allowed to have such a concession. In other words, there is little economic justification for charging a chain store manufacturer's cost-plus-brokerage when the chain organization eliminates the necessity for a middleman. Prohibition of brokerage concessions has led one large chain organization to state that it will not deal with manufacturers who make brokerage discounts to anyone.[1]

Much less controversy is involved over the prohibition of allowances for advertising and other purchaser-performed services, unless made available to all on proportionally equal terms. This system has been vicious and often based upon bargaining power of purchasers, rather than upon the actual worth of services rendered. On the other hand, offering allowances on proportionally equal terms may not always be fair to all purchasers, since the character of services may differ widely in individual cases. Most manufacturers use as a standard of allocation the volume of purchases, so that if $500 is allowed on a $5000 order, a like percentage must be allowed on any other order. But this does not take into account the real value of services rendered. Some retail outlets may be able to offer more service than others. The chain-store organization by its central control over a large number of outlets can better oversee the expenditure of promotional and advertising funds in ways suitable to the manufacturer. Furthermore, a manufacturer may desire to push sales more in one territory than another and should not be bound to offer allowances to everyone on proportionally equal terms.

The Federal Trade Commission has applied the Robinson-Patman Act in a vigorous way. Every section of the law has been invoked. The Commission has been upheld by federal courts in its interpretation of the troublesome brokerage clauses.[2] It has insisted that justification of discounts be proved by convincing cost analysis, and that justification of allowances for services be demonstrated by the actual performance of *bona-fide* services. The effect has been to require widespread overhauling of practices respecting discounts, customer classifications, and allowances for brokerage, advertising, and other services.

The changes in the price-discrimination law made by the Robinson-Pat-

[1] The Atlantic and Pacific Tea Company announced such a policy early in 1940. Although ostensibly announced for the purpose of avoiding legal misunderstandings, this policy clearly tends to force manufacturers to quote all prices on a brokerage discount basis. See *New York Times*, January 25, 1940, p. 28. It is interesting to note that this large chain store has not been able to follow this policy completely but has undertaken to do so as far as possible.

[2] See *Biddle Purchasing Co. v. F.T.C.*, 96 Fed. (2d) 687 (1938), cert. denied, 305 U.S. 634 (1938) and *Oliver Bros. v. F.T.C.*, 102 Fed. (2d) 763 (1939). In both these cases the courts upheld the Commission in refusing to allow brokerage payments to a purchasing agent owned by buyers.

man Act present an interesting conflict in the desire to preserve economies resulting from large size in the merchandising field, and at the same time to help the independent retailer to survive competition of the mass distributors. If, in administering the law, the Federal Trade Commission merely tries to stamp out price discriminations based upon superior bargaining power, there need be little economic loss. Yet, as the result of these very price discriminations in the past, many manufacturers have been forced to adopt more efficient methods. Should the Commission apply the law strictly, as seems to be the case, the new law could become a means of protecting independent retailers, whether efficient or inefficient, at an increased cost to the consumer. If this results, the consumer should be educated, at least to the extent of being able to decide whether the existence of independent middlemen is worth the cost.

c. Price discrimination and basing points. One of the most disputed aspects of price-discrimination regulation has been the use of basing points.[1] In many industries, the practice of pricing goods at a basing point plus freight from that point to the point of purchase has been common. Where every producing point is a basing point, the system becomes merely one by which the price is the delivered price to the purchaser. Generally, however, one or a few basing points are fixed by an industry at main producing areas. All producers, whether at these basing points or not, charge the same price to customers, by using the same base price plus freight charges from the basing point.

The basing-point pricing system makes possible a uniform policy in an industry. In this way it may be a means of effectuating a gentlemen's agreement or some other combination agreement to fix prices. The real attack upon the system, however, has been made under the price-discrimination provisions of the Clayton Act.

(1) *Commission attitude toward basing-point systems.* In 1924, the Federal Trade Commission ordered the United States Steel Corporation and its subsidiaries to cease and desist from pricing their goods on a Pittsburgh-plus-freight system.[2] The Commission held that this system caused unlawful price discrimination between fabricators of steel at producing points other than Pittsburgh and fabricators in Pittsburgh, or those who were merely departments of an integrated steel-producing organization. For example, under the Pittsburgh-plus system of pricing, the user of steel in Chicago paid the base price plus freight from Pittsburgh to Chicago, even though the steel might be produced in the Chicago area. This placed an independent steel fabricator at a disadvantage in relation to a fabricator in Pittsburgh. But if the United States Steel Corporation had a subsidiary in Chicago which used steel ingots or sheets produced by another subsidiary, this subsidiary fabricating company was in a better position than an independent concern. Even if the subsidiary of the Steel Corporation was charged Pittsburgh-plus, this was really only a

[1] See *supra*, pp. 414, 423.

[2] *F.T.C. v. U.S. Steel Corp.*, 8 F.T.C. 1 (1924).

paper charge, in that both steel producer and fabricator were in virtually the same business organization.

The United States Steel Corporation did not contest the Commission's order — although it claimed that it had adequate grounds to do so — and increased the number of basing points in compliance therewith. The number of basing points was also increased a few years ago, when opposition to the system again became vocal.

The Federal Trade Commission has not formally proceeded against the multiple, as contrasted to single, basing-point systems in existence in many industries, such as cement, steel, tile, and lumber, to mention only a few.[1] Where such systems have been used as an element in an agreement to restrain prices, the Commission has issued many orders against such practices. But it has not forced discontinuance of multiple basing-point systems on the ground of price discrimination as it has that of single basing-point systems. There may be several reasons for this. In anti-trust cases, the Supreme Court has taken the position that dissemination of basing-point information, without outright collusion, was not action in restraint of trade.[2] Moreover, the use of multiple basing points has made it somewhat more difficult to prove that the lesser price discrimination resulting is such as to diminish competition substantially in an industry.

While the Commission has not issued cease-and-desist orders against all basing-point systems, it has generally condemned them.[3] Its attitude is that such systems destroy free competition by giving manufacturers a formula for computing prices at any consuming point, a formula which, along with recognized base prices and differentials,[4] permits the quotation of identical prices. Under such circumstances, according to the Commission, "competition in such crude matters of price and quality has been put aside, and all that seems to remain is a gentlemanly emulation in the art of making friends and influencing people." [5]

The Commission finds many specific objections to basing points. The price-discrimination aspects have already been noted. The Commission claims also that basing points cause wasteful cross-hauling. Since all sellers in

[1] See *Investigation of Concentration of Economic Power*, pt. 5, p. 1897 (1939). A detailed discussion of the basing-point system may be found at pp. 1863–1982.

[2] See *Maple Flooring Mfrs.' Ass'n. v. U.S.*, 268 U.S. 563 (1925), and *Cement Mfrs.' Protective Ass'n. v. U.S.*, 268 U.S. 588 (1925).

[3] Federal Trade Commission, *Price Bases Inquiry: the Basing Point Formula and Cement Prices* (1932); *idem, Basing Point System in the Steel Industry* (1935); *idem, Monopoly and Competition in Steel* (1939). This report as well as the testimony of Federal Trade Commission witnesses against basing-point systems are found in *Investigation of Concentration of Economic Power*, pt. 5, pp. 1861–1987, 2192–2200. See also, for a position in opposition to basing points, Fetter, F. A., "The New Plea for Basing Point Monopoly," 45 *Journal of Political Economy*, pp. 577–605 (1937).

[4] These differentials may be price differences between basing points, or those based upon certain kinds of products. Thus, a certain special type of steel may be priced at base plus a percentage for "extras."

[5] *Monopoly and Competition in Steel*, *supra*, p. 2192.

a certain basing-point area are placed on an equal price basis, any advantage of location is not passed on to customers in the form of lower transportation costs. Mills may deliver their product in the neighborhood of other mills, and these in turn may ship to the vicinity of their rivals. The system artificially distorts the area of distribution of each mill, with resultant higher costs. Moreover, customers are usually charged base plus *rail* freight, even though a lower-cost transportation facility may be available. This, of course, increases the cost to customers and aids sellers in maintaining a system of uniform delivered prices.

The Commission also claims that the basing-point system, by permitting the fixing of higher prices, places an "umbrella" over high-cost producers and tends to cause existence of unused productive capacity when goods will not be purchased at the fixed price. The position of the Commission is that this encourages inefficiency in use of natural resources, capital, and labor. Hence, its objection to basing-point systems is that by aiding in the restraint of competition they contribute to inefficiency and higher prices.

(2) *The defense of basing-point systems.* In defense of the basing-point system, industrialists and certain economists [1] have claimed that the device permits greater competition than would be possible without it. They point to the economically sound argument that one of the characteristics of a perfectly competitive market is the existence of a single price within it. They also maintain that the basing-point system allows all producers within a certain area to enter all markets on an equal basis. Without it, because of high freight rates in those industries using basing points, local mills would tend to have a monopoly within the vicinity of their operations.

Steel men insist that in actual practice there is little cross-hauling or selling in a local market at prices based upon freight from a distant point. They maintain also that in the last few years the number of basing points has so increased that most principal places of steel production have a base price, and that this price does not generally represent a differential from Pittsburgh. Assertions of similar import are made by representatives of other industries using the basing-point system.

Those who support the use of basing points also maintain that the system makes for fair competition. If all pricing were F.O.B. the mills, and if the custom of observing uniform prices and differentials were abolished, the result might be competitive chaos. Owing to large fixed costs in the industry, competition would tend to become cut-throat, and the larger and stronger firms would drive the weaker from the field. This vigorous type of competition would not necessarily mean the survival of the more efficient producers but that of the producers having the strongest financial position.

[1] See statement of representatives of the steel industry in *Investigation of Concentration of Economic Power*, pt. 27, pp. 14, 619–70 (1940). Also see Daugherty, C. R., de Chazeau, M. G., and Stratton, S. S., *The Economics of the Steel Industry* (New York: McGraw-Hill Book Company, Inc., 1937), vol. II, pp. 579–732.

(3) *Economics of basing points.* As this writer views the situation, basing points have been used as a means of making informal price agreements or price leadership effective. The existence of uniform prices, while a feature of perfect competition, does not denote that such competition has taken place. Under the basing-point system, prices are set by sellers, subject only to the possible influence of elasticity of demand for their product. Where basing points have been used prices have shown a tendency to be inflexible over time. This is hardly due to the unchanging character of demand and supply, for forces constantly operate to change these elements of price determination. As a matter of fact, markets such as the organized produce markets which approach pure competition are characterized by prices which, though uniform at an instant of time, are extremely sensitive to changes in demand or supply.

At the same time, there is probably more competition in such industries as steel and cement than critics of the basing-point system are willing to admit. Scrapping of obsolete plants, increase in the number of basing points, the many cases where competitive flurries occur and identical bids do not exist, are a few indications of this fact. Furthermore, there is the practical question as to what would happen if basing points were abolished. Industries have grown up under the system's stable influence; to remove the system now might lead to a period of ruinous competition and demoralization.

(4) *Basing points and social policy.* The use of basing points brings up problems much broader than the mere question of price discrimination. It raises the question of the proper price-competition policy for government to pursue in certain industries. The industries in which basing points have been used are usually those producing a bulky and standardized good, made under conditions in which large capital outlay is required, in which fixed costs are a considerable part of total costs, in which the transportation charge is an important element in cost to the buyer, and in which there are relatively few firms.

If price discrimination and other monopolistic characteristics of the basing-point system are to be eliminated, the solution must be accompanied by some means of controlling evils which might follow the restoration of competitive conditions. In dealing with the system, two broad lines of policy seem to be indicated. In the first place, it may be allowed to continue, but regulation of its use and the prices fixed through it could be instituted; this follows the line of the public-utility type of control. A second policy would seem to involve abolition of the system, possible atomization of certain industries to the extent necessary to restore competition, and institution of effective regulation against price and other kinds of discrimination by which, under competition, the financially strong might attempt to drive out the weak. To abolish basing points without providing for measures to meet the consequences hardly seems to be wise policy.

2. Tying Contracts and Exclusive Dealing Arrangements. Section 3

of the Clayton Act makes it unlawful for a person engaging in interstate commerce to sell or lease a good on the condition that the purchaser shall not use or deal in the goods of a competitor of the seller, where the effect is substantially to lessen competition or to tend to create a monopoly. The Federal Trade Commission and the Department of Justice have interpreted this provision as applying to tying contracts and exclusive dealing arrangements. In the case of the tying contract, a seller or lessor agrees to sell or lease a good only on the condition that another good be purchased and used with the first. This type of contract has generally arisen when a seller has a patented article which calls for the use of non-patented supplies. The exclusive dealing arrangement is one in which the seller or lessor forces the purchaser not to deal in the goods of a competitor.

In administering this portion of the Clayton Act, the Commission has often combined it with section 5 of the Federal Trade Commission Act, under which it has power to prohibit unfair methods of competition. One reason it has done this is that the Federal Trade Commission Act requires a showing of hindrance to competition and not necessarily a substantial lessening of competition in a *line* of commerce.

The government has had mixed success in applying these prohibitions. The Department of Justice was successful in its suit against the United Shoe Machinery Company, and forced it to give up certain clauses in contracts whereby the lessee of shoe machinery was required to use United machines for other operations and to purchase supplies from the company for the machines leased.[1] The government also caused the International Business Machines Company to give up requiring persons using its patented tabulating machines to buy supplies from it exclusively.[2] In each of these cases, the government found and the Supreme Court agreed that the effect of the contracts was to force buyers not to deal with competitors. While these leading cases did not arise by action of the Federal Trade Commission, they do serve to give meaning to section 3, under which the Commission and the Department of Justice have a joint administrative duty.

In several important cases under section 3, the Commission has not been as successful. In 1919 it issued complaints against the Sinclair Refining Company and some forty other refiners and wholesalers with respect to the practice of leasing pumps and tanks to dealers at nominal prices on the condition that the equipment be used only with gasoline supplied by the lessors. Twenty-seven cease-and-desist orders were issued against the oil companies, and the case was carried to the Supreme Court.[3] That Court held that the Commission had failed to prove that the lease contracts caused a substantial lessening

[1] *U.S. v. United Shoe Machinery Co.*, 258 U.S. 451 (1922).

[2] *Int. Bus. Machines Corp. v. U.S.*, 298 U.S. 131 (1936). For other cases of similar import see *Radio Corp. of America v. Lord*, 28 Fed. (2d) 257, cert. denied, 278 U.S. 648 (1928), and *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

[3] *F.T.C. v. Sinclair Refining Co. et al.*, 261 U.S. 463 (1923).

of competition. It pointed out that the dealers could buy wherever they chose, could lease as many pumps as they wished, and could buy outfits of their own and use them without hindrance.

Further difficulty encountered by the Commission in applying the clause is shown by the case involving exclusive dealing contracts of the Curtis Publishing Company. This company had a practice of requiring its agents not to sell copies of magazines except those published by it. The Commission found this practice to be unlawful under the Clayton Act and issued a cease-and-desist order. The company appealed the case, maintaining that the contract restrictions were lawful agreements between principal and agent, and, not being sales or lease contracts, were not contrary to the Clayton Act. With this position the United States Supreme Court agreed.[1]

In still another leading case the Commission was rebuffed by the courts. A producer of oleomargarine entered into exclusive dealing contracts with its customers. The Commission entered a cease-and-desist order under the Clayton Act. But the federal Circuit Court of Appeals found that the business of the producer was so small that the exclusive dealing contracts did not cause a substantial lessening of competition.[2]

While section 3 may be used to thwart some of the more dangerous types of monopolistic tying devices, the power is not without its shortcomings. To be unlawful under this portion of the Clayton Act, an arrangement must be between seller and buyer or lessor and lessee. Agency arrangements do not fall within the prohibitions of the law. Companies wishing to obtain the benefits of tying arrangements can easily circumvent the law by resorting to agency contracts. Moreover, to prove a substantial lessening of competition is not easy. The dealer may have alternatives, in which case the contract does not substantially reduce competition; or the dealers concerned may not represent such a large proportion of a trade as to endanger the working of competition generally.

3. Intercorporate Relationships. Another kind of practice specifically prohibited by the Clayton Act falls under the classification of intercorporate relationships which tend to reduce competition. Section 7 prohibits in certain instances the purchase of stock by one corporation in another, where the effect of the purchase is substantially to lessen competition, or to restrain commerce in any section or community, or to tend to create a monopoly in any line of commerce. Purchasing stock for investment purposes only, or for the purpose of establishing a legitimate subsidiary company, is not prohibited by the law. By section 8, certain interlocking directorates are forbidden. In the case of industrial corporations, the prohibition applied only where one of the two companies involved had capital, surplus, and undivided profits aggregating more than $1,000,000, and where the companies had been competing

[1] *F.T.C. v. Curtis Publishing Co.*, 260 U.S. 568 (1923).

[2] *Pearsall Butter Co. v. F.T.C.*, 292 Fed. 720 (1923).

in interstate commerce. Under section 8 interlocking directorates between banks, banking associations, and trust companies are forbidden, where the banks are organized under federal law and where the total deposits, capital, surplus, and undivided profits aggregate more than $5,000,000.

Neither section 7 nor section 8 has been particularly effective. The government agencies have run into difficulties in reaching many intercorporate relationships. For one thing, section 7 applies only to the purchase of stocks and not to that of assets through a process of merger. The United States Supreme Court has held that the Commission has no power to force the divestment of assets acquired by two competing concerns, even though this acquisition followed upon an unlawful purchase of stock.[1] Because many mergers follow a period during which stock control is obtained, unless the Commission proceeds during the stock-purchase period it is debarred from stopping the combination after the assets have been acquired.[2]

Even where the Federal Trade Commission acts to force divestment of stock purchases, it must clearly prove that the purchase of stock substantially lessens competition. An illustration of the difficulty of doing this is the International Shoe Company case.[3] When the International Shoe Company purchased substantially all of the common stock of the McElwain Company, another shoe manufacturer, the Commission charged a violation of section 7. This order was reversed upon appeal to the Supreme Court. The Court found that the International company sold to a different kind of shoe market from the McElwain company and largely in a different territory, and that there was consequently no substantial lessening of competition. Moreover, the company maintained, and the Court agreed, that the purpose of the purchase was to obtain additional factories which the International could not itself build with sufficient speed to meet an increased demand.

The prohibition of interlocking directorates in section 8 has been practically of no significance. Few actions have even been undertaken by the Commission. There are several reasons for this. It requires study and investigation to divulge the extent of interlocking directors. Even if the interlocking relationship is found to be within the scope of the law, the director involved can cause the case to be closed merely by resigning his directorate. But this may not end a community of interest between two competing companies. The controlling parties may have dummy representatives sitting on the boards while those in control remain in the background. Obviously, a prohibition against interlocking directorates cannot reach this type of joint control.

[1] *F.T.C. v. Western Meat Co.*, 272 U.S. 554 (1926).

[2] Of course, the Department of Justice might proceed under the Sherman Anti-Trust Act.

[3] *International Shoe Co. v. F.T.C.*, 280 U.S. 291 (1930).

E. UNFAIR METHODS OF COMPETITION

As was noted at the beginning of this chapter, the Federal Trade Commission Act of 1914 gave the Federal Trade Commission power to define and forbid unfair methods of competition. By amendment in 1938, the Commission's authority was broadened to include unfair or deceptive acts or practices which affect interstate commerce, even though they may not be methods which arise in competition. By amendment in 1938, false or misleading advertising of foods, drugs, devices,[1] and cosmetics was specifically made an unfair or deceptive act in commerce.

1. THE MEANING OF UNFAIR OR DECEPTIVE METHODS OR PRACTICES. Except for the inclusion of false or misleading advertising in the amendment of 1938, the law does not define what is meant by unfair methods of competition or unfair or deceptive practices in interstate commerce. Consequently, it has been the task of the Federal Trade Commission to define a practice as belonging within the prohibition of the law. Because its orders can be enforced only by resort to the federal courts, the latter have been in a position to review its definitions.

Some light on the nature of the Commission's power can be obtained from the decisions of the courts. They have held that what is unfair must be considered in view of the "standards of fair dealing which the conscience of the community may develop." [2] But this does not mean that the Commission has the power to press upon business its own code of morals which it believes to be for the good of business.

Before the 1938 amendment, the Supreme Court declared that an unfair method of competition must meet three requirements before the Commission might proceed against it.[3] In the first place, the method complained of must be unfair. This apparently included practices which were oppressive, fraudulent, deceptive, or made in bad faith, and practices which restrained free and open competition or tended to a monopoly. A practice is not unfair merely because it gives a concern an advantage over its rivals. In the second place, the Court held, a practice must be a method of competition in interstate commerce. Practices which were unfair or injurious to purchasers did not thereby fall under the law unless they affected competition. And unless the practice affected competition in interstate commerce, the Commission had no jurisdiction. The third requirement stated by the Court was that the Commission could prevent practices only where such proceeding appeared to be in the public interest. This interest must apparently be specific and substan-

[1] The Federal Trade Commission Act, as amended, defines "devices" in sec. 15 (d) as "instruments, apparatus, and contrivances, including their parts and accessories, intended (1) for use in the diagnosis, cure, mitigation, treatment, or prevention of disease in man or other animals; or (2) to affect the structure or any function of the body of man or other animals."

[2] *F.T.C. v. Standard Education Society*, 86 Fed. (2d) 692 (1936).

[3] *F.T.C. v. Raladam Co.*, 283 U.S. 643 (1931).

tial, and the power of the Commission could not be used to interfere in a private controversy.

The amendments of 1938 have changed this formula in one respect only. The Federal Trade Commission now need not fulfill the second requirement. If an act is prohibited as being an unfair method of competition, this requirement would still apply. But now, a deceptive or unfair practice which does not necessarily affect competition, but which merely harms the public and is in interstate commerce, may be forbidden. The Commission need no longer prove a relationship between the act or device and competition. Hence, both competitors and the public may be protected under the new law.

An illustration will serve to emphasize the importance of this amendment. The Raladam Company had been manufacturing an obesity "cure" and advertising the product as one which could be safely taken as a reducing agent. The Federal Trade Commission found that the product could not be taken safely by all individuals without medical direction and advice, and ordered the company to cease and desist from its misleading advertising. The Supreme Court refused to uphold the Commission.[1] The position of the Court was that the company's advertising might damage the public, but that the Commission had failed to show that it injured competition to a substantial extent.[2] This case was decided before 1938, but had it arisen after the amendments of that year, the position of the Commission would surely have been upheld.

2. TYPICAL PRACTICES DISAPPROVED BY THE COMMISSION. The Federal Trade Commission has dealt with hundreds of cases involving unfair trade practices. It has condemned numerous kinds of such methods, a recent compilation showing thirty-one different types, some of which have many variations.[3] It is impracticable to discuss this entire list here, but some of the more important and usual types of unfair competitive methods will be noted briefly:

(1) The use of false and misleading advertising, calculated to mislead and deceive the purchasing public to their damage.

(2) Misbranding of fabrics and other commodities with respect to their materials or ingredients, their quality, origin, attributes or properties, history, or nature of manufacture.

(3) Passing off goods for well and favorably known products of competitors through misappropriation or simulation of trade-names, labels, or packaging.

(4) Selling rebuilt or second-hand products as new.

(5) Bribing buyers and employees of customers to secure patronage.

(6) Procuring business or trade secrets of competitors by espionage or bribery, or by similar means.

[1] *F.T.C. v. Raladam Co.*, 283 U.S. 643 (1931).

[2] In later cases involving misleading advertising of a sort harmful to the public, the Commission was apparently able to show how this advertising interfered with competition, for the lower federal courts upheld it. See, for example, *E. Griffith Hughes v. F.T.C.*, 77 Fed. (2d) 886 (1935).

[3] See Federal Trade Commission, *Ann. Rep.* (1939), pp. 82–89. See also *Investigation of Concentration of Economic Power*, pt. 5, pp. 2182–84 (1939).

(7) Making false and disparaging statements respecting competitors' products and business.

(8) Using merchandising schemes based upon lot or chance.

(9) Combinations or agreements of competitors to enhance or maintain prices, or divide territory, or cut off competitors' source of supply, or otherwise restrain free and fair competition.

(10) Various schemes to create the impression in the mind of a prospective customer that he is being offered an opportunity to make a purchase under unusually favorable conditions when such is not the case.

(11) Using containers ostensibly of the capacity customarily associated in the mind of the buying public with standard weights and quantities, so as to make the purchaser believe that he is receiving standard weight and quantity when such is not the case.

(12) Misrepresenting the position of the seller so that the buyer is led to believe that he is especially fortunate to deal with the seller. (Making claims to be an "authorized distributor," or a "manufacturer," or an "importer" when such is not the case.)

(13) Use by associations of businesses of standard cost accounting systems, price lists, or guides, calculated to result in observance of uniform prices.

(14) Giving products misleading names so as to give them a value to the purchasing public they would not otherwise possess. (For example, representing products as being inspected by the government when such is not the case.)

3. The Commission and Unfair Competition. The work of the Federal Trade Commission in defining and removing cases of unfair competition has represented a tremendous task. In the decade 1917–1926 over 55 per cent of the cease-and-desist orders issued by it, and in the decade 1927–1936 more than ninety per cent, had to do with this phase of its work.[1] Even this does not give an accurate picture of the volume of work, since many complaints of unfair competition have been dealt with through stipulations.[2]

The position of the Federal Trade Commission has been somewhat strengthened by the amendments of 1938. By including in the law unfair or deceptive practices which do not necessarily affect competition, and by making false and misleading advertising unfair, the administrative job of the Commission has become easier in given cases, even though it may mean that more complaints will come to it. Before the amendments, the Commission had to prove in every case that the method suppressed competition among honest competitors. While it has not had too much trouble in doing so, and there may be question as to whether the amendments add much of substance, the fact remains that now the Commission may proceed against fraudulent or deceptive practices which are in interstate commerce, whether they harm a competitor or not and without the necessity of working up a case showing harm to competition.

[1] Lyons, L. S., Watkins, M. W., and Abramson, V., *Government and Economic Life*, vol. I, App. B. (Washington: Brookings Institution, 1939).

[2] For example, in the period from January 1, 1933, to April 30, 1939, the Commission reviewed and investigated 22,038 cases, made 3379 stipulations, and issued 1218 cease-and-desist orders. See *Investigation of Concentration of Economic Power*, pt. 5, p. 1734 (1939).

This short summary of the Commission's work in cases of unfair trade practice is sufficient to indicate the importance of the Federal Trade Commission Act as an instrument for removing devices which harm competitors and consumers. While the Commission has ordinarily waited for complaints before taking action, its record of proceeding against both small and large businesses whenever a question of substantial public interest is involved has acted as a deterrent to the use of many unfair business practices. To be sure, the Commission has not removed all the practices which it has deemed to be unfair. It has been forced to proceed against concerns individually even after a practice has been condemned in other cases. This requirement has been a burdensome one.

One of the features of the amendments of 1938 which is often overlooked has tended to reduce the administrative burden placed upon the Commission. Now it may issue a cease-and-desist order, and if not contested within sixty days it becomes final. Disobedience of a final order involves a penalty of not more than $5000. Before this amendment, orders were not final until approved by the courts. Under it, the Commission may order several companies to cease from a certain practice. If the practice has already been condemned by the courts, appeal becomes useless, and to escape penalty compliance ordinarily follows.

F. RESALE PRICE MAINTENANCE

Fixing of resale prices by a manufacturer or wholesaler has been looked upon by the Federal Trade Commission as an unfair method of competition. In the previous chapter, the relationship of resale price maintenance to the anti-trust laws was discussed.[1] There it was shown that such price-fixing was regarded as being in opposition to the anti-trust laws. Not until the Tydings-Miller Act of 1937 were resale price maintenance contracts in interstate commerce made lawful, and then only when allowed by state law.

Resale price maintenance is of interest here primarily because of its relationship to the concept of fair trade. At first looked upon as a type of practice promotive of monopoly, the practice has come into a position where it is regarded as a "good" or "fair" business device. This metamorphosis is exceedingly interesting as representing a changed concept of fair competition. And the subject itself is so important, because of its implications for additional regulation, that it is here separated for special treatment.

1. ECONOMICS OF RESALE PRICE MAINTENANCE. Strictly speaking, resale price maintenance is the practice of fixing the resale price by contract for a trade-marked or otherwise differentiated product. Similar devices are those whereby the retailer is forbidden to sell below the cost of the good to him, or below that cost plus a mark-up to cover a reasonable cost of selling. The lat-

[1] See *supra*, pp. 454-56.

ter type of control is usually effected through special state legislation making it unlawful for a dealer to sell below cost. The first type is ordinarily effected by private contracts between manufacturers and wholesalers and retailers whereby the resale price is fixed. As a practical matter, fixing resale prices by contract can only be accomplished where the good is differentiated and not subject to free competition.

Why should the manufacturer be interested in fixing resale prices? Why should dealers desire that this be done? And what effect does this have upon the consumer and upon society? The real pressure for resale price maintenance laws has come from the host of small dealers throughout the country, especially in those fields threatened by competition of the chain store, the large department store, and the mail-order house. The position of the small retailer is not difficult to understand. Faced with competition from large retailing outlets, he has desired a system which would protect him from the inroads of competition. Moreover, he has been more generally in a position in which he must sell well-known and trade-marked brands of merchandise. He must make much of his profit on this type of good. He generally has no private brands upon which to fall back when he has enticed customers into his store by low prices on well-known brands.

The manufacturer has been a supporter of resale price maintenance, largely because of the pressure of retailers,[1] and partly to protect the value of the good-will attached to his trade-marked product. If retail price-cutting should drive the small seller from the field, the manufacturer might well sell as much as before; but dealing with a few large buyers does not give him the independence he has when his retail outlets are legion. Moreover, if good-will is built about an article on a sales price of $1, cutting the retail price to 59 cents tends to make the public believe either that profits are too large or that the product is not worth the dollar. Cutting of retail prices also places a burden upon the manufacturer to lower his price to wholesalers and retailers. This means that he may be forced to skimp on quality or selling effort, or to take a cut below a reasonable profit margin. Whatever the course taken, even if the manufacturer does not yield to the demand for lower prices but takes a reduction in quantity sales, the result is a lowering of the profitableness of production. If quality or selling effort is curtailed, the market may fall off; if profit margins are cut too close, losses may result.

Society in general and the consuming group in particular have not had much to say about the adoption of resale prices. But the ideas of resale price maintenance and of forcing selling at cost or cost plus a merchandising profit have appealed to many individuals who are not manufacturers, wholesalers, or retailers. Many people fear the consequence to social stability of growing size in the merchandising field and the squeezing out of the independent merchant.

[1] As a matter of fact, relatively few manufacturers are genuinely in favor of resale price maintenance laws.

From an economic point of view, resale price maintenance may be viewed in different lights. A good case can be made for saying that the manufacturer has a property right of value in the good-will surrounding his differentiated product, that the price-cutter uses this property as an unfair means of getting customers into his store, and that he destroys it through the mere lowering of price itself. From the point of view of society, resale price maintenance, by forcing prices to be higher than necessary economic costs, makes the consumer pay too high a price for the good he receives. One of the main advantages of vigorous competition is the production of goods and services at lowest costs and sales at lowest prices through the survival of the most efficient. If the resale price is high enough to give all retailers a reasonable profit margin, it is probably high enough to shield the inefficient middleman. It therefore does not allow the lowered cost of efficient marketing to be passed on to the consumer. This is hardly in the interests of efficiency and high-living standards.

On the other hand, if resale price maintenance contributes to the maintenance of competition, there may be some social and economic justification for it. If the small retailer would be driven out of the field without it, and if marketing outlets would become few and large, so that competition would decline, consumers might be subject to the dangers of oligopoly pricing. This eventuality seems remote, however, especially in view of the competition between large distributing units, as well as the ability of many smaller units to keep in the competitive stream even before widespread resale price maintenance.

2. Resale Price Maintenance Under the Federal Trade Commission Before 1937. Prior to the passage of the Tydings-Miller Act of 1937, the Federal Trade Commission took the position that fixing of resale prices was a method of unfair competition as prohibited by section 5 of the Federal Trade Commission Act. It held that resale price maintenance was contrary to public policy. At first, it insisted that all attempts of manufacturers to fix resale prices by whatever method were unlawful.

In its case against the Beech-Nut Packing Company, the Federal Trade Commission ordered the company to cease and desist from suggesting resale prices to dealers and then, by refusing to sell to price-cutters and by keeping a blacklist of them, enforcing these prices. The order was upheld on appeal to the Supreme Court.[1] In its decision, however, the Court made it clear that not all attempts to fix resale prices were unlawful. In this connection, it followed the cases brought under the anti-trust laws.[2] If resale prices were forced by contract or by any other system of enforcement, the plan was held to be unlawful as a suppression of competition among retailers. But a manufacturer might suggest prices and request that they be observed and, if the seller did not follow out the suggestion, refuse to sell to him in the future. The vice of the Beech-Nut system was the introduction of an element of threat and coer-

[1] *F.T.C. v. Beech-Nut Packing Co.*, 257 U.S. 441 (1922). [2] See *supra*, pp. 454–55.

cion to bring about compliance with the request. The practice of spying upon dealers, keeping a blacklist of price-cutters, and engaging in other co-operative schemes to maintain prices went beyond a mere system of request.

After the decision in the Beech-Nut case, the Federal Trade Commission proceeded more slowly against attempts to fix resale prices. However, where it had reason to believe that any coercive measure beyond mere refusal to deal after price-cutting had been employed, until 1937 it proceeded vigorously against the parties concerned.[1] Even since then the Commission, while being debarred from proceeding against resale price maintenance contracts, has taken the position that they probably damage the public far more than the damage that may come to producers through price-cutting.[2]

3. STATE FAIR-TRADE LAWS. Legalization of resale price maintenance came first through state legislation. Largely because of fear of unbridled competition engendered by the depression and the belief that the chain store would drive the independent retailers out of business, public opinion came to favor development and the lobbying pressure introduced by retailer groups led to the enactment of state fair-trade laws, the first of which was passed by California in 1931. Some of the codes of fair competition under the National Industrial Recovery Act of 1933 included provisions allowing resale price maintenance by manufacturers. When the codes were invalidated in 1935, a new impetus to the passage of fair-trade laws was experienced in many states.

By 1937 forty-one states had laws allowing manufacturers to fix resale prices by contract, and by late 1940 forty-four states had them. Some of these laws allow the manufacturer to fix the minimum resale price, while others permit the fixing of the price itself. Most of them provide that a manufacturer of a branded or trade-marked product may make a contract with wholesalers and retailers (directly or through the wholesalers) binding the retailers to sell the good at a certain price. These laws generally provide that contracts need not be made with all sellers, but that a contract made with any becomes binding on all upon notice to the sellers. In order to avoid evasion of established prices by special concessions, the newer type of laws forbids offering to sell a price-fixed article with a "gift" of any item of value or any other concession. They provide for selling below the fixed price only under the following circumstances: (1) sales of goods which have been damaged and are sold as such; (2) sales to close out a stock for purpose of discontinuing a product (but often state laws provide that the manufacturer must be given an opportunity to repurchase this stock); and (3) sales made by an official acting under orders of a court.

In addition to laws allowing resale price maintenance by contract, many

[1] See, for example, *Toledo Pipe-Threading Mach. Co. v. F.T.C.*, 11 Fed. (2d) 337 (1926); *Moir v. F.T.C.*, 12 Fed. (2d) 22 (1926); *Cream of Wheat Co. v. F.T.C.*, 14 Fed. (2d) 40 (1926). But the Commission has been overruled many times. See, for example, *Harriet Hubbard Ayer, Inc. v. F.T.C.*, 15 Fed. (2d) 274 (1926).

[2] See *Investigation on Concentration of Economic Power*, pt. 5, pp. 2170–72 (1939).

state laws have set up limitation upon sales of any good below cost. These laws are ordinarily called "unfair practices" or "unfair sales" acts. By late 1940, such laws had been passed in twenty-four states and were pending in many others.[1] While these laws vary somewhat, they are all designed to require wholesalers and retailers to sell at no less than invoice cost,[2] or at invoice cost plus some percentage mark-up, or at invoice cost plus the cost of doing business. Sales below these limits are usually allowed where necessary to meet competition, to close out a line of merchandise, or to sell upon orders of a court. The purpose of the laws is largely to supplement resale price maintenance laws by placing a floor on prices of goods which are not branded or trade-marked. These laws have also been pushed by such retailers as the tobacco dealers. Since cigarette manufacturers have such a hold upon the consumer market through the reputation of their brands, they have felt that they have little to gain, if anything, by discouraging price-cutting through resale price maintenance contracts.

These loss-limitation laws are generally difficult to enforce where the minimum is placed at invoice or replacement cost plus the cost of doing business. While the items of cost incurred by the retailer are usually listed in the law,[3] computations are not necessarily uniformly made, and costs differ so much and enforcement is so difficult that this type of law has been found fairly unsatisfactory. Most laws have recently required a definite percentage mark-up, generally 6 per cent. For example, a recent Oregon amendment placed the minimum mark-up for retailers at 6 per cent above invoice price. Where invoice prices differ as between stores or over a period of time, a dealer, of course, has the right to place his price at a level to meet competition.

The purpose of loss-limitation laws is to stop the use of low-priced leaders, sometimes sold at a loss to attract trade, and to put a stop to ruinous price-cutting which has a tendency of driving a competitor out of business. As a matter of fact, some of the laws have as a clear purpose also the maintenance of a level of prices high enough so that practically all retailers, small and large, efficient and inefficient, may be kept in business.

A loss-limitation law which merely requires that a dealer sell at a price equal to or above his invoice price would seem not to be open to criticism, since it merely stops the use of loss-leaders and the more vicious types of cut-throat competition. But laws which provide for a minimum percentage mark-up do not take into account either the possibility that an efficient merchandiser may not need such a mark-up, or the fact that fast-moving goods may require, on a basis of cost, a lesser mark-up than slow-moving ones. As

[1] See summary of these laws in Public Administration Clearing House, *News Bulletin*, Release No. 5 (October, 1940).

[2] Generally invoice cost or replacement cost, whichever is lower.

[3] The cost of doing business is usually defined as including the following: all wages and salaries, rent, interest on borrowed capital, depreciation, maintenance, selling costs, delivery costs, accounting and auditing costs, losses, cost of licenses and fees, taxes, insurance, and advertising.

for laws which require that the mark-up be equal to the average cost of doing business, little favor can be found from an economic point of view. Such laws require in effect that an equal percentage of total average costs, including both fixed and variable costs, must be applied to every dollar's worth of merchandise sold. They overlook the very nature of fixed costs, and of cost allocation where fixed costs exist. Rather than lose business (and after all, consumers' demands are often very elastic), it might well be in the interests of most profitable operation to sell some goods at a mark-up below the average cost of doing business. Moreover, if the purpose of this kind of legislation is to curtail price competition which tends toward monopoly, to require mark-ups equal to the cost of doing business is to overshoot the mark. Such a requirement seems to go beyond mere price-cutting and becomes a device for insuring profits to independent sellers.

4. The Courts and State Fair-Trade Laws. To the surprise of many constitutional lawyers,[1] the United States Supreme Court in 1936 held unanimously that state laws allowing for resale price maintenance contracts were valid.[2] The main objection advanced against their constitutionality was that they denied to the owner of property the right to determine for himself the price at which he will sell. The law was claimed to be a price-fixing one and to take property without due process of law, since the retailer was not engaged in a business falling under the classification of those "affected with a public interest." Mr. Justice Sutherland, speaking for the Court, denied the validity of this position as applied to contracts for resale price maintenance. He pointed out that while a retailer buying a product from a manufacturer, owned the commodity, he did not own the good-will which a trade-mark or brand symbolized. If fixing of resale prices is necessary to protect the value of this good-will, then, he declared, legislation allowing such contracts to be made is a reasonable measure for protection of the manufacturer's property. He emphasized that a retailer might sell the physical commodity without benefit of the trade-mark at whatever price he might choose, but that if he sold it with the identifying mark of the manufacturer he was selling with the aid of the latter's good-will. Consequently the law was not a price-fixing law, because the seller could sell that which he owned — the physical commodity devoid of identification — without any restraint whatsoever.

As yet the United States Supreme Court has not passed upon the validity

[1] It is interesting that just prior to the United States Supreme Court decision, the New York Court of Appeals had held a New York resale price maintenance law to be unconstitutional as a restriction upon the property right of the retailer. See *Doubleday, Doran and Co. v. R. H. Macy and Co.*, 269 N.Y. 272 (1936). The New York Court had relied largely upon decisions regarding resale price maintenance made by the United States Supreme Court under the anti-trust laws and the Federal Trade Commission Act. However, during the same year state resale price maintenance laws were upheld by the highest courts of California and Illinois. See *Pyroil Sales Co. v. The Pep Boys*, 5 Cal. (2d) 784 (1936), and *Seagram Distillers Corp. v. Old Dearborn Distrib. Co.*, 363 Ill. 610 (1936).

[2] *Old Dearborn Distributing Co. v. Seagram Distillers Corp.*, 299 U.S. 183 (1936).

of loss-limitation laws. In the lower courts, they have been both upheld and rejected.[1] Where the courts have found these laws unconstitutional, the primary basis has been that such regulations were arbitrary, capricious, and without substantial relation to the object desired, thereby taking property without due process of law. Even in these cases, the courts have generally admitted that the state may regulate prices if necessary for the public welfare.[2] They have held that the enactment of proper legislation to insure fair-trade practices is within the police power of the state. But loss-limitation laws, by making price-cutting itself evidence of intent to suppress competition, discriminate unfairly against merchants who may sell below cost, as defined by the law, without intent of substantially lessening competition or causing actual injury. In defining "cost" of doing business, the definitions used have been held to be fictitious, arbitrary, and vague.

Those courts finding these laws constitutional have taken the point of view that such regulation is a valid means whereby a state under its police power may curtail unfair competitive practices. The California Supreme Court held that loss-limitation laws had fundamentally the same purpose as resale price maintenance laws in that they both aimed at destructive price-cutting and the use of loss-leaders. Where the laws have been upheld, the courts have intimated that the practice complained of must be such as to show an intent to suppress competition or a definite injury to fair competition.

5. Federal Government Approval of State Resale Laws. In spite of the passage of state fair-trade laws involving resale price maintenance by contract, and their approval by the Supreme Court, the contracts made under these laws would have been of limited effectiveness if Congress had not taken favorable action. As the state laws stood, they gave a manufacturer no power to make a resale price maintenance contract in interstate commerce. The Federal Trade Commission had held that fixing of resale prices by contract was a method of unfair competition contrary to law, and the Department of Justice had received court approval for its position that resale price maintenance was in opposition to the anti-trust laws. This meant that while within a state a resale price contract might be made, in the field of interstate commerce the federal laws still applied.

To remove this impediment, Congress was asked in 1936 to exempt such contracts from all the anti-trust laws. Despite much opposition, clever politi-

[1] See the following cases where such laws have been held to be unconstitutional: *A. and P. Tea Co. v. Ervin*, 23 Fed. Suppl. 70 (Federal District Court found parts of Minnesota law unconstitutional, 1938); *State v. Ruback*, 281 N.W. 607 (Nebraska Supreme Court, 1938); *Pennsylvania v. Zasloff* (No. 209, April term, 1938, Pennsylvania Superior Court). In other cases, these laws have been found to be constitutional. See *Wholesale Tobacco Dealers' Bureau v. National Tobacco and Candy Co.*, 82 Pac. (2d) 3 (California Supreme Court, 1938); *State v. Langley*, 84 Pac. (2d) 767 (Wyoming Supreme Court, 1938); *Associated Merchants v. Ormesher*, 86 Pac. (2d) 1031 (Montana Supreme Court, 1939).

[2] In taking this position, the courts have followed the lead of the United States Supreme Court in upholding regulation of the sale price of milk in New York. See *Nebbia v. New York*, 291 U.S. 502 (1933). See *supra*, pp. 287–88.

cal maneuvering caused the bill to be attached as a rider to the District of Columbia Deficiency Bill. Since this was done at the very end of the session in 1937, and since Congress could not vote down legalization of resale price maintenance without also voting down appropriations for the operation of the District of Columbia, the bill, known as the Tydings-Miller Act, was passed and approved by President Roosevelt. Whether the law would have passed if it had been voted upon independently is open to question. Judging from statements made by the President, the law would surely have never been signed by him had it not been attached to the appropriations bill.

The Tydings-Miller Act exempts the making of resale price maintenance contracts from the anti-trust laws; but they must be for trade-marked or branded merchandise and must be lawful within the state where the sale is to be made. The act stresses that it permits vertical price-fixing only and in no way legalizes the making of contracts between sellers who are in competition with each other.

6. State Fair-Trade Laws and Society. Whatever might be said about state fair-trade laws, the concept of fairness employed therein is somewhat of a perversion of an earlier meaning of "fair trade." Reference has been made to finding resale price maintenance a monopolistic device in opposition to the anti-trust laws. The Federal Trade Commission has also interpreted it to be a method of unfair competition. Yet there is an element of precedent in calling these laws fair-trade laws. Both the Clayton Act and the Federal Trade Commission in its administration of the Federal Trade Commission Act have implied or held that unscrupulous price-cutting which tends to suppress competition and create a monopoly is unlawful. Strangely enough, it has been this price-cutting that has furnished independent retailers and manufacturers with a moral issue upon which to base their campaigns for legalization of resale price maintenance and loss-limitation laws.

From the point of view of traditional anti-monopoly and fair competition policy, these retail price-fixing laws seem to represent a sharp departure. As has been noted above, vertical price-fixing tends to lead to horizontal price-fixing. If a large manufacturer refuses to put his goods under resale price maintenance contracts, pressure is immediately brought to bear by organized retailers and other manufacturers to have him do so.[1] This would seem to be a sort of joint action to force the suppression of competition, an action unlawful under the anti-trust laws.

Moreover, loss-limitation laws constitute horizontal price-fixing at its simplest. By making price competition "unfair," that aspect of the competitive struggle long regarded as "fair" seems to be replaced by a policy conducive of uniform prices. Certainly this type of program is a far cry from traditional American reliance upon competition. If monopoly is threatened by price competition, the approach more in line with American tradition would be to

[1] For evidence on this point see Edwards, Corwin, "Appraisal of 'Fair Trade' and 'Unfair Practice' Acts," 5 *Journal of Marketing*, pp. 31–51 (July, 1940).

enforce anti-trust laws where a combination in restraint of trade is built up and where predatory price competition threatens to eliminate competition. Outright fixing of prices is pretty strong medicine for removing this threat to competition.

From a social point of view, there seem to be two primary considerations by which these laws might be judged. The first, and by far the most important, has to do with the questions of efficiency in marketing and production and of low prices to the consumer. If fixing of resale prices, whether by contract or by mark-up laws, places a protective "umbrella" over both the efficient and inefficient, society must pay for this encouragement to inefficiency. If these laws encourage the raising of prices above necessary costs, the consumer is forced to pay more or turn to products not favored by the law. As compared to prices existing before the state laws, even after allowing for a rise in the price level, there does seem to be evidence that the consumer has paid more.[1]

A second consideration of great importance to society is whether this type of program is in the direction of protecting the small-business man from monopolistic tendencies in marketing, and even if it is, whether such protection is wise. A question might be raised as to whether without resale price maintenance monopolistic conditions would arise. If mere unreasonable price discrimination between a manufacturer and his customers is erased and if predatory price-cutting below invoice or replacement cost is restricted, perhaps the small retailer does not need more protection. Even if he should, is it wise, even as a political measure, to subsidize one group of entrepreneurs over another? Moreover, the small-business man and the manufacturer who have asked for some degree of price control may have opened the way for a greater program of government regulation of their businesses in the future. Government regulatory schemes have a way of making themselves more effective by introducing more far-reaching controls.

G. DISCRIMINATORY CHAIN-STORE TAXATION

Another measure to restore "fair" competition to competitors of mass distributors has been discriminatory taxation of chain stores. Beginning with anti-chain-store tax laws passed in Georgia, Maryland, and North Carolina in 1927, by the end of 1938 such laws were in force in twenty-four states of the Union.[2] By 1940, however, they had been repealed in three of these.[3] Al-

[1] *Investigation of Concentration of Economic Power*, pt. 8, p. 3371 (1939). Also see Cotter, A., "Legislating against the Consumer," 9 *Barron's*, no. 2 (January 9, 1939), p. 28. Gault has made a study of the effect of fair trade in Michigan. His study considered one hundred and sixty price-maintained drug products before and after the resale price maintenance law went into effect. He found that consumers who formerly purchased drug products at cut prices paid 15 to 30 per cent more after price control. See Gault, E. H., "Fair Trade," *Michigan Business Studies*, vol. 9, no. 2 (Ann Arbor: University of Michigan, 1939), pp. 41 ff.

[2] Lee, M. W., "Anti-Chain-Store Tax Legislation," 9 *Studies in Business Administration*. (Chicago: Univ. of Chicago, 1939), pp. 5–6. The data in the following discussion are based upon this study.

[3] 25 *Domestic Commerce*, p. 142 (March 10, 1940).

though differing in detail and severity, the laws have had as their purpose the placing of a larger tax burden upon chain stores than upon single independent stores, in order to even up some of the advantages enjoyed by the chains.

1. Provisions of Chain-Store Tax Laws. State laws vary considerably. In most states, however, they are based upon the Indiana chain-store law. This provides for a tax graduated upward with the number of stores within the state. The tax levied by the Indiana law of 1933 is representative. It applied a tax of $3 per year on the first store, $10 on the second to fifth stores, $20 on the sixth to tenth, $30 on the eleventh to twentieth, and $150 on each store after the twentieth. Varying tax rates are found in other states, with a maximum as high as $750 for each store in excess of fifty in the Texas law of 1935.

Another type of this law has appeared. Instead of the taxation's being based upon the number of stores located within the state, it has been based upon the number of stores within the chain system, whether within or outside of the state. Such a law is found only in Louisiana. In 1934, that state placed a tax upon chain stores varying from $10 per store for one to ten stores in a system to $550 per store where there were more than five hundred. Thus, if a chain of more than five hundred stores had only one store within Louisiana, that store would be subject to a tax of $550 per year.

In a few states taxes upon chain stores have been based upon a percentage of gross receipts per store, this percentage being higher as the number of stores in a chain increases. Thus, the Florida law levied a tax of ½ of 1 per cent of gross receipts where only one store was in a system, but 5 per cent where there were more than fifteen stores. It is interesting that this tax was combined with a graduated tax based upon the number of stores.

2. Constitutionality of Anti-Chain-Store Taxes. In the first case on anti-chain-store taxes to reach the United States Supreme Court, the Indiana law was held to be constitutional by a close decision of 5 to 4.[1] The majority of the Court pointed out that while the power of taxation may not be used to deny equal protection of the laws, a classification of the subjects of taxation has long been regarded as lawful so long as it is based upon a reasonable distinction. Where a reasonable classification is made, equal protection of the laws is not denied. The Court agreed that there was enough difference between the business of a chain store and other types of stores to make such a tax classification reasonable. In support of this claim, it pointed to the differences in ownership, organization, management, merchandising policy, and type of business transacted.

The dissenting justices held that tax classification should be "jealously confined to the limits set by the Constitution," since the power to tax is the power to destroy. They saw in the chain-store tax a device which could be used to oppress business, and if the tax were so used, there seemed to be little hope that the courts would step in to prevent excessive exactions.

[1] *State Board of Tax Com'rs. v. Jackson*, 283 U.S. 527 (1931).

In the Indiana case, the classification for tax purposes was based upon the number of stores doing business within the state. But in a case testing the constitutionality of the Louisiana chain-store tax, the Supreme Court held that taxing on the basis of the total number of stores in a single system did not involve an unreasonable classification.[1] The majority declared that the competitive advantages of a chain store bore a direct relationship to the size of the chain, whether the latter operated entirely within a state or in several states. The Court held that the tax was not based upon the location of stores but upon the character of the business, and that as such the classification was reasonable.

In the Louisiana case, the Supreme Court seemed to broaden the basis for chain-store control by suggesting that restriction of chain-store operations might be justifiable as a use of the state police power. In this connection the Court said:

> In the exercise of its police power the state may forbid, as inimical to the public welfare, the prosecution of a particular type of business or regulate a business in such a manner as to abate evils deemed to arise from its pursuit. Whatever a state may forbid or regulate it may permit upon condition that a fee be paid in return for the privilege, and such a fee may be exacted to discourage the prosecution of a business or to adjust the competitive or economic inequalities.[2]

Where chain-store taxes have been levied in accordance with gross receipts, they have not been so successful in the courts. In a case involving the Kentucky tax, the Supreme Court in 1935 held that a tax based upon gross receipts of an entire organization caused an unequal and arbitrary classification for tax purposes.[3] It held that this type of tax was not based upon any differences in doing business, but resulted in different exactions between two persons doing similar acts, merely "because the one has performed the act oftener than the other."

3. CHAIN-STORE TAXATION: CONCLUSIONS. The cases reaching the United States Supreme Court have given states a wide range of power by which to curb the growth of multiple-outlet retailing. Not only do the states have the power to place a discriminatory tax upon the chain stores, but the Louisiana decision indicates that the states may discourage their development by the use of the police power. This wide grant of power leaves the question of suppressing chain stores to the legislature.

Until the last few years, the chain stores had done little to place their case before the public. Their position had been that their job was to win the public by low prices and good service. With the rapid development of discriminatory legislation against them, they have undertaken to influence public opinion against such laws. This program has borne some fruit. No new state laws were passed in 1938 or 1939, and many bills calling for repeal have been introduced in state legislatures. Interesting too is the fact that a federal

[1] *Great A. and P. Tea Co. v. Grosjean*, 301 U.S. 412 (1937).
[2] *Ibid.*, at pp. 425–26.
[3] *Stewart Dry Goods Co. v. Lewis*, 294 U.S. 550 (1935).

government bill frankly designed to destroy national chain-store organizations through taxes running as high as $49,000 on a single store was never given a committee hearing until 1940.

From an economic and social point of view, discriminatory chain-store taxation is subject to the same considerations as the other devices aimed at the mass distributors. The aim is to place a burden upon these large organizations for the purpose of protecting the smaller retailing units. Such laws would seem clearly to penalize the more efficient middlemen for the benefit of the less efficient. On the other hand, the political and social desirability of a distribution system made up of small and independent protected units may overcome the cost involved. But before such a step is undertaken the social cost of interference with new and economical types of middlemen should be considered.

H. SPECIAL REGULATION OF DECEPTION: FOOD AND DRUGS

Somewhat related to the work of the Federal Trade Commission and other agencies set up to enforce fair standards of competition are the federal and state pure food and drug administrations. While these agencies are interested primarily in the welfare of the consumer, their approach is not widely different from that of the trade commissions. This is particularly true of the Federal Trade Commission because that body has undertaken to protect the purchaser almost as much as the competitor of an unfair seller. Be that as it may, regulation for pure foods and drugs is regulation to prevent deception, since the consumer would hardly purchase products which he knew to be impure or harmful.

1. FEDERAL PURE FOOD AND DRUG LAWS. The principal basis for food and drug regulation by the federal government is the Pure Food and Drug Act of 1906. This act was not changed in any material extent until 1938, when, by the Copeland Act, cosmetics and therapeutic devices were added to foods and drugs. Since the original law, administration of this regulation has been in the hands of the Pure Food and Drug Administration, an agency in the Department of Agriculture until 1940, when it was placed under the Federal Security Agency.

The present law prohibits the shipping in interstate commerce of any food, drug, device, or cosmetic which is adulterated or misbranded. It declares that a food product is adulterated if it contains any poisonous, filthy, or decomposed substance, if it is mixed with an inferior substance so as to reduce quality, if it is mixed with a substance to increase weight or bulk, or if it is manufactured so as to conceal damage or inferiority. A food product is misbranded if it is labeled so as to deceive or mislead the purchaser through imitation of another article, through replacement of original content of a package by another substance, or through packaging which leads the buyer to believe the contents to be different in quantity or quality than they are. In addition,

labels must bear an accurate statement of weight or other measure of contents. Any other information required under the administration of the act must be shown on the label, and all information must be plainly described. The use of coloratives and preservatives must also be noted on the label.

Prior to the amendment of 1938, there were several important exceptions to the application of the law against foods. Provided an article contained no injurious ingredient, the act exempted goods produced under a distinctive trade-name where this trade-name was not an imitation and the place of manufacture was shown. Also exempted were compounds, blends, or imitations, plainly labeled as such, where the products contained no harmful ingredients. Because these exemptions furnished too great a loophole for evasion of the law, they were removed in 1938.

The present law holds a drug [1] or device [2] to be adulterated if it contains filthy or decomposed substance, is manufactured under unsanitary conditions, or falls below the standard of strength and quality recognized by the United States Pharmacopeia or the National Formulary. The latter requirement applies only if the drug or device is described in terms of standard meaning. The same qualifications found in the definition of misbranding of food apply to drugs. In addition, drugs containing any habit-forming ingredient must be labeled as such. Drugs must be labeled with adequate directions for use, and adequate warnings where mistaken use might be dangerous to health.

In connection with the regulation of drugs, it is interesting that the Federal Security Agency (probably through the Pure Food and Drug Administration) is given power to forbid the channels of interstate commerce to new drugs if it finds that the methods of manufacture, processing, or packaging have not developed to the point where the identity, purity, strength, or quality of the drug cannot be preserved. The Agency is also given the power to deny entry to interstate commerce of new drugs which are not yet safe for use.

Regulation of cosmetics is entirely new with the 1938 amendment. The law interestingly excepts soap from its definition of cosmetics, making the term apply to other preparations intended to be rubbed, poured, sprinkled, or otherwise applied to the human body for purposes of cleansing, beautifying, or altering its appearance. The description of what may make a cosmetic adulterated or misbranded is similar to that given in the law on food and drugs. One minor exception may be noted. Hair dyes may include harmful coal-tar colors if the label conspicuously notes this and warns users as to the deleterious effects which may follow.

To enforce the act, criminal penalties are provided. If an offending person is guilty of mere infraction of the law, he may be fined up to $1000 or imprisoned for one year, or both. But if a person is found to be guilty of viola-

[1] The law defines a "drug" as any article recognized to be such by the *United States Pharmacopeia* or *National Formulary*.

[2] See *infra*, p. 486, n. 1.

tion with an intent to defraud or mislead, the fine may be $10,000 and the imprisonment may be for three years. These penalties were placed in the law by the amendment of 1938. Before that time, infractions were punishable only by fines ranging from $200 for a first offense to a fine of $300 or imprisonment for one year for any succeeding offense. Furthermore, the law provides that adulterated or misbranded goods may be confiscated by the government; while they may thereupon be sold or destroyed, in some cases the original owner may have them restored upon the promise not to violate any federal or state laws on the subject.

The Pure Food and Drug Administration is given broad powers of inspection, investigation, and examination of goods in transportation and in the process of production. Under this power it examines thousands of samples of foods, drugs, devices, and cosmetics. On the basis of these samples, numerous seizures are made and prosecutions for violations undertaken. The Administration has also published many pamphlets containing advice for buyers. It has taken the attitude that unless it has the intelligent co-operation of buyers educated to detect adulterations and misbranding, its necessarily limited work in examination and prosecution will not be as effective as it should be. When it is considered how many products and manufacturers fall under the jurisdiction of the Administration and its relatively limited budget,[1] the wisdom of this approach cannot be denied.

2. Other Federal Food Laws. In addition to its authority over foods, drugs, cosmetics, and devices, the Food and Drug Administration has power to control adulteration of insecticides, proper branding of caustic poisons designed for household use, standards for imported tea and milk, and inspection and grading of naval stores, such as turpentine and rosin. Not all of the regulation to prevent deception or harm in the preparation of foods is under the Administration. The part played by the Federal Trade Commission has already been noted. Inspection of the preparation of meats for entry into interstate or foreign commerce is placed under the Bureau of Animal Husbandry of the Department of Agriculture. Other regulations under various agencies of the Department include the inspection and grading of many agricultural commodities,[2] and the regulation of importation of seeds. Special regulation of branding and grading of alcoholic beverages is also found under the Federal Alcohol Administration. Special regulation to prevent misbranding of wool products was placed under the Federal Trade Commission by legislation enacted in 1940.

3. State Pure Food and Drug Laws. Pure food and drug laws are found in practically every state. While these show a high degree of variation, they

[1] For 1940, the budget for the Food and Drug Administration was only $2,978,000. See United States Government, *Budget* (1940), p. 299.

[2] This list has grown to include, among others, wheat, oats, rye, rice, corn, cotton, barley, butter, eggs, tobacco, wool, fruits, vegetables, potatoes, fats, oils, cottonseed meal, and peanuts.

tend to follow the federal laws. As one might expect, not only do they vary in many details, but the character of administration and of effective enforcement is subject to wide differences. In some states, remarkable progress in regulation has been made, one of the most noteworthy cases being that of North Dakota. For nearly four decades, this state has been a leader in protection of the consumer from deceptive and injurious practices in the preparation and marketing of food, drugs, and many other products.

State laws have often provided special regulation of the preparation and sale of certain commodities. In many states the production and distribution of milk and milk products are singled out for rigid regulation. Because of the high susceptibility of milk products to contamination and adulteration, many states require the licensing of milk dealers, inspection of milk plants, testing of herds, and examination of milk handlers, and of the milk and milk products. In states specializing in the production of other foods, distinctive laws are found. Illinois, for example, has more than ordinary regulation of the preparation of meats, and Florida has strict laws regulating the sale of citrus fruits.

Regulation of foods and drugs has been upheld in practically every instance by the courts, even where it may involve products entering interstate commerce or received through interstate commerce channels.[1] The attitude of the courts has been that the state has a clear power to protect the health of the public and that, unless a law is in definite opposition to federal regulation, such legislation should be upheld.

The principal problem in this kind of regulation by the states is effective administration. The legislative basis upon which this regulation rests is generally broad enough. The effectiveness of state control, however, has often been impaired by inadequate appropriation of funds. Such regulation requires a large staff of competent inspectors and analysts, and many state legislatures have not been willing to provide funds enough to establish effective enforcement of the broad laws placed upon the statute books.

4. Other Regulation of Deception by the States. In order to meet deceptive or harmful business practices, the state governments have many detailed regulations other than those having to do with food and drugs. While there are so many of these exercises of the police power that they cannot be discussed here, a few may be noted for the purpose of showing the widespread control of competition regarded as unfair to the consumer. Many such regulations have to do with labor and will be discussed in later chapters. Others have to do with deception in the sale of securities and are also reserved for later discussion.

States generally forbid selling articles or services by means of lotteries. Licenses are required of individuals engaged in skilled trades or the professions, mainly for the protection of the public against incompetent or unscrupulous

[1] See, for example, *Price v. Illinois*, 238 U.S. 446 (1915), and *Sligh v. Kirkwood*, 237 U.S. 52 (1915).

practitioners. In some of these professions, particularly those of dentists, lawyers, doctors, and certified public accountants, special regulations against unethical practices are provided. Most states have laws providing for inspection of weighing devices, containers, and packaging, with a view to enforcing uniform standards and avoiding deception.

5. CONCLUSIONS. The special regulations of deception involved in pure food and drug acts and the other legislation noted above are primarily designed to protect the purchaser. As such, they represent prime evidence that the forces of competition are not sufficient to furnish such protection, because of the ignorance or indifference of buyers. In other words, society has attempted to supplement consumer discrimination by regulatory control where it appears that the consumer cannot or will not protect himself.

But these activities, helpful as they are, should not lull the consumer into feeling that the government has guaranteed him against being deceived or harmed by careless or unscrupulous business enterprises. Government laws are not broad enough to cover all such cases. Administration of these laws is not effective enough to eliminate all violations, even if the statutes are adequate. One authority has pointed out that the annual advertising budget of a single toothpaste manufacturer has been larger than the enforcement budget of the federal Food and Drug Administration.[1] Federal and state governments have not attempted to set up machinery which could even approximate complete enforcement of these laws. Perhaps to do so would be too expensive and would involve too detailed regulation. However, if these agencies can give publicity to types of abuses, the greatest hope for eradication lies in an intelligent and discriminating buying public and an enlightened business leadership.

I. BUSINESS SELF-REGULATION

In the first part of this chapter mention was made of the trade-practice agreement as one of the procedures by which the Federal Trade Commission exercises regulation of competition. By this device, representatives of various business groups have set up standards of business conduct for their membership. When this code of fair practice is approved by the Federal Trade Commission, the rules have the practical effect of law, with the Commission co-operating with the trade to obtain compliance. Through this method business itself has a part in framing the content of control, and has the advantage of knowing in advance what the Commission considers to be unlawful competitive activity.

Business self-regulation gained special prominence from 1933 to 1935 when the National Industrial Recovery Act was in effect. This law, set up by the federal government as a means of combating the competitive excesses of the

[1] Phillips, C. F., *Marketing* (Boston: Houghton Mifflin Company, 1938), p. 690.

depression, provided for business control through codes of fair competition established by trade groups of business men and approved by the government. While the act was found to be unconstitutional in 1935,[1] business self-regulation through codes existed prior to it and has continued since its invalidation. Moreover, there are many business men who feel that this type of regulation is still the hope of effective co-operation between business and government for the control of unfair methods of competition.

Control through codes is a device for regulation rather than an extension of regulation itself. The content of any code depends upon what business men in a trade may agree to and upon that which the government may be willing to approve and enforce. Therefore, any of the regulation of competition included in the above sections may be included in a code.

1. Business Codes Under the Federal Trade Commission. In 1919 the Federal Trade Commission announced that it would co-operate with business groups in the formulation of codes of fair practice through trade-practice conferences. To obtain such a code, trade associations or representatives of a substantial portion of an industry were invited to apply to the Commission for a conference. With the Commission acting as sort of adviser and referee, such conferences were held and codes of fair competition were drafted. If the Commission found the conference to be representative of an industry and the code provisions not tending to restraint of trade or monopoly but conducive of fair competition, it approved the code. From that point, the rules so formulated became a basis for lawful business behavior, with the implication that the Commission would not proceed against members of the group who lived up to the code.

This does not mean that the Federal Trade Commission has affirmatively enforced all the rules of a trade conference. The rules included in a code have been divided into two parts. Those which constitute settled interpretation of the law have been enforced by the Commission; those which have been recognized by it as constituting good business ethics but are believed to lie outside its jurisdiction are left to enforcement by the trade itself through the influence of business opinion and enlightened leadership.[2]

Business has adopted the trade-practice conference and codes resulting from it with enthusiasm. Many industries have held such conferences with the Commission and have adopted codes. By 1940, some two hundred industries had done so. Each year sees a number of industries holding new conferences with a view to revising and bringing up to date rules for business competition.[3]

[1] *Schechter Poultry Co. v. U.S.*, 295 U.S. 495 (1935).

[2] It should be noted that with the broadening of the Federal Trade Commission's jurisdiction in 1938 to include deceptive practices in interstate commerce, the portions of codes not affirmatively enforced by the Commission has tended to diminish.

[3] Federal Trade Commission, *Ann. Rep.* (1940), p. 112. Twelve trade conferences proceedings reached the rule-promulgation state in that year.

There are a number of distinct advantages in this practice of regulation. For one thing, the trade-practice conference is a flexible instrument of control allowing business men to have a part in determining fair practices in industry. Those in a business are often best qualified to define practices which are harmful to fair trade and deceptive to the customer. Generally the practice in question is one which only a minority may favor, although a majority may be forced to employ it to meet competition. Furthermore, the trade conference, by leaving some of the rules to be enforced by the trade itself, represents business self-regulation at its best in a way which is not subject to secretiveness.

From the point of view of the individual business man, the trade-practice conference has the advantage of making him certain of the government's attitude toward questionable trade practices. Many business men may not even be aware that a given practice is unlawful or unethical. The conference and the resulting code may be of great educational value to those who wish to conduct their businesses in line with the principles of fair play, but who would not otherwise know the rules until actually proceeded against by some governmental agency.

The code system of regulation is also helpful to the Federal Trade Commission and any other governmental agency concerned. In enforcing its authority to forbid unfair practices in interstate commerce, the Commission must proceed against individuals rather than against the practice itself. This often means that orders must be directed against a large number of individuals all of whom may be guilty of the same kind of offense. The trade-practice agreement tends to reduce the amount of such duplication. By outlawing certain practices in codes of fair competition for an industry, the members are more likely to know what practices are unlawful and are less likely to take their chances of being prosecuted.

2. Code Regulation Under the Recovery Act, 1933–1935. The plan of business self-regulation involved in the trade-practice conferences formed the administrative means by which the purposes of the National Industrial Recovery Act were carried out in the two years of its application. The act, however, attempted to do far more. It established as its purpose widespread regulation of business through creation of codes in every industry. These codes, while springing from the industries themselves, had to be approved by the President, and could not receive his approval unless they contained certain definite rules; for example, provisions allowing unhampered collective bargaining for employees, setting up maximum hours for labor, minimum wages, and other standards of work. The codes were also expected to contain a detailed statement of business practices which the trade, with the approval of the government, found to be inimical to the public interest. When approved by the Federal Administrator, as the representative of the President, they were to have the force of law, and infractions of any of their provisions involved penalties of fine or imprisonment. Moreover, if an industry could not agree upon

a code which might be approved by the government, the Administrator was empowered to prescribe one.

The code regulation established by the National Industrial Recovery Act was much broader than that carried out under the Federal Trade Commission through trade-practice conferences. Codes under the Recovery Act were obliged to contain certain definite provisions, and all these were made applicable to all members of an industry through legal compulsion; these features had not existed in the trade-practice agreement. Furthermore, the Recovery Act codes covered a much wider field. Their labor provisions, and many others approved by the Administrator, had never been deemed to be proper subject matter for the trade conference. Among these provisions may be mentioned the use of production quotas, control of hours of plant production, and fixing of prices, both by direct and indirect means.[1] In further contrast to the results of trade-practice conferences under the Federal Trade Commission, it is interesting to note that many practices which had been held by the Commission to constitute unfair competition became fair competition under the codes. For example, the Commission had always held basing-point price systems to be unfair competition, but many codes included them as methods of fair competition.

The National Industrial Recovery Act furnished an interesting, but happily short, experiment with the use of the code device for widespread business regulation. By broadening the concept of fair competition to include any practice which business men wanted to eliminate and the government would permit, the codes revolutionized what had theretofore been regarded as a fair plane of competition. By going beyond methods in trade to methods in production, and by curbing "unbridled" competition, they practically provided for the subservience of individual motivation to group will. The codes, consequently, seemed to be drawn for the purpose of eliminating competition rather than enhancing it.

Even if the life of the Recovery Act codes had not been cut short by the Supreme Court, their survival as effective instruments of social policy would hardly have been long. The task of administering so many detailed regulations in so many industries proved to be tremendous and complicated. Moreover, management had begun before 1935 to realize that they had given up too much of their independence, especially in labor matters, to repay them for their escape from competition. Labor, having had a taste of freedom and minimum working standards, strove to keep these aspects of the codes enforced to the letter, and at the same time tried to obtain even more concessions. The consumer also by 1935 had begun to wake up to the fact that code regulation, particularly because codes were generally set up by the monopolistic participation of labor and management groups, did not protect him from paying maximum charges for a minimum of goods and services.

[1] See Burns, A. R., *The Decline of Competition*, chap. X.

3. CODE REGULATION: CONCLUSIONS. For some purposes, self-regulation by business through codes has much to commend it. In order to protect society from controls made by business groups for the benefit of those groups, however, government supervision is obviously necessary. This type of regulation has perhaps been at its best in the trade-practice conferences supervised by the Federal Trade Commission. Its success has been due in large part to the vigilance of the Commission in detecting restraints which are not beneficial to society. The Commission has shown that it is interested in maintaining a high level of business conduct, but a level still operated upon principles of competition. The difficulty of code regulation of business affairs when such supervision is not present is that business men, in their zeal to curb competitive practices which harm them, whether fairly or unfairly, may tend to control competitive activity by the elimination of competition itself. This seems to be borne out by the Recovery Act experiment. If that experiment teaches any lesson, it seems to be that control of business practices by special groups often overlooks the interests of the consumer.

J. CONTROL OF COMPETITIVE PRACTICES: CONCLUSIONS

Our study of the government's part in controlling the level of competitive behavior has shown that such control has been becoming broader and based upon somewhat different factors. Common-law regulation of competition was founded primarily upon fraud practiced by the seller against the buyer or another seller. Regulation under the Clayton Act was based largely upon the premise that certain specified practices accounted in large part for the growth of monopolistic combinations. This was also the primary purpose behind the creation of the Federal Trade Commission and the endowment of it with power to prohibit unfair methods of competition.

To a great extent, the fear that certain practices may enable a seller to get such an upper hand that he may drive competitors out of business or force them to combine with him still lies behind the laws concerned with competitive practices. But these laws have developed along other lines, and other motives have been introduced. The Federal Trade Commission itself has come to feel that its job is not alone to keep business on a non-monopolistic level of competition, but also to raise the standards of business morality and protect the buying public from the dishonesty and guile of the irresponsible seller. This attitude of the Commission, often difficult to apply before 1938, was given a sounder legal basis for action when unfair or deceptive methods in commerce were outlawed along with unfair methods in competition in interstate commerce. The result is that now the work of the Federal Trade Commission and that of such agencies as the Pure Food and Drug Administration are rapidly approaching the same end. A seller guilty of infraction of the federal pure food and drug laws could in most cases be found guilty of an unfair or decep-

tive practice in interstate commerce by the Federal Trade Commission.

Another interesting development of the laws has to do with the concept of fair trade. From the notion that discrimination in prices by a seller to injure his competitor often leads to monopoly and suppresses competition, the law has undergone changes so that now a seller may not discriminate between purchasers except on the basis of differences in cost or service rendered. Hence, the supposition is made that differences in selling price not justified by differences in cost must be made with the intent or effect of reducing competition and creating monopoly. State laws making it unlawful for retailers to sell at less than invoice cost or replacement cost plus a mark-up to cover the cost of doing business have also been justified as a means of curtailing price competition which tends toward monopoly by driving honest competitors out of a field. Legalization of privately made resale price maintenance contracts, surprisingly found lawful as a means of protecting a manufacturer's good-will — a property right which he does not sell with the physical good — has also been defended as a means of protecting sellers and manufacturers from the inroads of conscienceless competitors.

While practically all recent developments can be justified as means of preserving competition through curtailing unfair competition, there is a danger that the results similar to monopoly may follow. If the law against unfair competition develops to the stage where competition is made sterile and where price is not determined by the laws of demand and supply, the result may be a system in which the inefficient, rather than the efficient, are protected. If laws tend to make all sellers sell at prices determined not by themselves but a legislature or a manufacturer, what is to happen to the vigor of competition? Does it matter too much for the consumer whether prices are fixed by a law requiring horizontal uniformity or by a combination of sellers? To be sure, the legislature may be more careful in looking out for a consumer's interest, but a large combination might be more effective in obtaining efficient production and gauging the elasticity of buyers' demand. Care must be exercised lest in the name of regulation of competition, competition itself be destroyed.

From an economic and social point of view, there is one rather hopeful sign in the regulation of competitive practices. By eliminating fraud and deception in the selling process and by educating the consumer as to the nature of things he buys, the laws may be making for a wiser expenditure of the consumer's dollar. To the extent that the consumer need not rely upon deceptive names or misleading advertising, he may be better able to compare different brands upon their merits and select the one that yields him satisfaction at the lowest cost. If he becomes so educated, or if the laws protect him against his own ignorance, the demand facing the seller of a particular good may become far more elastic than is now the case, and conditions more like perfect competition may be approximated. The drawback to such a development lies in the "fair"-trade restraints by which the individual seller is kept from engaging

in price competition and by which prices may not be forced down to the level of the most efficient. To the extent that these developments go beyond the rules of fair play necessary to maintain honest competition, they tend to operate in opposition to movements aimed at protecting the consumer from his own ignorance.

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Part Five

REGULATION OF FINANCIAL AND EXCHANGE INSTITUTIONS

CHAPTER

21

REGULATION OF FINANCIAL ORGANIZATIONS

In the regulation of many privately owned businesses, the government has been influenced by the desirability of protecting investors as well as consumers. This fact is particularly clear as concerns businesses affected with a public interest. In regard to the financial practices of transportation agencies and other public utilities, the primary purpose of the government has been to safeguard their credit and thereby make the production of services economical. To a very great degree, the same motives dominate the regulation of financial organizations and exchange institutions. But in addition, the government is concerned with them because they are custodians of public funds and distributors of financial resources of society. Moreover, the policies they follow have widespread effects upon business prosperity and the fluctuation of prices.

In this section of our study, attention is devoted to the regulation of those financial and exchange institutions which are under private ownership. In a later section the program of the government as respects the furnishing of a monetary system and special credit facilities for certain groups will be discussed. For study of the many problems of administration of financial organizations and exchanges, the student is referred to textbooks and other works in the fields of banking, financial organization, and investments. The operation of these enterprises will be alluded to here only where necessary to indicate the public interest in regulation.

A. FINANCIAL ORGANIZATION AND THE REGULATORY PROBLEM

In the present chapter, it is proposed to deal with the regulation of financial organizations, and in the following chapters to discuss that of security issuance and of stock and commodity exchanges. Within the scope of financial organizations are included enterprises commonly known as banks, businesses en-

gaged in group-investment activities, those underwriting the sales of new securities, and those which are forced into group investment as a corollary of insuring risks.

1. TYPES OF FINANCIAL ORGANIZATIONS. The leading types of financial institutions in private ownership are: (*a*) deposit and loan banks, (*b*) investment banks, (*c*) trust companies, (*d*) investment trusts, and (*e*) insurance companies. While separate companies engage in these functions, it is not unusual for two or more of them to be carried out by the same company.

a. Deposit and loan banks. In terms of numbers and extensiveness of regulation, the deposit and loan banks are the most important financial organizations. There are many kinds in existence, but the most significant types are the commercial bank, the savings bank, the mortgage bank, and the consumptive credit bank.

At present, the essential functions of a commercial bank are the acceptance of deposit of business funds which are temporarily idle and the making of short-term loans primarily to furnish working capital to business men. In addition to these two functions, until 1935 some commercial banks furnished a part of the paper money in circulation by issuing bank notes. Through making loans to business men and creating deposit liabilities subject to check on demand, the commercial banks have furnished a large part of the medium of exchange, about ninety per cent of all transactions being made through the use of this type of "money." Thus the commercial bank trades its more acceptable credit for the business man's less generally acceptable promissory notes, backed frequently by goods in process of manufacture or sale. Purchasing power for current needs is thus provided anticipatory to financial return from present or future operation.

Commercial banks are usually chartered either by the national government or by state governments. A negligible number are private banks not incorporated under the state or national banking laws; these banks, ordinarily partnerships, are relics of the days of unregulated banking, and are now subject to the same control as specially chartered banks. There are some 5200 national commercial banks in the United States and more than 9300 state commercial banks.

Another type of deposit and loan bank is the savings bank. These banks gather together the savings of many individuals and invest them in high-grade securities or loans on fixed capital. The main emphasis is placed upon safety, and only high-grade bonds, mortgages, or other investment paper are placed in their portfolios. Savings banks are usually either mutual or stock savings institutions. The former have no capital and are operated under the control of boards of trustees, who run them for the benefit of the depositors, to whom profits above expenses and beyond the accumulation of a surplus accrue. In stock savings banks, the capital is obtained through sale of stock, the bank is operated by a board of directors chosen by the stockholders, a specified rate

of interest is paid to depositors, and profits accrue to stockholders. Both mutual and stock savings banks are chartered under state law and the national government does not charter any pure savings banks under private ownership. Of the two types of pure savings banks, the mutual savings banks are the more important, both in terms of deposits and numbers.

Somewhat similar to the savings banks are the mortgage banks. Their function is to lend funds upon real estate, obtaining them directly from stockholders or by issuing bonds with the mortgages as collateral. Mortgage banking has been complicated by federal legislation designed to encourage organization of co-operative groups, which are aided by government capital and government guarantee of mortgages, and which lend money for farm purchase and maintenance, for building and repair of urban homes, and for refinancing of private mortgages. While much mortgage business is still done by savings banks and some commercial banks, as well as the familiar privately owned savings and loan association, government aids in the mortgage field have overshadowed the private nature of this type of banking business.

Another type of banking business is the consumptive credit institution. These institutions range from loan sharks doing an illegitimate business at usurious interest rates to legitimate personal and small-loan organizations. In addition to individual loan sharks and pawnbrokers making loans to consumers, there are five legitimate types of personal consumptive credit organizations. The industrial banks, ordinarily the Morris Plan banks, make loans to wage-earners who can offer the signatures of two acceptable co-makers. These banks require periodical repayment and encourage periodical savings after notes are paid. Most of the loan funds are obtained from savings accounts. Another kind of furnisher of consumptive credit is the commercial banks, which have established personal loan departments along Morris Plan bank principles. Under state regulation and a special incorporation law, personal finance companies have also been organized. These companies lend funds upon a chattel mortgage, wage assignment, or upon the personal signature of borrowers whose earning power indicates them to be a good credit risk. They generally accept no deposits, but obtain their funds from the sale of securities or by loans obtained from commercial banks.

Another type of organization for consumer credit is the credit union. Organized either under state or national charter, credit unions are co-operative savings and loan institutions. Members must own stock and only members can borrow. Funds are obtained from the membership and profits are distributed on a co-operative basis. As might be expected, these unions generally operate among employees of specific business concerns, but in spite of this drawback have made rapid progress in recent years.

In addition to the types of consumer-credit agencies which make loans directly to individuals, there are finance or installment credit companies organized for financing consumer purchases, and purchases of retailers, whole-

salers, and manufacturers. These companies are most prominent in the financing of automobiles, although they finance many other kinds of consumer purchases. They lend money to the seller to cover a portion of the cost of the purchased article, with the buyer making a down payment and periodical repayments to make the resale value of the purchased article, upon which the finance company holds a chattel mortgage, higher than the remaining portion of the loan. Finance companies raise funds for the loans by sales of stocks, bonds, and notes, and by borrowings from commercial banks.

b. Investment banks. Investment banks are not really banks in the popular sense of the term, but are organizations engaged in the distribution or merchandising of securities. They are primarily engaged in financing the needs of governments and private businesses for long-term capital. New bonds and stocks are ordinarily distributed by investment banks. They may purchase the securities outright and resell them at a profit through their own sales organization or through independent dealers. They may merely underwrite an issue, attempting to sell it and agreeing to purchase on their own account any portion unsold at a certain time; or they may occasionally do little more than guarantee to take an unsold portion of the securities in return for a certain fee.

These banks may be incorporated, or they may be privately organized. In addition to the merchandising of securities, they may offer special services to customers, including investment counseling and brokerage service for securities which have already been distributed. As an important aspect of their merchandising services, the banks ordinarily keep in close touch with the business of the companies whose securities they sell in order to advise them on financial matters which will aid in the selling of new securities.

c. Trust companies. Trust companies are generally corporations whose chief function it is to act as trustees to accept and execute trusts. A trust is a common-law arrangement whereby one party (the creator) grants legal title to property to a second party (the trustee) to manage that property in the interests of a third party (the beneficiary). Trusts are established for a variety of reasons, and any kind of property can be placed in trust. Trusts are created often to provide an income for support of dependents after the death, or even during the life, of the creator. They are often established to insure the carrying out of an educational or other project. Trusts may also be formed by order of a court to hold property of any person adjudged to be incompetent. They may further be set up to hold a mortgage title under a bond indenture.

In addition to the various trust activities of trust companies, these organizations usually act as agents in handling many business affairs for individuals, partnerships, and corporations. Thus, they act as transfer agents for changing titles to shares of stock, as stock registrars, and as agents for payment of dividends or other designated funds. They also frequently insure titles to real estate and search titles in seeking the legal status of real-estate deeds.

Trust companies, by virtue of their trustee and agency work, are naturally

concerned with the management and safeguarding of investment. It is not surprising, therefore, to find trust functions and commercial or savings-bank functions carried on by the same companies. Many commercial and savings banks have trust departments. Likewise, many trust companies do a regular banking business.

d. Investment trusts. The investment trust is somewhat related to the savings bank in that its function is to gather together funds from many relatively small investors and place them in a diversified portfolio of stocks and bonds. It is also somewhat similar to the trust companies in that many are formed as common-law trusts and title to the trust fund rests in the name of the trustees. On the other hand, the investment trust differs from the savings bank, and to some extent from the trust company, in that it has generally emphasized the holding of common or preferred stock in preference to high-grade bonds. Instead of placing its primary emphasis upon safety of dollar principal and low but safe dollar income, the investment trust has aimed at obtaining appreciation of principal and income through holding stocks and at gaining safety through diversification of holdings.

The investment trust, then, is a company, either incorporated or in the form of a trust, which sells shares of ownership and occasionally bonds to investors and uses the proceeds of these sales to invest in securities of other companies. It differs from the holding company in that the holding of stock is primarily for purposes of investment rather than control. While investment trusts always attempt to gain safety through diversification of holdings, some of them diversify over a field of many industries, while others diversify within the field of one industry, such as insurance, railroads, aviation, or chain-merchandising.

Investment trusts may be of several types. If the management can invest funds as it pleases, selling and buying at will, the trust is called a management trust. If the trust is established with a certain number of shares, each of which represents a definite investment in specified stocks or bonds, and if no change can be made in the content of this investment, it is referred to as a fixed trust. Other trusts represent modifications of these two primary types. An important type of trust, incorporating principles from both the management and fixed types, is the semi-fixed trust. Under this form, the trustee may not make changes in the portfolio at will, but only upon the occurrence of certain definite contingencies. Sales are often allowed when the stock passes a dividend for a given period of time, or falls below or rises above a certain percentage of its cost.

e. Insurance companies. Although insurance companies are engaged in pooling risks of a large number of individuals and in levying only the average cost of these risks plus a management charge to individuals, they are primarily financial organizations. They gather funds from policyholders and pay them out to those persons upon whom the loss has fallen. They are consequently financial organizations in that they are collecting funds from many sources

for the payment of current losses to the few. More than that, because premiums for protection are paid to cover a period in advance and losses occur over the whole period, the insurance companies become custodians of funds contributed by the insureds for the period that the insurance is in force. This fact makes it wise for insurance companies to make investments so that such reserve funds may be earning a return and the cost of insurance may be reduced. In fire, theft, casualty, accident, liability, and similar forms of insurance, premiums are generally based upon the cost of insurance for each year and are paid only one to three years in advance. In life insurance, however, premiums are generally calculated so that they far exceed actual insurance costs in the first years in order to build up a reserve, without increasing premiums, to cover the higher costs as insured persons become older and more susceptible to death. This prepayment of insurance costs is much greater in the case of life insurance than with other insurance, and life insurance companies accrue large sums for investment.

Insurance companies are almost always incorporated under special state law. Some are stock companies with capital furnished by stockholders and operated for the profit of stockholders. Others are mutual companies in which the policyholders are the owners and the beneficiaries of any profit made by the underwriting of risks. In fields of insurance, except life insurance, the stock company is most prevalent. In life insurance, on the other hand, mutual companies are of somewhat greater importance than stock companies. Even where stock companies operate in the life insurance field, provision is often made for participation of policyholders in the profits of the business.

f. The intermixture of functions. One cannot stress too much that the above discussion of financial organizations is functional and attempts to describe briefly the principal types of functions of financial organizations. Individual companies generally carry on several of the above functions. Commercial banks usually have savings departments and trust departments, and often make mortgage and personal loans. Savings banks occasionally have a commercial banking department, sometimes offer life insurance, and often have trust departments. Other intermixtures of functions may be found. While investment trusts and insurance companies seldom carry on functions of other financial institutions, it is not at all unusual for close relationships to exist between them and commercial banks and investment banks.

2. PUBLIC INTEREST IN FINANCIAL ORGANIZATIONS. This brief description of the leading kinds of financial organizations is adequate to indicate the great public interest in the conduct of these organizations. They solicit funds from nearly every business and individual in the nation. They act as custodians of these funds, whether the funds are deposited for repayment upon demand, invested in securities or mortgages, or pooled to remove a contingent loss. The borrowing public is also interested in these organizations. Business has to a large degree become dependent upon insurance and short-

term credits; home and farm owners as well as the construction business have relied on these organizations to supply credit needs; and individuals requiring funds to meet an emergency or buy a good for consumption have looked to them for their help.

The interest of investors and users of credit is primarily in obtaining a safe, continuous, adequate, and efficient financial system. They want deposited funds to be safe from dishonest or incompetent hands. They want the system to furnish a flow of funds to meet legitimate production and distribution needs. They desire that the system be operated efficiently, so that interest rates paid by borrowers be no higher than necessary and returns to investors be as high as economically feasible, without sacrificing safety.

But the social interest in financial organizations is even greater than the reasonable desires of individual investors and borrowers. These organizations all have a part in directing the flow of society's capital. The wisdom of their choice in making investments or encouraging investment by others is a matter of the greatest concern. Contrary to the belief of many uninformed who confuse capital with money or credit, capital is a scarce good, and a good necessary for efficient production and higher material living standards. Those who undertake to direct this flow are charged with a duty of the highest public importance.

The social interest in financial organizations also springs from the fundamental nature of money and credit. Since the latter are not themselves capable of producing anything or satisfying the wants of many consumers, but are merely means for gaining title to such useful goods, the demand for them depends upon the volume of exchange transactions for which they are needed. If money and credit should be increased beyond the normal need for them, the result would tend to be a drop in the value of dollars and a resultant rise in price levels. The upward spiraling of prices, fed by unwise credit expansion, can have disturbing effects upon business and the efficient operation of the economic machine. Likewise, an abnormal contraction of credit can contribute disastrously to the smooth functioning of the economic system through causing a downward spiral of prices. Furthermore, the structure of credits built upon credits, caused by such instances as lending funds backed by credit, may build a false superstructure of values which, when liquidation is attempted, dislocates sensitive economic equilibria. With the expansion and contraction of this credit structure financial organizations have much to do, and must accept responsibility.

3. The Legal Basis for Control of Financial Organizations. Regulation of financial organizations by the states has never been seriously questioned. This is particularly true with banking companies, but little difficulty has been encountered in extending regulation to other types of financial organizations. From the earliest days of the Union the Constitution has placed no bar in the way either of state ownership or of state regulation of banks. Likewise, the

power of states to regulate insurance companies has been developed until it can no longer be doubted that virtually every aspect of the insurance business falls under the state police power. Regulation of such matters as insurance rates and commissions paid to brokers has specifically been upheld by the United States Supreme Court.[1] The fiduciary nature of the businesses of financial organizations and the public interest in their honest and sound operation make ample grounds for their regulation by the states.

The legal basis for federal ownership and regulation of banking was established by a famous case decided by the United States Supreme Court in 1819.[2] In this case, Chief Justice Marshall carefully reasoned that the power of the federal government to establish a bank could be implied from the powers to tax, to borrow money, and to regulate commerce, even though no specific authority over banking was granted by the Constitution. Although this case only established the right of the federal government to charter a national bank, it has been used as the basis for supporting the constitutionality of federal regulation of banking.

The power of the federal government to control other kinds of financial organizations has been open to some doubt. On several occasions in the past the Supreme Court has stressed that insurance businesses are not engaged in commerce.[3] But regulation of insurance companies and other financial organizations would now seem to be constitutional in view of the recent interpretation of interstate commerce.[4] If public-utility holding companies, investment bankers, and security issuance may be regulated under the interstate commerce power, it is difficult to believe that the insurance companies, investment trusts, and other financial organizations are beyond the power of the federal government.

4. Problems in Regulation of Financial Organizations. In order to comprehend the difficulties and complexities in regulation of financial organizations, certain American traditions should be understood. These businesses in the United States have developed along lines of free private enterprise. No serious attempt has been made to keep the incompetent out of banking, insurance, or other financial businesses. Requirements for entry have been made low enough so that any small group with a modest outlay of capital can set up in business. This has meant that thousands of banks and many other financial institutions have been incorporated, and many of these have not always been well conceived, adequately financed, or efficiently operated. Along

[1] See *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389 (1914), and *O'Gorman & Young v. Hartford Fire Ins. Co.*, 282 U.S. 251 (1931).

[2] *McCulloch v. Maryland*, 4 Wheat. 316 (1819).

[3] *Paul v. Virginia*, 8 Wall. 168 (1869); *N.Y. Life Ins. Co. v. Cravens*, 178 U.S. 389 (1900); *Hooper v. California*, 155 U.S. 648 (1895).

[4] See *supra*, pp. 40–45. Note that public-utility holding companies have been held to be within interstate commerce in *Electric Bond and Share Co. v. S.E.C.*, 303 U.S. 419 (1938). Regulation of investment banking operations under the securities laws of 1933 and 1935 also appears to be constitutional. See *infra*, p. 571.

with the *laissez-faire* attitude toward the right of anyone to enter these businesses, there has been a strong tradition against centralizing banking, whether by a system of relatively few large private banks or by a government bank monopoly. This suspicion of centralization of financial power has not only encouraged the existence of numerous small banks, but has discouraged dominance of federal government control in the banking or other financial business fields.

In addition to encouragement of free private enterprise and opposition to largeness, the field of financial business has been complicated by the development of new kinds of institutions to meet new business and personal needs. In the loan and deposit banking business alone a large number of specialized banking institutions have been developed. In addition to the more important types mentioned earlier in this chapter, the government has established a variety of lending, banking, and investment organizations. When one considers the ramifications of insurance and the growth of newer types of financial organization, such as the investment trust, one finds a complexity in the sphere of financial businesses which is hardly duplicated in any other line of endeavor. This complexity is heightened by the specialization of functions in certain institutions and the overlapping and intermixture of financial functions in other organizations.

With this background of complexity, it is not surprising that regulation should present like characteristics. In the banking field, each state and the federal government have banking laws. In the same locality, some banks may be under state supervision, others under federal government control, and others regulated by both. Even in the federal regulations there are complexities. National banks are subject to the control of the Comptroller of Currency and to the regulations of the Federal Reserve System. Both state and national banks may be controlled by the Federal Deposit Insurance Corporation if they wish the protection of such insurance. Moreover, trust companies attached to national banks are under federal supervision, while other trust companies must meet state standards of operation. Investment banks are under federal regulation through control over commercial banks and by regulation of security issuance under the Securities Exchange Commission. Investment trusts were practically unregulated until 1940, when federal government control was legislated. Insurance companies, especially since the turn of the twentieth century, have been entirely regulated by the states.

This picture of complexity and confusion is drawn merely to acquaint the student with the difficulty of clearly understanding the regulation of financial organizations. Because of the number of governments regulating financial organizations, the overlapping of regulation, and the intermixture of banking functions, every detail of regulation can hardly be presented. All that can be attempted here is to take the leading types of financial organizations and study the principal kinds of regulation affecting each.

B. REGULATION OF LOAN AND DEPOSIT BANKS

The greatest confusion of regulation exists in the loan and deposit banks. These include all those financial organizations which make loans, accept deposits, or do both. While these institutions vary from commercial banks making short-term business loans and handling demand deposits to mortgage and savings banks handling deposit or credit on a long-time basis, there are certain points where regulation is surprisingly uniform. These have to do with the control over entry into business, the functions of the federal reserve banks, the supervision of operation, the regulation of combination, and the relationship of such banks to a system of central banking.

1. REGULATION OF ENTRY INTO BUSINESS. The public character of the banking business makes it desirable for the government to control the number and kind of banking companies and to pass upon the moral and business qualifications of persons interested in starting banks. Unnecessary duplication of banking facilities and undue competition between banks are hardly in the public interest, and dishonesty or incompetence in bank management should be guarded against by society.

The federal government in recent years has set up fairly effective standards for regulating the entry of persons into the commercial banking business. To some extent, however, this attempt at sound control has been thwarted by inadequate requirements in many states for the promotion of state banks. Under federal law, a national bank may be chartered by any group of five or more natural persons. The minimum capital requirements vary as follows: in cities of more than 50,000 population, the minimum is $200,000; in cities of 6000 to 50,000 population, at least $100,000 of original capital must be subscribed; in cities of 3000 to 6000 population, the minimum is $50,000; and in towns of 3000 or less, the requirement is only $25,000. Before business may be commenced at least half of the subscribed capital must be paid in by stockholders in cash, and the remainder of the subscription must be paid within a few months after the beginning of business.

If a group of five or more persons can meet the minimum capital requirements for starting a commercial bank, they apply to the Comptroller of the Currency for a national charter. The Comptroller turns the application over to a bank examiner, who investigates the necessity for the proposed bank and the character of the applicants. Under the law, the examiner must consider the adequacy of existing banking facilities in the city where the applicant proposes to operate, the economic position of the town and the probable success of a new bank, and the character and experience of its organizers. If his investigation presages probable success and public need for a new bank, he recommends that the charter be granted. This recommendation is almost invariably followed by the Comptroller, and a charter is issued upon the fulfillment of certain requirements. The capital must be subscribed and the re-

quisite portion be paid in cash, as noted above. In addition, every national bank must become a member of the Federal Reserve System by subscribing to capital stock in the reserve bank of the district, and must also become a member of the Federal Deposit Insurance Corporation. The nature and regulatory activities of these two federal agencies will be discussed later.

In the more progressive states, particularly those in the northeastern section of the United States, requirements at present pretty much parallel those of the federal government. In general, however, state banking laws are not as strict or complete as those of the federal government. There are states which grant virtually free incorporation to bank promoters who can meet the capital requirements, and there are cases where capital requirements to start a bank are as low as $10,000. Thus, in many of our states the banking business is still within the reach of groups of persons of moderate means and perhaps little talent for banking.

What has been said above applies primarily to commercial banks. Other types of banks are generally chartered by the states under special legislation. As a usual thing, the minimum capital requirements are lower than for commercial banks and not as much attention has been paid to the question of need for the institution in the community. Nationally chartered commercial banks have been allowed to establish savings departments and personal-loan departments, and encouragement has been given to some mortgage banking through federal government guarantees for loans to farm and home owners.

In the field of mortgage banking, the federal government has encouraged establishment of mortgage banks to make farm real-estate loans, intermediate credit banks to make loans on livestock and warehouse produce, and home loan banks to handle mortgages on urban real estate. These banks have been partially privately owned and partially government-owned, with the national government subscribing a part of the capital stock and guaranteeing securities issued to raise funds for financing the mortgages. Hence, these banks fall more in the sphere of government aids to business than in that of the mere regulation of privately owned and operated enterprises.

2. The Federal Reserve System and Control. Before continuing with an analysis of regulation of individual banks, it will be well to sketch the policy of the federal government in its efforts to develop a centralized system from the numerous banking organizations of the country. To effect centralized banking while leaving numerous independent and privately owned banks in existence, the Federal Reserve System was established by legislation in 1913. Although the legislative basis of the System has undergone many changes since 1913, its framework remains practically the same.

a. The federal reserve banks. The Federal Reserve Act divides the United States into twelve districts with a federal reserve bank for each district in the following cities: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Dallas, Chicago, St. Louis, Minneapolis, Kansas City, and San Fran-

cisco. Each of these banks is a sort of central bank for each district. The banks were set up by capital subscriptions from member banks within the district, each member bank being required by law to subscribe an amount equal to 6 per cent of its own capital stock and paid-in surplus. One half of this subscription must be paid in cash and the other half is subject to call. All national banks are required to join the System as member banks or give up their national charter. State banks are permitted to join upon meeting requirements similar to those demanded for the chartering of national banks.

The twelve federal reserve banks are managed by a board of nine directors representing varied interests. According to law, there are three groups of directors. Three directors are chosen by stockholding member banks as representatives of these banks. Three other directors are elected by stockholding banks from individuals engaged in agriculture or a business not connected directly with banking. A final group of three directors is selected by the Board of Governors of the Federal Reserve System as representatives of the public. The president of each bank is selected by the directors subject to approval by the Board of Governors. One of the public directors must be named as federal reserve agent and acts as the agent in each bank for the Board of Governors.

The twelve federal reserve banks are really bankers' banks. They are managed much like other banks. Their deposits are made up almost entirely of deposits of member banks. They also act as depositaries for the United States Government and have a few individual business depositors. They make loans to member banks on the security of bonds, commercial paper, and occasionally upon real estate. They discount commercial paper which member banks have received from business in support of loans. They issue federal reserve notes under special authority, and become the furnishers of the principal kind of paper currency in circulation.

Federal law requires the reserve banks to hold a minimum reserve of 35 per cent in lawful money behind deposits. The security behind the federal reserve notes must be 100 per cent in gold certificates,[1] commercial paper, or government bonds, but the proportion of gold certificates cannot be less than 40 per cent. While this provision limits the reserve banks in their issuance of notes, it allows them to expand or contract the currency to some extent, owing to the large holdings of gold certificates, the rediscounting of commercial paper and loans on government bonds, and the purchase or sale of commercial paper or bonds in open-market operations.

b. Member banks. As has been mentioned, all national banks must become members of the Federal Reserve System, and other banking organizations may be admitted to membership. All banking institutions except the federal farm

[1] Originally the requirement was that this must be gold, but since the government took title to all gold in 1934, the federal reserve banks hold gold certificates, a kind of irredeemable "warehouse receipt" for gold.

banks and home loan banks may become members of the System if they can meet certain requirements. Although eligibility for membership is made very broad, relatively few of the state banks have joined. By 1941, there were about 5200 national bank members and over 1300 state bank members, but there were approximately 9000 banks outside of the System. Perhaps the principal reason for so many financial organizations staying out of the Federal Reserve System, a reason which reflects on the disorganization and inadequate regulation of banking in the United States, is that state regulations are far less restrictive than the requirements of the Federal Reserve System.

For the purpose of administration, particularly in the matter of reserve ratios, member banks are placed in three classifications. Member banks in the two centers of American business, New York and Chicago, are classed as central reserve city banks. Member banks in more than sixty fairly large cities are classed as reserve city banks. Other member banks are classed as country banks.

Each member bank of the Federal Reserve System, in addition to abiding by the various rules and regulations of the System, must deposit its legal reserves in the district federal reserve bank. Each member bank has its checks cleared through the reserve banks and carries a deposit in that bank for such purposes. This privilege is also open to non-member banks upon the meeting of certain requirements.

c. The Board of Governors. The agency charged with co-ordinating and controlling the entire Federal Reserve System is the Board of Governors. It is made up of seven members appointed by the President of the United States by and with the consent of the Senate. The term of office of each governor is fourteen years, and he can be removed only for cause by the President. A governor cannot resign his position and enter the banking field for two years after resignation. Each governor receives a salary of $15,000 and traveling expenses. The purpose of the above provisions is to attract capable men to the Board and to place these members in a position relatively free from political influence. Until 1935, the Secretary of the Treasury and the Comptroller of the Currency sat as *ex officio* members of the Board of Governors, but this provision was discontinued in order to remove the Board from political and other influences.

The Board has been given broad powers over credit policy and banking regulations. To control the flow of credit in the country, it has power to approve rates at which the twelve federal reserve banks will discount commercial paper of member banks, to change the percentage of cash assets to deposit liabilities that member banks must have, and to fix the policy to be followed by federal reserve banks in buying or selling securities, commercial paper, or real-estate mortgages. In the sphere of banking regulation, the Board may make examinations of all banks in the Federal Reserve System, pass upon admission to membership, suspend banks from membership, regulate interest

rates of member banks, regulate the use of a bank's discount privilege, control interlocking directorates, pass on requests to establish branch banks, suspend or remove officers of any reserve or member bank, and do other things to improve the caliber of banking operations. In addition, the Board has power to control the issuance of most of the country's currency through its authority over the leading type of paper money, the federal reserve notes. While these notes are issued by the reserve banks, the control of conditions of issuance rest with the Board, subject to certain definite legal requirements for the notes.

d. The Federal Advisory Council. A minor part of the System is the Advisory Council. This agency is made up of one representative from each federal reserve district, who is elected annually by the board of directors of each reserve bank. The purpose of the Council, which meets four times a year in Washington, is to advise and consult with the Board of Governors regarding the reserve policy to be pursued by it. The function of the Council is purely advisory, and it has no power to enforce its recommendations.

e. The Open Market Committee. The federal reserve banks in each district have authority to engage in open market operations with a view to expanding or contracting the volume of credit. These operations involve the buying or selling of government bonds, commercial paper, and occasionally other types of securities. The theory of open market operations is that if the federal reserve banks buy, cash reserves of banks will be increased through such purchases and greater credit expansion will be possible; and that if the banks sell, cash reserves will be reduced and credit expansion facilities will be curbed.

Under present law, a Federal Open Market Committee has been established with powers to control the policy to be followed by reserve banks in their open market operations. It is made up of the Board of Governors plus five representatives of the twelve reserve banks. Since the Board of Governors dominates the Open Market Committee, through having seven members on it, any policy unanimously desired by the Board can be forced on the reserve banks. On the other hand, representation of reserve banks on the Committee and the fact that members of the Board of Governors may be divided as to proper policy opens the way for this aspect of credit control to be shared between the Board of Governors and the representatives of the district banks.

3. Supervision of Operation. Practically all kinds of loan and deposit banks are subject to regulation of certain aspects of their operation. The supervision of commercial banks is generally more complete than that of other loan and deposit organizations, although states customarily exercise close control over certain aspects of other banking organizations, such as the investments of savings banks. The supervision of bank operation is carried on by several government agencies. States customarily have a banking department headed by a superintendent who administers the state banking laws. Since this supervision is largely administrative in character and calls for little

judicial determination of questions, the single commissioner and an administrative staff, rather than the commission of several members, are usually found. The Comptroller of the Currency supervises the operation of nationally chartered banks. Members of the Federal Reserve System are subject to supervision of the Board of Governors and the officers of the district federal reserve bank. Any bank, whether national or state, which has taken out insurance on deposits in the Federal Deposit Insurance Corporation is also subject to supervision by the corporation's staff; a bank may consequently be supervised by more than one government agency, and as a general rule is so regulated. While it is impracticable to separate the supervisory work of each agency toward each type of bank, the general subjects of regulation can be noted.

a. Note issue. In the earlier days of banking, all commercial banks and often other banks had the power to issue bank notes which circulated as a part of the monetary medium of exchange. The lack of supervision of state bank note issuance and the lack of safety and uniformity of such notes led to the placing of a prohibitive federal tax on these notes in 1866. Until 1935, national banks were permitted to issue bank notes which were backed by prescribed issues of United States Government bonds and by a small redemption reserve held by the Treasurer of the United States. The power to issue such promises to pay which circulated as currency was effectively ended by the action of the Secretary of the Treasury in redeeming the bond issues upon which national bank notes might be based. As a result, individual privately owned banks no longer issue bank notes, all paper currency at present being issued in the last analysis as an obligation of the United States Government, although banking channels are still used for its distribution.

b. Reports and examinations. One of the most important features of supervision of bank operation, both as an end in regulation and as a means of exercising other controls, is the periodical examination of bank affairs. The financial condition of banks, particularly those which accept deposits, is of greater significance to the public than that of any other publicly regulated business. Nationally chartered banks are required to make at least three reports of their financial condition to the federal government each year and must publish abbreviated reports in the newspapers. In addition, the Comptroller of the Currency may require reports whenever he believes them to be necessary for a more complete exposition of conditions. Reports are also required of banks which are members of the Federal Reserve System or of the Federal Deposit Insurance Corporation. Moreover, loan and deposit banks which are chartered by the states are required to make reports to the state banking department, although the requirements differ somewhat between states and between different kinds of banking organizations.

Banks of all kinds are subject to periodical examination by examiners from the state banking department or the federal government control agencies. Examinations are usually made at least twice during a calendar year, and

examiners arrive unannounced. Besides making a study as to the existence of assets, the legality of the bank's holding, and the value of the assets, they attempt to discover practices which are illegal or unsound, or operations which involve inefficiency or carelessness, and to make suggestions to bank officials for the improvement of their holdings and operating practices. Where circumstances warrant, the examiner may report serious infractions of the law or evidences of bad practices to the state or federal regulating agency concerned. If further investigation makes such a course desirable, operation of the bank may be suspended or a change in policy may be ordered. In other cases, the examiner may merely suggest changes informally to bank officials without any formal actions being taken by the chief regulatory agency.

Bank examination naturally leaves much to the discretion of individual examiners. Whether an investment is unsound, or risky, or slow is not always subject to clear definition. Whether an operating practice is inefficient or careless is likewise subject to the attitude of bank examiners. Examiners have differed considerably in the thoroughness and strictness of their examination, and those in some states have shown marked variation in their attitudes as compared to those in others and to the examiners of some federal agencies.[1] To meet this lack of uniformity, the federal agencies adopted a revision in bank examination procedure in 1938, and this revision was supported in principle by the National Association of Supervisors of State Banks. Among other things, the revised procedure stresses the importance of safety in investment rather than day-to-day marketability, and advises the setting up of larger reserves to cover possible loan and investment losses.

The record of bank examination has not always been as good as might be expected. The difference in quality of examinations, especially as between state banks, has resulted in conditions which have caused depositors losses. This lack of uniformity in examinations, owing to the need for well-defined objectives and the fact that so many different agencies carry on examinations, has led to a tolerance in some quarters of banking practices which have made banking history in the United States replete with failures. With the improvement of bank examination in the last few years and centralization of control under such agencies as the Federal Deposit Insurance Corporation, bank supervision in the future should show materially better results.

c. Loans and investments. The most thoroughly developed phase of bank regulation [2] has been in the control exerted over loans and investments. Under their discretionary powers bank examiners do much to improve the charac-

[1] National bank examiners are well paid and district chief examiners draw from $9000 to $20,000 salary. The federal government makes many attempts to maintain examining personnel on a high level. See *Administrative Procedure in Government Agencies*, 76th Cong., 3d Sess., Sen. Doc. No. 186, pt. 13, p. 3 (1940).

[2] Because nearly all kinds of deposit banks have been accepted in the coverage of the Federal Deposit Insurance Corporation, most federal laws apply to some extent to state and nationally chartered commercial banks, savings banks, trust companies, and other companies receiving deposits.

ter of loans and investments. The federal law can serve to illustrate the kind of statutory regulations covering them. State laws have differed somewhat from the federal laws, and many state legislative standards fall below federal requirements, but the more progressive states have followed the lead of the federal government.

According to the federal law, the total liabilities of any one person or corporation to a bank must not exceed 10 per cent of the bank's capital stock actually paid in and unimpaired, plus 10 per cent of its surplus. This limitation is subject to the exception that more liberal loans or investments may be made where the borrower pledges as security bonds of the United States Government, or where the loans are backed by actually existing values arising out of business transactions. Loans by a bank to its own officers are restricted to a maximum of $2500, and any such loan must be approved by a majority of all the directors.

Although real-estate loans by national commercial banks were sharply restricted some years ago, the federal law has been liberalized to allow such loans up to 60 per cent of the appraised value of the property if the terms of the loan will result in amortization of 40 per cent of the principal within ten years. Straight loans on real estate not providing for amortization may not be made for more than 50 per cent of appraised value or for a period of more than five years. With amortizing loans of the kind mentioned above, the loan may be made for a maximum time of ten years. The maximum amount which a bank may lend on real estate is placed at the entire amount of capital and surplus, or 60 per cent of time and savings deposits, whichever is greater. Exempted from these requirements are loans for individual purposes made in cooperation with the federal reserve banks or the Reconstruction Finance Corporation, and loans guaranteed by the government under the National Housing Act.

Of all loan and deposit banking companies, the mutual savings banks have had their investment policies most rigorously regulated, particularly by the more progressive states, such as Massachusetts and New York. These banks may place their funds only in certain high-grade bonds and mortgages and occasionally in commercial paper. In most states, the banking superintendent is charged with making a list of bonds which are legal for savings-bank investment, and mortgages must meet certain definite tests. These tests, while often arbitrary, are designed to eliminate all speculative securities. The tests and their administration have led to lists which include only the best grade of railroad, public-utility, and government bond issues. Mutual savings banks must select bonds from these lists, and if a bond is dropped from the legal list the bank must dispose of it. While these lists are not infallible, because tests place so much reliance upon past records, the history of mutual savings banks has shown unusual financial stability over the years.

Stock savings banks are also generally required to invest savings funds in

legally prescribed bonds. In many states, however, the portfolios of these banks are not subject to such restriction.

Commercial banks have not had quite the degree of regulation of quality of their portfolios that savings banks have had. Both state and federal laws have usually not allowed commercial banks to invest directly in stocks, although loans secured by collateral of marketable stocks have been permitted. Until the last few years, the power of commercial banks to invest in bonds was practically unrestricted. More control over portfolio has been provided recently. For example, the federal Banking Act of 1935 authorized the Comptroller of the Currency to regulate the security purchases of national banks. In carrying out this power, the Comptroller has forbidden banks to purchase issues listed by investment advisory services as being speculative. Since there are several private investment services in the country, and the listings do not always agree, on some occasions confusion has existed as to what was a "speculative" security.

d. Interest payment. The government regulates both the payment of interest by banks to their depositors and the interest charged by lending institutions to their borrowers. The principal purpose of regulating interest paid to depositors is to conserve the resources of banks by eliminating the competitive stress of paying too high returns and the danger of speculative loan or investment practices. The regulation of interest charges has a twofold purpose. The public desires to keep lending agencies from charging an extortionate rate of interest to those who need funds, for much the same reason that public-utility consumers are protected from too high or discriminatory rates. The government has also intervened in the setting of interest rates on loans to encourage or discourage the flow of credit and thereby influence the course of business.

As for interest paid to depositors, national laws now forbid the payment of interest on demand deposits by any banking organization, whether chartered by the federal government or a state, so long as the organization is included under the federal deposit insurance plan.[1] Banks in the insurance plan are also limited as to the amount of interest they may pay on time deposits. The present law grants to the Board of Governors of the Federal Reserve System and the directors of the Federal Deposit Insurance Corporation the right to fix interest rates on time deposits. They may change these rates at will and may fix rates for time deposits varying as to maturities, withdrawal conditions, or conditions existing in certain localities. The regulations provided in 1940 for time-deposit rates as follows: savings deposits, 2½ per cent; time deposits payable in six months or more, 2½ per cent; time deposits payable in periods ranging from ninety days to six months, 2 per cent; and time deposits for less than ninety days, 1 per cent.

[1] Nearly all the commercial banks, whether state or federal, and a large portion of the savings banks, as well as other institutions, are included under the plan.

Some states also limit the payment of interest on deposits. This is particularly true in the case of savings banks, since a larger proportion of these banks are outside of federal control. Many of these state regulations follow the federal rulings on time-deposit interest rates. Some states, however, have placed the rate lower. For example, in 1939 the State of New Jersey fixed the maximum rate to be paid by all state savings banks at 1 per cent.

e. Interest charges. The federal laws provide that banks under federal jurisdiction may charge a rate of interest either as high as the rate allowed by the state in which the bank operates, or as high as 1 per cent above the rate fixed by the federal reserve bank for discounting of ninety-day commercial paper. If the state law sets no rate, the bank under federal supervision is limited to charging a maximum of 7 per cent. Most state laws limit charges for commercial banking operations to 6 to 8 per cent.

Regulation of interest charged by savings-bank and mortgage-loan institutions under state jurisdiction follows the 6 to 8 per cent maxima, although many states allow higher rates. In the small-loan business, however, where loans are made to consumers, the legal maximum is generally placed at 3 per cent per month, or 36 per cent per year. In a few states, the maximum has been lowered to 2½ per cent per month, and occasionally the maximum for amounts borrowed in excess of $100 is placed as low as 2 per cent. While these maxima are quite high, and perhaps higher than necessary, the cost of administering small loans is said to be great, so that a relatively high rate of interest must be permitted. Question exists, however, whether these small-loan rates are too high.

The government has influenced the actual interest rates fixed with a view to encouraging or discouraging the use of credit by business or by consumers. This attempt to control price levels or purchasing power and stimulate business is, strictly speaking, not banking regulation. The purpose is to aid business and, as such, this aspect of control will be discussed in Chapter 29.

f. Guaranty of deposits. In order to protect depositors from losses encountered by bank failure and to aid the banking system to meet the threat of mass withdrawal of deposits, the federal government set up a comprehensive system of deposit regulation in 1933. In response to agitation by bank depositors for protection against losses from failures of banks, which amounted to more than $1,600,000,000 from 1920 through 1932,[1] the Federal Deposit Insurance Corporation was created to undertake insurance of bank deposits.

Deposit insurance was not new with the federal law of 1933. A number of states had tried deposit insurance, particularly in the period following the panic of 1907. Every one of these systems failed, however, owing to poor administration, to inadequate regulation of bank lending and investment policy, and to the fact that most of the schemes were tried in agricultural states where banking risks were particularly great and not diversified.

[1] Rufener, L. A., *Money and Banking* (Boston: Houghton Mifflin Company, 1934), p. 715.

The Federal Deposit Insurance Corporation was set up with capital funds obtained from a subscription of $150,000,000 of stock by the federal government, and subscriptions of stock from the twelve federal reserve banks and the banks which became members of the insurance plan. The stock carries no vote and the entire managerial control over the Corporation is vested in a board of directors with three members, two being appointed by the President of the United States and the third being the Comptroller of the Currency, sitting *ex officio*. One of the two members appointed by the President is designated as chairman of the board and acts as administrative head of the system.

All national banks and banks which have taken out membership in the Federal Reserve System are required to become members of the Federal Deposit Insurance Corporation. Commercial banks, mutual and stock savings banks, Morris Plan banks, and trust companies, not members of the Federal Reserve System, have been permitted to join the insurance plan if they meassure up to the requirements of the Corporation.

The Federal Deposit Insurance Corporation provides for insurance of deposits for each depositor in an insured bank to the extent of $5000; deposits in excess of this amount are not insured. The purpose in thus limiting the insurance was to reduce its cost, and also to set at ease that group of moderately small depositors who are most likely to withdraw deposits in mass if events occur which might shake confidence in the banking system. Even so, large depositors may secure themselves by distributing their funds over many banks.

The cost of the deposit insurance is provided for by a levy of 1/12 of 1 per cent annually on the deposits of each insured bank. These assessments plus the capital subscriptions of the United States Government and the insured banks, along with interest on investments, constitute the assets of the Corporation. At the end of 1940, these assets amounted to more than $497,000,000.[1]

When an insured bank is unable to meet the demands of depositors, the Federal Deposit Insurance Corporation *must* be appointed as receiver in the case of national banks, and *may* be appointed as receiver if the bank is chartered by a state; actually, it is usually appointed in either event. The Corporation is required by law to pay the insured-deposit liabilities as soon as possible, either by making available a transferred deposit in another bank, or by the payment of cash outright. The Corporation acquires the rights of the depositors and attempts to collect the amount of the deposit insurance in the liquidation of the closed bank. Ordinarily, insured deposits are not immediately liquidated. Instead, the Deposit Insurance Corporation is empowered to establish a new national bank to assume the insured deposits and certain assets of the closed bank,[2] to receive new deposits, and temporarily to carry on other banking functions. The deposits of the new bank are auto-

[1] *Report of the F.D.I.C.* (December 31, 1940).

[2] Only the better and sounder assets are taken over. Low grade assets of the old bank are generally segregated and liquidated and the Insurance Corporation furnishes funds to the new bank in lieu of these assets.

matically insured, and the Deposit Insurance Corporation receives any profits or bears any losses from the new bank. When it seems desirable, new stock of the bank is transferred to the management of the stockholders and the Corporation drops its management. If enough stock is not sold, or if it seems wise not to offer stock for sale, the Deposit Insurance Corporation may offer the assets and liabilities of the new bank to another insured bank. If this move is not successful, the Corporation liquidates the new bank and its assets and liabilities are assumed by the Corporation. The insured deposits are then paid by the Deposit Insurance Corporation. The Corporation thereafter holds the claims of the insured depositors against the old bank and, when the affairs of the bank are wound up, receives its pro-rata part of the liquidated assets.

If the Deposit Insurance Corporation believes it to be in the public interest, loans may be made to insured banks to help them to reopen or to banks which take over their assets. This is an important optional power in that it makes it possible for the Corporation to encourage the continuance of a banking business without the expense and trouble of liquidation of assets. This procedure is often far less costly than taking over the assets of the bank and paying depositors. Where a bank is fundamentally sound but is embarrassed by temporary financial conditions, the rehabilitation of the bank or a merger of its assets with those of another bank has proved to be economical and wise.[1]

The record of the Federal Deposit Insurance Corporation in the few years of its existence has been good. From the beginning of deposit insurance to the end of 1940, financial difficulties forced 358 insured banks to close their doors. Of these, 3 were reopened or taken over by insured banks, and 355, having 1,133,379 depositors with total deposits of nearly $439,000,000, were liquidated or merged by the aid of loans from the Corporation. Of all these depositors, only ¼ of 1 per cent sustained any losses. Over this period, the Corporation has built up a surplus of $207,000,000 resulting from an excess of income over expenses and losses, and has had charges for losses and operation of only $67,800,000.[2]

Most of the banking organizations in the country have become members of the Federal Deposit Insurance Corporation. Of some 15,000 such organizations in the United States, about 13,500 were members of the deposit-insurance system at the end of 1940. Some banks have been unable to qualify, others have felt that they did not need the insurance and desired to save the cost of assessments, and still others, particularly savings banks, have been protected by the insurance plans in effect in the states. At the beginning of 1940, the banks within the system had around $23,000,000,000 of insured deposits. Of this

[1] For example, in 1940 the Deposit Insurance Corporation furnished the First Citizens Bank and Trust Company of Utica, New York, with a $15,000,000 cash advance and took over certain "sub-standard" assets of the bank. By doing so the Corporation corrected a hazardous situation in a bank with $35,000,000 in deposits. See *New York Times*, June 4, 1940, p. 35.

[2] *Report of the F.D.I.C.* (December 31, 1940).

total, approximately $22,000,000,000 was in commercial banks, representing about 45 per cent of their total deposits. In terms of the number of depositors, however, 98.4 per cent of the deposit accounts were covered.[1]

The Federal Deposit Insurance Corporation can be regarded as an example of the federal government in business. Its significance to the banking system as a regulatory agency, however, is probably equal in importance to its mere deposit-guaranty functions. In undertaking to insure deposits, the federal government has granted to the Corporation wide regulatory powers. These have been mentioned above in connection with bank examination, control of loans and investments, and regulation of interest rates. Since most of the banking organizations of the nation were outside of direct federal government control before the advent of deposit insurance, the acceptance of such insurance by state banks has strengthened and broadened the sphere of federal control. It is altogether possible that the growth of federal deposit insurance will be instrumental in bringing about a large degree of uniformity in banking operation and regulation.

g. Reserve ratios. To meet cash demands in connection with the withdrawal of deposits, banks must keep on hand or as a deposit in other banks enough cash to make such payments promptly. While savings banks and savings departments of commercial banks have a legal right to demand notice in advance of a withdrawal, this right is not generally enforced. Practically all banks of deposit have to be able to pay out any deposit in cash when desired by the depositor. The bank cannot, of course, operate profitably and keep enough idle cash on hand to pay off all depositors' claims on demand. Since the portion of deposits which tend to be withdrawn on any business day or in any business week is likely to be a very small part of the total deposits, and since new deposits are continually being made, it is obvious that the cash reserve necessary to meet withdrawals would normally not be large. The ratio of such cash reserves to the total amount of deposits for which they exist is known as the "reserve ratio."

Ordinary business prudence would dictate that an adequate reserve ratio be maintained by a banking organization. But this has seemed so important to bank stability that legislation has been provided fixing minimum reserve ratios. It might be mentioned that the purpose of some of this regulation has been the control of credit as well as regulation for safety. If minimum reserve ratios are increased, the same cash reserve held by a bank will support a smaller volume of deposits than before. Because deposits of commercial banks, at least, result largely from loans made by them, to curtail deposits by increasing reserve ratios is to limit expansion of loans. Likewise, a reduction in the reserve ratio may tend to encourage loan expansion.

For more than one hundred years state governments have required banking companies to hold minimum cash reserves. Nearly every state fixes minimum

[1] Prather, C. L., *Money and Banking* (Chicago: Richard D. Irwin, Inc., 1940), p. 400.

reserve ratios for commercial banks, savings banks, and trust companies. In many of the states the reserves follow the federal regulations. In some, however, the competitive urge remains and state banking is made to seem more favorable to private enterprise by making state reserve ratios lower than those required by the federal government.

Since the introduction of nationally chartered privately owned banks by the National Banking Act of 1863, the federal government has regulated the minimum reserve ratios of national banks. At present, such regulation is under the Board of Governors of the Federal Reserve System. The minimum reserve ratios are fixed by law, but the Board is given power to raise them to not more than twice the amount fixed by law if necessary to prevent injurious credit expansion. To prevent contraction of credit which might be harmful the Board may lower the ratios, but may not put them below the minima fixed by law. The legal minima on demand deposits vary as follows: 13 per cent for central reserve city banks, 10 per cent for reserve city banks, and 7 per cent for country banks; for all time deposits the legal minimum is 3 per cent. After discretionary power was given to the Board of Governors to change rates in 1935, the rates were changed several times, being doubled in 1937 but being reduced in 1938 to 22¾ per cent, 17½ per cent, and 12 per cent on demand deposits, and 5 per cent on time deposits.[1] The higher reserve ratios required for central reserve city banks and reserve city banks are held to be necessary because of the activity of deposit accounts therein. These banks carry deposits for other banks and large industrial and commercial depositors who are more likely to withdraw funds in times of stress than are smaller depositors.

h. Payment of dividends. Banking organizations are not free to pay dividends to stockholders as desired even if such dividends be earned. The national banking law and the laws of many states require the accumulation of a surplus from earnings. Thus, the federal law declares that banks must carry one tenth of their annual net profits to surplus until the latter amounts to 20 per cent of capital stock. This provision, like so many of the regulations affecting operation of loan and deposit banks, is designed to increase the financial strength and stability of these organizations.

4. Control of Centralization and Combination. As compared to most foreign countries, the lack of centralization in American banking is striking. Where Canada has one state-owned central bank and ten chartered commercial banks with about 3300 offices, and Great Britain has one central bank and fifteen commercial banks with around 10,000 branches, the United States has 14,500 separate commercial banks with a rather small number of branch offices. This large number of banks, many of which necessarily have small financial resources, has not only complicated banking business and regulation, but has probably been the largest single contributing cause of the sad record of bank failures.

[1] 26 *Federal Reserve Bulletin* (February, 1940), p. 122.

While banks should not be allowed to combine with each other, or with other kinds of financial organizations, without government supervision, government policy toward centralization of banking in the United States has discouraged combination which might have built up larger and sounder banking companies.

Such centralization of banking in this country as has been effected has been carried on through the use of branch banks, consolidations, chain banking, and group banking. In addition, a problem has arisen as to the combination of commercial or savings banks and investment banks. Combination of functions of other kinds has not presented a serious problem.

a. Branch banking. Branch banks are simply banking offices of a single company, and may be operated on a nation-wide, state-wide, or city-wide basis. Each office is in charge of a branch manager, but is subject to control of the owning corporation. Although branch banking prevailed in the United States before the depression of 1837, the system fell into disrepute because of the failures of that panic. The national banking law of 1863 did not authorize the establishment of branch banks and few states permitted it until recent years. After a struggle between forces in favor of more centralized banking and groups fearing the absentee control of "Wall Street" in case branch banking was permitted, Congress enacted legislation in 1927 permitting very limited branch banking by national banks. Since that time, and especially after 1933, both state and national governments have liberalized the laws regarding branch banking.

By 1940, the federal law permitted national banks to establish branches in any part of any state where and to the extent that this was permitted by state law. Although national banks must have the permission of the Comptroller of the Currency in addition, this law leaves the real control of branch banking to the states. In the latter part of 1939, only 18 states and the District of Columbia permitted state-wide branch banking, 17 allowed it in restricted areas, 9 did not permit it, and 4 had passed no legislation on the subject.[1]

With the loosening of restrictions on branch banking, branches have been rapidly developed. By 1940 there were more than 900 banks with over 3600 branches operating in the United States.[2] It may be that the future will see a rapid development of branch banking and the growth of a far more centralized banking system. However, the guaranty of bank deposits by the Federal Deposit Insurance Corporation so protects the reputation for safety of small banks that they may be able to exist in almost as large numbers as at present. Proponents of centralized banking have pointed out that a strong system of a few large banks with numerous branches would remove the need for and the cost of deposit insurance.

b. Control over consolidation. Consolidation of two or more banking organiza-

[1] 25 *Federal Reserve Bulletin* (October, 1939), p. 852.

[2] *Idem* (June, 1939), p. 479 and (September, 1940), p. 993.

tions is usually subject to control by both the states and the federal government. Such consolidation ordinarily requires permission by the Comptroller of the Currency or the state banking superintendent. As a general rule, consolidations are fairly readily permitted if the banks are located in the same city, village, or county. By legislation passed in 1927, Congress permitted national banks to consolidate with state banks under the supervision of the Comptroller of the Currency. While many consolidations have been effected in the last two decades, most of them have been consummated to provide for the taking over of financially embarrassed banks by stronger institutions.

c. Group and chain banking. "Group banking" is a term which has been applied to the control of several banking companies by a holding company. "Chain banking" refers to the common control of the stock of more than one bank by a person or a group of persons. Both methods made rapid progress during the latter 1920's and until the depression of 1932. In 1929 there were nearly 300 chains or groups operating almost 1800 banks in most of the states of the union.[1] On account of the development of branch banking with its superior administrative advantages and the difficulty of properly supervising members of a chain or group, this type of combination has tended to decline in importance.

State control of group or chain systems is virtually impossible, although examiners and administrators may deal with the individual banks in the combination. Where the systems are controlled by holding companies, many states have passed laws placing such systems under their control. To meet the problem encountered by interstate bank holding companies, the federal government has provided that holding companies must obtain permission of the Board of Governors of the Federal Reserve System before voting the stock of member banks. In applying for such permission, they must agree to make statements of condition and to allow examination by federal authorities.

Under many of the state laws and the federal laws, chain banking is reached by defining the holding company as including any association of persons with a specified control. Where the common holdings are privately or secretly held, however, control has been difficult. Some regulation has been provided by the Clayton Anti-Trust Act of 1914 prohibiting interlocking directorates between banking organizations where capital, surplus, and undivided profits of either company aggregate more than $5,000,000. This law only covered the larger companies, and has not been any more effective in the banking field than the prohibition of interlocking directorates has been in the industrial field.

d. Divorcement of commercial and investment banking. Many commercial banks have found it advantageous to organize investment-banking affiliates. Commercial banks had a deposit and trust fund clientele to whom securities might

[1] Moulton, H. G., *Financial Organization and the Economic System* (New York: McGraw-Hill Book Company, Inc., 1938), p. 350.

be sold, connections with business firms who might be in need of fixed capital, the prestige of a name already known in financial circles, and a ready supply of credit to aid the affiliate in underwriting a new security issue. With these advantages, investment banking by affiliates of commercial banks grew so important by 1930 as almost to dominate the field.

The depression following 1929 brought to light many evils of the combination of investment and commercial banking functions. Among those disclosed by an investigating committee of the United States Senate were the following: (1) investment banking affiliates took speculative investments made by the bank and offered them to the public; (2) affiliates sometimes unloaded securities, which they had underwritten and failed to sell, on trust departments of commercial banks; (3) officers of commercial banks urged depositors seeking disinterested advice to invest in securities being sold by affiliates; (4) liberal, and occasionally unwise, credit was extended to investment-banking affiliates to the detriment of the commercial bank; and (5) the investment affiliate became a means whereby officers of the bank engaged in excessive speculation. These evils, and the fact that commercial banking with its concern for short-term credit and investment banking with its interest in long-term capital are inconsistent in purpose, led to adoption of legislation to divorce these two functions.

Under the Banking Act of 1933 and the Banking Act of 1935, member banks of the Federal Reserve System are forbidden to have investment affiliates and to participate in the underwriting of new securities, except for domestic government securities. To make the requirement of divorcement more effective, the federal law provides that investment banking companies engaging in interstate commerce or using the mails may not engage in a deposit banking business. Member banks are still permitted to act as agents for any customer in the purchase or sale of securities, but this is a brokerage function, not to be confused with the business of dealing in securities.

5. Regulation of Loan and Deposit Banking: Conclusions. For a business so greatly affected with the public interest, the regulation of loan and deposit banking presents a picture of some confusion. The regulations of the federal government and of some state governments seem well designed to gain safety and soundness in banking practices. Yet altogether too many banking organizations are under the control of state governments which have tended to compete with each other in laxity of regulation. Perhaps the greatest move toward uniformity and adequacy of regulation has come from the development of deposit insurance under the Federal Deposit Insurance Corporation. Because of the obvious value to a bank of pointing out to depositors that their accounts are insured, many banking companies which found the regulations of the Federal Reserve System too restrictive and its benefits of questionable value have gone into the insurance scheme. Nevertheless, the very adoption of deposit insurance is evidence of the danger of unsound practices.

It must be recognized that no system of regulation can insure sound banking. Regulation may eliminate certain abuses and set standards conducive to good banking. But the question of extending credit to a borrower must be answered in the light of the facts in each case. The determination of eligibility of persons for loans is a part of the broader problem of sound investment. Legal formulas cannot determine sound investment, but what is sound must be primarily a function of management. Thus, good banking must stem from competent bank management. The law may establish minimum standards and create aids to good banking, but it can hardly be expected to solve the problem of managerial mistakes or incompetency.

The tradition of free private enterprise in banking and the fear of "Wall Street" dominance have militated against the growth of a strong system of central banking in the United States. While sound banking might require exclusive regulation by the federal government, or even federal ownership of banks, it has been politically unfeasible to put such a policy into practice. The constitutionality of dominance by the federal government in the banking field is hardly open to doubt, but the full use of such powers has been blocked by local interests. The picture of government employees as distributors or controllers of credit is admittedly not appealing to local users of credit.

At the same time, certain developments point to the ultimate growth of more centralized banking under stronger and more uniform federal government control. The rôle of the Federal Deposit Insurance Corporation has been mentioned. Liberalization of branch banking laws has already led, and will probably continue to lead, to larger banking systems; and large banking systems can hardly escape federal regulation. In addition, the government has itself entered the banking business on an ever-increasing scale. The system of postal savings under the Post Office Department, the sale of "baby" bonds, the super-bank activities of the Reconstruction Finance Corporation, and the lending agencies for farm and home credit, to mention only a few of the more important, supply ample evidence of this trend.

C. REGULATION OF TRUST COMPANIES

The functions of trust companies have been mentioned earlier in this chapter. These organizations, which have been called "the omnibus of financial institutions" because of their widespread activities, exist in large numbers as departments of commercial and savings banks, and also as separate organizations. Even where trust companies are found as separate organizations, they often do a deposit banking business and fall under the regulation of federal and state laws. Owing to the close relationship ordinarily existing between trust companies and deposit banking, these companies are under regulations which apply primarily to loan and deposit banks. There are a few regulations, however, which are aimed primarily at the trust business.

1. Regulation of Trust Companies. In their capacity as trustees of various kinds, trust companies are subject to close supervision by the courts. According to the common law, a trustee is bound to discharge his duties honestly and to exercise such care over the property entrusted to him as an ordinarily prudent man would exercise over his own property. He is liable for losses caused by dishonesty, misconduct, or gross negligence.

Besides the regulation of trust company deposit business, the principal control of these organizations has had to do with the holding and management of assets in trust accounts. Trust funds must ordinarily be invested in securities taken from a list which state authorities compile as being safe for that purpose, although some states allow discretion to the trustee where the deed of trust so specifies. Trust companies are generally required to submit to periodic examination of accounts and investments. Trust funds must be separated from other funds of a trust company, and in many states deposits of trust funds in commercial banking accounts of the same company must be secured by placing readily marketable collateral with the trust department.

In addition to regulations respecting the investment policies of trust companies, many states control the fees charged by them. They are also under strict supervision in connection with their work as transferors or registrars of corporate securities. In fact, it can be said that nearly all the multifarious duties of the trust company are under some degree of state or federal supervision.

The work of trust companies in acting as trustees of mortgages in corporation bond issues has recently been subjected to special legislation. Although trustees for bond mortgages would seem to be charged with the duty of acting in the interests of bondholders, the past experience has been that they are often little more than agents, perfunctorily attesting the authenticity of bonds and exercising other duties without actively protecting the legal rights of the bondholders. To make the position of trustee one of greater responsibility, the Trust Indenture Act of 1939, among other things, defined the obligations of trustees of corporate mortgages. Since one of the trustees for a corporate mortgage is required to be a trust company, this law is partly a regulation of trust institutions. By the law the trustee must furnish periodical and special reports to bondholders regarding the mortgage and other matters, must obtain evidence from the corporation as to financial matters pertaining to the mortgage, must notify security-holders of any defaults from the mortgage, and must take active steps to protect them in case of such default. In short, this law imposes on trust institutions acting as bond trustees the legal obligation to carry out these duties actively.

2. Improvement of Trust Company Operation. Trust companies have been subjected to ever-increasing regulation, particularly since 1933. Their usual combination with commercial or savings banking opens their activities to much of the government supervision of these banks. In addition, most of

the volume of trust business is done by a relatively few banking organizations. While many banking companies have trust departments, the overhead expense and risk involved in handling all kinds of trust activities have made them willing to leave the greater share of such business to the few large companies. The resultant concentration has built up some highly specialized and competent companies, has meant almost invariably that they are under federal as well as state control, and has helped to simplify the task of regulation.

D. REGULATION OF INVESTMENT BANKS

The investment banking business was practically free of government regulation until 1933. Since that time several legislative acts have tended to bring it under government control. Because these banks are not banks of deposit, it is not surprising that government regulation has been so slow in overtaking them. As merchandisers of securities they have been caught in the wave of regulation of security issuance.

1. CRITICISM OF INVESTMENT BANKING. The records of some investment bankers before 1933 have led to several lines of criticism, and legislation has been adopted to remove certain evils.[1] Investment bankers have been criticized for putting on the market highly speculative, if not fraudulent, security issues without adequate examination; they have even been accused of being parties to the foisting of securities of highly questionable worth on an unsuspecting public.

Investment bankers have also been criticized for exercising an arbitrary control over the allocation of capital supply. Since most businesses are fairly dependent upon investment banks for the merchandising of new securities, they are in a position to dictate the terms upon which many businesses can enter the capital market. In this connection, investment bankers have been charged with undue conservatism, favoritism, and interference with the managerial affairs of their customers. The mere presence of representatives of investment bankers on the boards of industrial, public-utility, and railroad corporations has often been pointed to as evidence of "banker control." Other criticisms specify the lack of competitive bidding among investment bankers for new issues and the monopoly of such issues by certain investment firms with resultant high costs of financing, and unfair manipulation of the security markets so that new securities may be sold.

In fairness to the past history of the investment-banking business, it might be mentioned that many investment bankers have not abused their position, and that the nature of the business makes necessary some of the conditions complained of. Investment bankers can hardly be expected to assume responsi-

[1] An excellent analysis of these criticisms as well as of the business of investment banking can be found in Guthmann, H. G., and Dougall, H. E., *Corporate Financial Policy* (New York: Prentice-Hall, Inc., 1940), chap. 14. The writer has drawn from this book.

bility for the ultimate soundness or success of a security offering. There are no statistical devices known and no judgment so perfect as to make such an assumption reasonable. Care should be taken that offerings of investment bankers are judged in the light of conditions existing at the time of sale, rather than by the turn of subsequent events. As for the position of power over the capital market which the investment banker holds and the lack of competition in the business, it should be noted that this business is one calling for a close relationship between the banker and the corporation offering the securities. The former must be in a position to know the affairs of the latter, to advise it on the status of the capital market and the kind of securities to be offered, and to follow the course of its business after the security has been issued. Otherwise, the investment banker cannot expect to build up a successful merchandising business or a satisfied clientele. In many cases, securities are purchased largely on the faith of the purchaser in the investment bank offering the security. Moreover, because new issues of securities are likely to affect market prices adversely and to disturb the orderly absorption of the securities, market manipulation is a reasonable and necessary function of the investment banker.

2. Regulation of Investment Banking. Investment bankers are naturally subject to some regulation under all the laws regarding the issuance of securities. Since these laws are discussed in the following chapter, only the special regulations affecting investment banking will be noted here. The prohibition against investment bankers' operating a deposit banking business has already been mentioned.

The Federal Securities Act of 1933 makes investment bankers liable, along with corporation executives, accountants, engineers, and others signing a registration statement, for losses incurred by security purchases as the result of omission of a material fact or inclusion of a misleading statement in the registration statement filed with the Securities and Exchange Commission before the issuance of a new security. Investment bankers are also made responsible for including misleading information in a prospectus by which a new issue is advertised to a possible purchaser. The new federal law requires merely full and accurate disclosure of information and makes the investment-banking house one of the parties responsible for fulfillment of this requirement. This provision, applicable to almost all new securities sold in the channels of interstate commerce or through the mails, has served to make investment bankers far more responsible in their investigation of new security issues.

Although the fees of investment bankers are not generally subject to regulation, the federal law requires that publicity be given to the amount of compensation to be received so that investors may take this fact into consideration. In the case of public-utility and railroad securities, many state commissions and the federal commissions having jurisdiction over them have powers to fix the compensation or to refuse to authorize an issue if the compensation proposed is too high. As a condition for authorization, too, they may apparently

require that the issue be opened to competitive bidding among bankers, and commissions have occasionally done this. As for the evils connected with market manipulation, even the federal securities law allows restricted manipulation to support the price during the period of distribution of a security.

E. REGULATION OF INVESTMENT TRUSTS

The investment trust is a comparatively recent development in the United States. While a few such trusts were organized before 1924, the period from 1924 to 1929 witnessed a mushroom growth. The investment trust, with its emphasis upon investment in common stocks and capital gain, as well as security through co-operative investment and diversification, harmonized with the speculative tenor of the latter 1920's. In the anxiety for speculative profit, the fundamentally sound principles of this form of organization were forgotten and promoters organized investment trusts rapidly and without careful consideration of the character of the investments made. As a result, the investment trusts were caught in the sweeping fall of security prices after 1929 and came into disrepute in the depression. After the failure of some of the more unstable investment trusts and the rise of security prices in recent years, the attitude of investors toward the better-managed companies has improved, and the investment trust is apparently returning to a position of prominence.

1. Abuses of Investment Trusts. Past experience with investment trusts has disclosed certain abuses for the treatment of which legislation has been enacted. Some trusts have been too careless in their selection of securities, and have been managed by individuals who have used the funds at their disposal to engage in market operations in utter disregard for even the more elementary principles of sound investment. Investment-banking houses and other firms interested in the sale of securities have sponsored investment trusts and have used them as a device for unloading poor securities which they themselves could not sell, at prices far in advance of reasonable market prices. Occasions have existed where brokerage houses have sponsored investment trusts and have drawn large commissions from them for the needless shiftings of investment holdings. Officers and promoters of investment trusts have raided their funds by charging excessive fees, and have abused the responsibility placed in them by borrowing securities of the trusts for personal loans. Some investment trusts have employed unsound accounting practices whereby they have made earnings seem better than was actually the case, and have paid dividends to investors out of capital. Trusts have sold securities on a rising market and have paid dividends from the profit, rather than building a reserve to meet losses in a falling market. They have sometimes followed the policy of considering the proceeds from the sale of stock dividends, stock rights, and additional stock resulting from the splitting of shares, as earnings, and distributing these funds as dividends to their investors.

2. Regulation of Investment Trusts. The investment trust has only recently been subjected to special regulation. In the latter part of 1940 Congress enacted the Wagner-Lea Law for its regulation by the federal government. While this law represents the first formal entry of government in controlling these organizations, the trusts were not entirely free of government regulation before 1940. The companies had to live up to their charter provisions like any other corporation, if incorporated, and if set up in the trust form the trustees had the fiduciary obligations attached thereto. Moreover, under the Securities Act of 1933 the investment trust marketing its securities in interstate commerce or through the mails had to make full disclosure of pertinent information, and if its securities were registered on a nationally regulated stock exchange, it was required to keep this information up to date.

The Wagner-Lea Law is interesting in that it was passed partly at the instigation of the investment trusts themselves. The sounder and better-managed trusts saw in regulation a means of ridding the business of firms which had been unethically managed, and of gaining a degree of public confidence. The lack of opposition to the passage of the law grew largely out of this attitude, and out of the general feeling that the act represented a fair program of regulation.

The law provides for control over investment counselors and advisory services, as well as investment trusts. It approaches this regulation through making compliance with its provisions a condition for using the mails and the facilities and instrumentalities of interstate commerce. The administration of the act is placed in the hands of the Securities and Exchange Commission. Investment companies are required to register with the Commission and to give current information relative to their size, financial structure, and investment policies. In order to prevent indiscriminate formation of companies, minimum net worth is fixed for future companies at $100,000.

Investment trusts are required for the future to eliminate the evils of complex financial structures, to apportion voting power equitably among security-holders, and to prevent unfair dilution of stockholders' interests by flotation of securities or loans with prior claims. The law provides strict regulation of the financial structure of investment trusts for the future, and attempts to safeguard actual stockholder control of their management. For issuance of any securities other than common stock, strict and conservative asset coverage requirements must be met. As a general rule, the law allows only one class of funded debt or preferred stock to be issued.

Investment activities of the trusts are closely regulated. Their funds may not be used to finance affiliated investment bankers and offerings of affiliated security merchandisers unless a majority of the directors are not personally affiliated with the bankers and this majority approves the arrangement, or unless it is approved by holders of a majority of the voting stock.

Loans to outside corporations are subject to governmental supervision, and purchases of securities from companies in the same investment-company system

are likewise supervised. Investment trusts are limited in buying securities in other investment trusts, thereby reducing pyramiding of companies.

Strict control over management is also provided. Except in unusual cases as defined by the law, not more than 60 per cent of the board of directors of an investment trust may be investment advisors of, or officers or employees in, the company. Transactions with companies in which directors or officers have a pecuniary interest are forbidden, unless approved by directors not so interested, who must form a majority of the whole board, or unless approved by stockholders. Managerial fees and commissions are subject to regulation to insure reasonableness. Uniform accounting and auditing methods may be prescribed, as well as periodical examination of records by the Securities and Exchange Commission, and the requirement of reports to stockholders. The payment of dividends from sources other than net income from interest and dividends is prohibited, unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment.

As for regulation of investment counselors and sellers of investment services, the law requires registration with the Securities and Exchange Commission. Such registration must disclose pertinent information as to the nature of the organization, the character of its personnel, and the methods of operations employed. Counselors are specifically forbidden to defraud or deceive customers, or to represent themselves unlawfully as counselors or advisors unless registered with the Commission.

Federal regulation of the investment trust was admittedly long overdue. However, the new law has probably benefited by the delay. The investment trusts themselves have come to see the need for government regulation and have had a material part in the framing of the act. Thorough and broad as the Wagner-Lea Law is, the honest and soundly operated investment trusts, happily in the majority, realize that they have little to fear from it.

In a great many places, discretion is left to the Securities and Exchange Commission. The law can become strict or it can be made lenient. Its purpose, however, is clear. Managerial practices detrimental to sound investment of funds of the public are attacked throughout the law. Practices especially aimed at are those arising from interested affiliations of insiders with companies with which the trusts have done business.

If the law is judiciously administered by the Securities and Exchange Commission, a new era of stability and respectability for the investment trust will surely be ushered in. But in considering laws on this subject, as well as in other fields of privately owned enterprise, it should be realized that legislation is no substitute for competent management.

F. REGULATION OF INSURANCE COMPANIES

The business of insurance is eminently affected with a public interest. The services of insurance companies in substituting a definite cost for the risk of a very large one have become necessary for the orderly operation of our economic life. Any interference with the flow of these services or any practice which would make users of them pay more than a reasonable price is of a great social concern. Moreover, in the very nature of the insurance business these companies become custodians of large sums of society's savings. Life insurance companies alone held nearly $29,000,000,000 of the total assets of $69,000,000,000 in principal savings institutions of the United States in 1938.[1]

Most of the insurance business in the United States is under private ownership. A few social insurance plans are operated by the states and the United States Government, especially insurance against industrial accident, unemployment, and old age. While the volume of savings held under these plans may in the future eclipse those held by private companies, the fact still remains that the insurance business in this country is predominantly privately owned.

Most of the important regulation of insurance has come in the twentieth century. Even though regulation by the federal government has been contemplated and seems to be an ultimate development, the regulation of insurance companies is still in the hands of the state governments. Practically all the companies doing a significant part of the insurance business of the country operate in more than one state, and many of the large companies handle insurance in every state and the territories of the United States. In spite of the interstate nature of the insurance business, the operations of companies in each state have been left to the individual states, the courts taking the position that insurance contracts are local in nature and that each state may set up requirements which it finds necessary to protect the public interest. State regulation of insurance has resulted in a variety of laws which large insurance companies find it troublesome to follow. This diversity makes it impracticable to study insurance regulation in detail here, but state regulations follow similar patterns, and a fair picture can be gained by noting the general provisions and principles of such controls.

The administration of state control of insurance companies is conducted through state insurance departments, with a commissioner or superintendent at the head. The predominantly administrative character of insurance regulation, in contrast to the judicial and legislative aspects of railroad or public-utility control, probably accounts for this kind of administrative device in the field of insurance as it does in the regulation of banks.

1. CONTROL OVER ENTRY INTO BUSINESS. The insurance business is usually carried on through branch offices and agents operating within a state. Hence, regardless of the domicile of the main office of the company, the making of

[1] *Investigation of Concentration of Economic Power*, pt. 9, p. 4052 (1940).

insurance contracts is held to be intrastate commerce within the control of the states in which business is being done. In a few cases insurance companies do business entirely by mail. Except for the state in which these companies have their offices, their operations are not open to state regulation. However, many mail insurance companies voluntarily obtain permission to operate in certain states, and submit to regulation in order to have the prestige and advantages of a licensed company in the states where business is obtained.

Insurance companies are ordinarily chartered under special incorporation laws. But the most important means of controlling entry into service is the requirement of a license or certificate of authority. This is required of every company doing business within the state, whether it was incorporated there or in another state. Granting of licenses usually rests with the state insurance department, and licenses are ordinarily restricted to short periods of time, such as a year, although they are renewable by application. This short period makes it possible for the burden of proof to be placed on the company if the department refuses for some cause to renew a license, rather than upon the department, as would be the case with revocations of licenses.

The license serves several purposes. It is a test of qualifications, an instrument for enforcing continuous regulation, and a basis for collecting taxes from operating companies. In applying for a license companies are required to agree to regulation, to make reports to the insurance commissioner, to show evidence of financial responsibility, and often to deposit securities in a certain amount with the state to insure proper performance of its contracts. In some states the insurance commissioner must grant the license if the law has been complied with, while in others he may refuse a license if he feels that the best interests of the public will be promoted thereby. This wide discretionary power is given to insurance commissioners in states with better systems of regulation, and furnishes them with power to control the number of companies doing an insurance business, as well as the business standards of those allowed to operate.

Companies incorporated outside of a state are generally allowed to do business within it on the same basis and with the same regulatory requirements as are domestic companies. In some cases, domestic companies are allowed to enter business merely by complying with the details of the law, and foreign companies are required in addition to prove that their entry would be in the interests of the people of the state. Many states set up in addition reciprocal requirements. For example, the state of New York provides that if another state requires higher taxes or regulations for the entry of a New York corporation than the state demands of its own companies, businesses chartered in the other state will be directed to meet the same qualifications in New York. These retaliatory laws do not always make for uniformity in treatment of domestic and foreign corporations, since most insurance companies have their home offices in relatively few states, and states with few domestic companies may impose discriminatory requirements without fear of serious effects.

In some states insurance departments have wide discretion in revoking licenses of insurance companies, particularly out-of-state corporations. The insurance commissioner need only show that continuance of the business is not in the public interest. In other states definite grounds for revocation must be specified, including violation of the law, unsound financial practices or condition, failure to meet contractual obligations, and non-payment of taxes.

2. Regulation of Insurance Company Operation. In most respects, insurance company operation is subject to regulations similar to those applied to loan and deposit banking organizations. The investment of insurance funds is an important aspect of this control. Some states, of which California and Connecticut furnish notable examples, allow investment in any securities which are not specifically banned by law. In Connecticut a life insurance company is forbidden to invest in stocks or bonds of mining companies and stocks of manufacturing companies. Other states allow insurance companies to invest only in securities which are specially authorized by the law or the insurance department. These states set up a legal list of securities valid for insurance company investment similar to that provided for savings banks. While states allow insurance companies to invest in well-secured first mortgages on real estate, actual holding of such investment is often limited to property needed in conduct of the business and to property taken over by companies in foreclosure. As a general rule, strict regulation of investments applies mainly to life insurance companies.

Because premiums are collected in advance, insurance companies do not become the equitable owners of them until the period for which the premium is paid has passed. These advance premiums are really funds held in trust for policyholders against losses which may be incurred during the term of protection. Since the maintenance of adequate reserves is necessary for successful operation of insurance, these reserves should clearly be supervised by the government. State laws require that reserves be adequate, some states defining this requirement as certain percentages of insurance liability, and others leaving the definition to the administrative discretion of the insurance commissioner. To aid in the regulation of reserves, states often give the insurance commissioner authority to evaluate the assets of insurance companies, and even where this authority is not specifically granted, an insurance commissioner may imply it as necessary for proper calculation of reserves.

Since the efficient and wise operation of insurance businesses has been held to be of interest to policyholders, particularly because they are often given an opportunity to share in the profits of companies, states have undertaken to regulate operating expenses and dividend policies. A few states, of which New York is an outstanding example, give their commissioners this authority. In most states, however, the commissioners exert influence on these matters through their general power to revoke or refuse to renew licenses.

States customarily have given their authorities power to regulate insurance

premiums. This matter is generally handled in the first instance by the insurance companies themselves through rating bureaus — co-operative organizations financed by the companies for the purpose of establishing just and equitable rates. After the bureaus have agreed upon the premiums to be charged by insurance companies for each kind of insurance, the rates are recommended to the insurance commissioners for their approval. In this way, the insurance companies help to regulate themselves and the governments are saved the expense of a large technical staff to study rate matters. In some states the commissioner has the authority to set reasonable minimum or maximum rates, but in many his powers are limited to approval or disapproval of rates suggested by rating bureaus.

In connection with rate regulation and the general control of expenses of insurance companies, states have undertaken to regulate the commissions paid to agents and insurance brokers. Since these commissions are often a material portion of the premium paid for insurance, and since insurance companies might engage in dangerous competition to obtain business, the regulation is clearly in the public interest.

Most states provide for regulation of the form in which policies are drawn. Insurance policies are long documents containing much legal and technical language which would make it difficult for laymen to understand them, even if they took the trouble to read them. Since jokers might be placed in policies in order to reduce the liability of the insurance companies unreasonably, and because of the need for uniformity in the coverage of certain kinds of policies, states have regulated policy forms. The exact wording of different kinds of policies may be prescribed by the legislature or by the insurance department; or the insurance commissioner may be given the authority to approve or disapprove policy forms drawn up by the companies.

The settlement of claims is ordinarily left to the courts, but in several states disputes between policyholders and companies must be submitted to arbitration. Private parties selected by disputants may act as arbitrators, or members of the commissioner's staff may be so employed. Since prompt and fair settlement of disputes arising from insurance claims is a part of the service purchased by policyholders, the states should act more generally than has been the case to set up machinery for this purpose. Where this has been done, unscrupulous insurance companies have found it difficult to escape liability by threatening a disputing policyholder with an expensive lawsuit. With most companies, however, the desire to have a reputation for fair and prompt dealing has minimized the problem of disputes over claims.

As in the case of loan and deposit banks, insurance companies are subject to periodical examination by state insurance officials. In addition, they must make reports to the state insurance department, to stockholders, and often to policyholders. These devices, important as means of obtaining data for control of operation, are also significant in their regulatory effect.

3. Regulatory Problems and Need for Reform. In the states with more advanced insurance laws, insurance businesses are fairly adequately regulated and little reform is needed. States in which are located the home offices of the larger companies almost invariably have good systems of regulation. As a result of the high character of regulation and the tradition of sound administration among insurance companies, the insurance industry has had an enviable record in recent decades for good operation and fair dealing. Large life insurance companies weathered the depression following 1929 well and continually increased their assets during depression years. Other kinds of insurance companies did not do so well, because of the existence of smaller companies and lesser governmental regulation, but their record as a whole has been good.

Perhaps the principal problem in government regulation of insurance companies is the confused character of state laws; with forty-eight states and several territories regulating insurance businesses, this condition of affairs is not surprising. Some states exercise full and adequate control, while others tend to be lax, either because of inadequate legislation or the lack of proper administration of laws already on the books. Moreover, state laws differ among themselves as to regulatory provisions. Since so much of the insurance business is carried on by companies operating in many states, this lack of uniformity has been confusing and expensive. Furthermore, a number of small companies have sprung up in laxly regulated states and have given rise to an element of unsoundness in an otherwise sound industry.

The only practicable solution to the confusion and inadequacy of state regulation appears to be for the federal government to take over control of those companies operating in interstate commerce. The insurance business is one of the very few operating in interstate commerce and clearly affected with a public interest for which no federal regulation has been furnished. One of the reasons for this has been the belief that insurance is not interstate commerce and not within the constitutional powers of the federal government. This belief no longer seems justified. Another reason is that local interests have feared to have control over such a large industry, with its billions of savings, placed in the hands of a distant national government. Curiously enough, the large insurance companies hampered by diverse state laws have opposed federal control, evidently fearing the centralization of authority in Washington and possible new regulations, such as modification of the agency system of selling insurance and increased supervision of investment policy.[1] The problems of life insurance regulation and possible federal control have been studied by the Temporary National Economic Committee, and the tone of its hearings and findings indicates that federal control is being seriously considered.[2]

[1] For the position of the companies, see a pamphlet, "Life Insurance Should be Supervised, Regulated and Governed by Law in the States," *Special Bulletin*, American Life Convention, *Investigation of Concentration of Economic Power* (T.N.E.C.), pt. 28, pp. 15609–13) (1940).

[2] See *Investigation of Concentration of Economic Power* (T.N.E.C.), pt. 10, pp. 4388–89 (1940), pt. 13, p. 6541 (1940), and many press releases of the committee. The writer draws this conclusion in spite of repeated statements by members of the committee that federal control is not planned.

One aspect of insurance company operation which may need regulation and which has been publicized by the investigation of the Temporary National Economic Committee is the interrelation between insurance companies and banking institutions and other financial organizations.[1] Directors of life and other insurance companies are often directors of banks and other financial organizations. Evidence obtained in the government investigation has indicated that insurance companies tend to place their largest deposits in banks in which directors have an interest, purchase securities through firms where the same interest exists, and sometimes purchase materials and supplies from interlocking companies. While there is no evidence that policyholders have been harmed by such practices, the danger of such harm and the power of insurance companies to aid in the success of selected concerns are probably great enough to warrant effective but not offensive control by government.

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[1] *Investigation of Concentration of Economic Power* (T.N.E.C.), pts. 4, 10, and 13 (1940).

CHAPTER

22

REGULATION OF SECURITY ISSUANCE

ANOTHER field in which private enterprise has not been allowed to operate freely is the issuance of securities by the business corporation. Government control of security issuance by transportation agencies and other public utilities has already been studied as an aspect of regulation of these quasi-public businesses. There, however, the primary reason for regulation has been the necessity of preserving efficient entry into capital markets so that a ready flow of capital to expand and improve service would be forthcoming, and so that the cost of capital would be kept down in order to protect consumers against high rates. The protection of the investment public has been of secondary importance.

In the regulation of security issuance by business generally the government has been concerned above all with the protection of the investor against fraud or loss caused by misguided choices. In a sense, general regulation of security issuance is also motivated by the desire to lower costs of production to society by preserving capital from loss and by aiding its flow into the most efficient channels.

General governmental regulation of security issuance is a relatively new development, largely because widespread public interest in business securities is a new phenomenon. Until after the turn of the twentieth century and even until the first World War, the number of purchasers of business securities in the whole population was relatively small, and those who did buy them were deemed to be a small class of the well-to-do who could take care of themselves. This picture changed with the advent of business opportunities after 1900 and the wide public sale of government bonds during the World War. By 1920 the American public had become "security-minded," and promoters took advantage of this appetite for stocks and bonds during the speculative twenties; people bought securities blindly, and often became victims of sellers of fraudulent and highly speculative stocks and bonds. The loss to the investing public

by purchase of worthless securities during a recent decade has been placed as high as $500,000,000 annually in New York State alone, and as high as $25,000,000,000 in the entire country.[1]

Statutory regulation of security issuance dates from the passage of a law by the state of Kansas in 1911; by 1933 most other states had followed suit. The federal government did not enter the field with a systematic scheme of regulation until 1933, although the law prohibiting use of the mails to defraud had occasionally brought it into contact with fraudulent security sales. Likewise, the common law had long made fraudulent transactions of all kinds subject to legal retaliation by the victims. Moreover, in emphasizing the control of security issuance by state and federal governments, one is likely to lose sight of the regulatory work of private business itself. The New York Stock Exchange and other privately operated exchanges have taken a leading part in encouraging honesty in security sales, as have local Better Business Bureaus and associations of security dealers. The salutary effect of the growth of a business morality which will not tolerate dishonest and deceitful practices should never be lost sight of in our enthusiasm for solving social problems by passing laws.

Closely related to the governmental regulation of security issuance is the problem of regulating the exchange of securities. While this topic is postponed until the next chapter, the reader should not forget that protection to the investor extends not only to the first sale of a security, but also to practices which might be adverse to the investor's interests in subsequent sales of the same security.

A. PUBLIC INTEREST IN SECURITY ISSUANCE

The public interest in security issuance has both its individual and its social aspects. Practices which harm the individual investor have probably had much more to do with securing passage of legislation than questions concerned with the efficient use of society's stock of capital. Whenever enough individuals are hurt by the free action of other individuals, agitation for legislation to curb abuses almost invariably follows. The evolution of security issuance regulation is evidence of this fact.

1. HARMFUL PRACTICES IN SECURITY ISSUANCE. The unregulated sale of stocks and bonds has led to certain practices which investors have found objectionable and costly. Financial history overflows with examples of promotions of get-rich-quick schemes where the natural avarice of human beings has been exploited to enrich unscrupulous individuals. The sale of fraudulent securities has been the chief cause for public insistence upon regulation of security issuance.

Hand in hand with the promotion of fraudulent securities is the misrepre-

[1] Rholfing, C. C., and others, *Business and Government* (Chicago: Foundation Press, rev. ed., 1938), p. 187.

sentation of the prospects of securities. Although fraud is basically a kind of misrepresentation, there are many highly speculative business enterprises launched and securities sold to an unsuspecting public through misrepresenting the nature of the business and the possibilities of its prospects. A mining enterprise may be started by a group of zealous promoters. It may be a perfectly honest venture in the sense that mining operations will actually be undertaken. But the sellers of securities in the business may so overstate the case as to make purchasers believe that the prospects are better than they are, that dividends have been or will be earned when this is not true or plausible, that assets are greater than they are, that certain well-known responsible persons are connected with the enterprise when such is not the case, or that other conditions exist which are far more favorable than they actually are. The objection of investors is based on the thesis not that the law should forbid the promotion of speculative enterprises, but that it should forbid misrepresentation of facts concerning the business.

It has also been claimed that the investor should have available all the information possible which will help him to make a wise selection among various opportunities for security purchase. Until the passage of thorough federal regulation requiring disclosure of information in 1933, conservative and sound business corporations, as well as the speculative and unsound ventures, rather generally followed the practice of withholding information concerning their business affairs. These corporations held that if they gave out too much information, their competitors would get valuable information or stockholders and bondholders might misunderstand the significance of the data. The investor in a private business in the 1920's did well if he could obtain a highly abbreviated income statement and a sketchy balance sheet to use as the basis for making his decision. Although there is no assurance that investors will make use of more information even if it is available, its disclosure will make it possible for investment advisory services to make a more accurate analysis of corporation issues. Moreover, many investors do take advantage of more complete information when it is available, and if more data are made public over a long period of time the number of such investors may be expected to increase.

2. Social Justification of Control. As in the case of regulation of financial organizations, the basic social justification of control over security issuance is that the supply of capital is limited. Society has an interest in seeing that this resource, so important to a high material standard of living, is rationed into efficient uses. Standards of living and efficient use of capital would not be advanced, however, if capital were not allowed to flow into speculative enterprises. The willingness of owners of capital to assume risks is a prerequisite of progress. Without this characteristic those new industries which have now materially raised the standard of living would never have been started. But if society is to rely on individual interests to choose where capital shall be placed, the investing public should be protected from fraud and misrepresenta-

tion and efforts should be made to give the investor as full information as possible. If the investing group can be informed and sheltered from dishonesty and deceit, there is hope that individual self-interest will make good use of capital.

The alternative to regulations which will help the individual in his investment problems seems to be legislation which will specifically allocate capital resources to particular uses. In certain instances, this collective control of capital may be wise; but inefficient as private investment is often held to be, the motive to economize and hence use efficiently is probably greater in individuals than it is in the government.

3. THE BACKGROUND OF REGULATION. Without the development of the joint stock company, the corporation, and similar forms of business, the problem of control of security issuance would not, of course, have arisen. Where individuals invest directly in a business or make a direct loan on a mortgage, they are likely to scrutinize the object of their investment closely. The problem of investment has assumed the complexity which has made regulation so necessary by virtue of the forms of business organization which issue securities. These forms, of which the corporation has been by far the most widely used, have made possible the accumulation of large sums of capital under one management; this accumulation has followed because certain characteristics, such as free transferability of shares, long life, and limited liability, have been appealing to countless small and large investors.

Moreover, if the power to incorporate or to set up a joint stock company or similar organization had been used sparingly, the problem of regulating security issuance as such might never have arisen. If legislatures had set up rigid requirements of disclosure of information, of the character of promoters, and of the prospects of the business before granting charters to corporations and like companies, the problem of separate security issue control might have been avoided. But actual experience has been different; the powers and privileges of incorporation have been granted indiscriminately by state governments in the United States, many states publicly carrying on competition in making incorporation easy and free from legal restraints.

The American system of regulation of security issuance has been patterned to a large extent on the English model. The regulations of England are made up of certain common-law principles and the so-called Companies Acts. The common law adopted both in England and the United States has long provided remedies to purchasers of securities; these principles are applicable to purchasers of any product. One such principle is that a purchase price is returnable if a seller has misrepresented a good and if the buyer has relied on this misrepresentation in making his purchase. But action must be brought against the misrepresentor. If the purchaser of the security tried to resell it or accepted dividends, he was held to have ratified the sale and to be debarred from further action. A purchaser might also sue for damages for malicious

deceit by the seller, and if the suit met with success, criminal penalties, as well as civil damages, might be levied against the seller. However, the seller must have deliberately misrepresented the security by statements he knew to be false, and the buyer must prove that he relied on such statements when he purchased the security. While these common-law principles were often effective, the obtaining of proof was far too uncertain and prosecution too expensive to give the general securities purchaser much protection.

The English Company Act of 1929 is a consolidation and revision of a number of statutes having to do with incorporation and security issuance and dating back to the early part of the nineteenth century. The general principles of security regulation in England were developed before 1900, and dependence upon common law had by that time definitely given way to the imposition of civil and criminal liability upon dishonest sellers. The present English statutory law makes it a criminal offense for corporate officers or directors to publish false statements of a "material" fact about the status of a company. Promoters, directors, officers, security sellers, and experts whose information is relied on are made liable for the accurate and full disclosure of information in the prospectus by which securities are sold.

In the United States the principle of "Let the buyer beware" in security dealings received its first modification at the hands of state governments. The first blue-sky law — so-called because of the belief that unscrupulous promoters would even sell shares in the blue sky — was passed by Kansas in 1911, and similar laws by other states followed shortly after. When in 1917 the United States Supreme Court upheld the constitutionality of the early laws,[1] impetus was given to the passage of such laws in other states, and by 1922 more than half the states had blue-sky laws on their statute books. The decline of security prices following 1929 led to further agitation for regulation, so that in 1933 every state except Nevada had enacted legislation controlling security issuance.

The federal government first entered the field of security issuance control in 1909 by making it a criminal offense for persons to use the mails to defraud. This law applied to general cases of mail fraud, but has been especially helpful to the states in combating fraudulent sales of securities. However, the law was at best only punitive and furnished no continuing supervision of security issuance. The real entry of the federal government into this field came with the Securities Act of 1933 and certain features of the Securities Exchange Act of 1934.

The Securities Act represented a rather late recognition that the problem of control of new securities was properly within the jurisdiction of the federal government, and that the states with their limited jurisdictions and varied laws could not be relied on to build up effective control. Of course, the immediate occasion of federal regulation was the stock market crash after 1929 and

[1] *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917), and *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568 (1917).

the disclosure in the depression of many questionable financial practices. Thousands of investors suffered losses, most of which were probably deserved because of the avarice and gullibility of the speculating public, and the cause of "driving the money changers out of the temple" became a popular one. The *laissez-faire* era of security selling and the jealous attitude of state governments toward federal control aroused the condemnation of public opinion.

B. STATE REGULATION OF SECURITY ISSUANCE

State laws vary considerably in regard to the extent, the objectives, and the means of control over new securities. They range from laws which merely strengthen the common law regarding fraud to those which make the state a sort of paternalistic guardian of its investors by granting power to a commission to qualify securities suitable for sale. The present state laws may be classified roughly as follows: (1) the "fraud" type, which merely provides penalties for fraudulent security sales and proceedings by the government against such sales; (2) laws which control security issuance by regulating and requiring licenses from sellers of securities; and (3) laws which require that securities be registered with a state agency, generally with power to approve or disapprove the actual issuance. It should be noted at the outset that certain state laws combine two or more of these types. Four states — Delaware, Maryland, New Jersey, and New York — use the "fraud" type of law; four states — Connecticut, Maine, Pennsylvania, and Rhode Island — place sole reliance on the regulation of dealers; and other states require some kind of registration of new securities, some of them supplementing this control by regulation of dealers.[1]

1. THE "FRAUD" TYPE OF LAW. The law of the state of New York may be taken as an example of the "fraud" type. It empowers the attorney general to stop the sale of any security which appears to be fraudulent, and to start criminal prosecution against the dealers or other persons who have anything to do with it. The attorney general is authorized to proceed if he believes that fraudulent practices will be, are being, or have been engaged in. He has the power to carry on investigations upon complaint or upon his own motion, and may subpoena witnesses and books. Upon showing of his information to a court, a temporary injunction may be ordered, and upon proof of fraud or possibility of fraud the injunction is made permanent. Dealers convicted of fraud are not only subject to fine or imprisonment, but are also permanently enjoined from future security sales in the state.

The "fraud" type of law does not undertake to protect the investor from anything except fraudulent practices; losses incurred from incompetent judgment, inadequate investigation of prospective investment, or sheer ignorance are not subject to its protection. Such a law should thus serve to impress

[1] Hall, F. P., *Government and Business* (New York: McGraw-Hill Book Company, Inc., 2d ed., 1939), p. 275.

investors with the responsibility they have to make considered investment commitments. However, the "fraud" type leaves something to be desired. Infractions are seldom discovered until the damage has been done; the committing of fraud is too often not detected until investors have been cheated out of their savings.

Because fraud is not capable of close definition and the distinction between fraud and highly speculative undertakings is sometimes difficult to make, the kind of law in use in New York has led to a small degree of prevention as well as punishment. Promoters of highly speculative security issues have often submitted information relative to a proposed issue to the attorney general before sale is made.[1] If the attorney general discourages the issue, the actual sale is not likely to be attempted.

2. Laws Licensing Sellers. Laws licensing sellers of securities are more generally used in connection with registration laws than alone. Under the licensing type of law, dealers, brokers, and others participating in the sale of securities must obtain a license before selling securities in the state. These licenses are usually granted for short periods, such as a year, and are invariably subject to revocation by the state agency in charge. To obtain a license, sellers must file information establishing that they are persons of "good repute." Data ordinarily asked for include business address, present occupation, previous business experience, and recommendations of others as to personal integrity. Licenses are refused to persons with criminal records or with any record of having taken part in fraudulent sales of securities. Revocation or refusal to renew licenses is left largely to the discretion of the licensing commission, and persons guilty of questionable business practices or disobedience of the securities laws are disqualified.

The seller-licensing type of law seeks to protect investors by insuring the moral standards of those who sell securities. For those who desire to make security selling their occupation, the power to grant or withhold licenses has a regulatory force which should not be underestimated. But this kind of law is subject to the same deficiencies as the "fraud" type. Some prevention results from careful qualification of sellers of securities, but the real effect of the law is more likely to be felt *after* a seller has defrauded the public. However, if a state licensing commission will take great care in licensing sellers and not make the granting of licenses a perfunctory task of approving applications, the law may be fairly effective. The worth of such legislation depends also upon seeing that all persons selling securities are properly licensed.

3. Laws Requiring Registration. The great majority of state blue-sky laws require that securities be registered, and most of them in addition require that they meet certain definite qualifications. Laws in some states permit certain securities, generally those of well-established corporations or bonds

[1] Livermore, Shaw, *Investment Principles and Analysis* (Chicago: Business Publications, Inc., 1938), p. 496.

adequately secured by a first mortgage on physical property, to be sold immediately upon registration and the filing of designated information. Usually, however, the securities must be registered with the state agency, pertinent financial information must be filed, and approval for sale must be granted before sale can be made. The administrative agency differs between states, corporation commissions, securities commissions, banking commissions, and the office of the secretary of state being the most frequently used.

In order to ease the burden on security dealers and reduce the work of security commissions, certain securities and transactions are almost invariably exempt. These exemptions naturally vary between the several states, but in general they include the following classes of securities: (1) securities of the United States, states, municipalities, other governmental units, governmental corporations and other agencies, and frequently foreign governments; (2) securities issued by railroads, public utilities, banks, insurance companies, and other businesses where some regulatory commission controls issuance; (3) securities issued by benevolent, charitable, or educational organizations; (4) short-term commercial paper; and (5) securities listed on certain designated stock exchanges where listing requirements serve to protect and aid the investor. Some laws exempt securities issued by co-operative associations producing, distributing, or processing agricultural products. Some states exempt securities which are listed in standard investment manuals, such as *Moody's* or *Poor's*, on the theory that these manuals do not list fraudulent companies and do present information which aids the investor in appraising securities. That such an exemption is probably too broad is clear from the fact that the companies publishing the manuals take no responsibility for the accuracy of the information, and include only information they can obtain, which in many cases is not very extensive.

In addition to specified types of securities, certain kinds of transactions are exempt. Sales of securities made by the courts in reorganizations or other legal processes, sales to dealers and to financial institutions, and sales to a company's own stockholders are among the most usual of these. The purpose of exempting such transactions is to remove from restrictions sales of a private or innocuous nature in which the general investing public does not have much interest.

In applying for the registration of a security, fairly complete information has been required by most of the state laws. This information may include balance sheets, income statements, incorporation papers, statement of the purpose of the issue, information of price to seller and to the investor, and often property appraisals by valuation experts. In addition, surety bonds for proper performance are frequently required. The state agency examines these data and approves or disapproves the registration. Ordinarily sales cannot be made until such approval is forthcoming.

The basis for approval of an issue by a state authority differs considerably between the states, both in the legal requirements for qualification and the

thoroughness and character of their administration. Usually all that state laws require is that the investigation by the state authority be adequate to show that the issue is not fraudulent and that the information filed is accurate. Some state laws impose further duties on the state authority. The Oklahoma law authorizes the licensing commission to approve of a security only if it is not fraudulent and if the company issuing it is not organized upon unsound business principles. The Vermont law adds to the Oklahoma requirements the provision that the offering price must be fair, and the New Hampshire act empowers the commission to refuse registration to a security if there is serious danger of financial loss to the purchaser.

States have sometimes provided that the commission to the seller of securities be reasonable in order for a registration to qualify. The basis for this requirement is that if the spread between the price to the issuer and to the investor is too high, the capital obtained by the business enterprise will be so low that earnings may be inadequate to pay a return to investors. Determination of whether this spread is reasonable is often left to the state regulatory agency. Occasionally, however, a state may grant power to its securities commission to fix the reasonable amount of the spread.

Altogether too few state laws provide for an accurate check-up on prospectuses or other advertising matter. While the information required may be adequate, it is too often placed in the files of the commission and is not made readily available to the investor. Moreover, those laws which impose a duty on the commission of passing judgment as to the soundness of a security are seldom accompanied by appropriations which will permit thorough examination and analysis. The result is that securities commissions are forced on too many occasions to pass upon a security on the basis of the general appearance of information filed, and are not able to make an analysis which would enable them to fulfill the requirements of the law. The same difficulties arise from laws which authorize approval on grounds of adequacy of information, questions of fraud, or the soundness of business principles of the issuer. Appropriations for administration have been too low to allow considered and accurate judgments based on a full analysis of information. Unless the administration of the laws is adequately financed and carried on by experts, the protection to investors may turn out to be delusive.

4. Constitutionality of State Security Laws. State courts and the United States Supreme Court have had no difficulty in upholding the constitutionality of state blue-sky legislation. The Supreme Court has emphasized that the prevention of deception is within the police power of the states and that licensing and regulation of sellers of securities are reasonable devices for enforcing that control.[1] The Court has pointed out that while regulations may curtail the liberty of the honest business, the burden so placed is not unreasonable in view of the power of states to police dishonest or deceptive business.[2]

[1] *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

[2] *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568 (1917).

Even where a state attempts to regulate securities issued or handled by sellers from another state, the sales being made within the state, the courts have not found this to be an unreasonable interference with interstate commerce.[1]

5. STATE SECURITY REGULATION: CONCLUSIONS. It is difficult to assess the value of state blue-sky legislation. Although these laws have not been successful in removing fraud or deception in security sales, there can hardly be doubt that they have had beneficial effects. The large number of issues disapproved by states with well drawn and administered registration laws is an evidence of this fact. Perhaps one of the greatest accomplishments of state laws has been the discouragement of fraudulent promotion before any attempt has been made to register or sell securities. Although this benefit cannot be measured, its value should not be overlooked.

Nevertheless, state regulation of security issuance has left much to be desired. Fraudulent sales and deceptive practices have been reduced but have still remained entirely too numerous, especially until the passage of federal legislation in 1933. With the exception of a few of the more progressive and better governed states, the actual regulation has fallen far short of the high purposes of the legislation.

The principal underlying causes of the inadequacy of state regulation are not difficult to find. In the first place, state laws have not been uniform in purpose or requirements, and the character of their administration has varied considerably. Some states have placed laws on their statute books which are wholly inadequate to deal with the problem of security issuance control. Others with elaborate legislation have failed to provide expert personnel and adequate appropriations for enforcement. Those states with lax laws or enforcement agencies have furnished a refuge for unscrupulous promoters and have consequently impaired the fairly thorough programs of other states. States with proper legislation but inadequate enforcement have lowered the standards of all security issuance regulation and have also unwittingly aided in the deception of investors. If a state law is so drawn that fraudulent or deceptive issues cannot qualify, and yet a commission is unable to make a careful examination with the possibility of such issuance in view, the public is deluded into thinking that all registered securities are safe for investment.

A second weakness of state regulation of security issuance has been the inability of authorities to detect and apprehend sales across state lines, especially where done by direct mail and through advertising in magazines or newspapers sent into a state. Although postal authorities have aided state authorities in many cases, the lack of control over sellers in other states makes continuous supervision of security dealing impracticable.

Third, state security laws and their administration have failed to get information to investors regarding new security issues. Few states have felt that

[1] See *Hall v. Geiger-Jones Co.*, *supra*, pp. 557 and 559; also *Wrigley Pharmaceutical Co. v. Cameron*, 16 Fed. (2d) 290 (1926).

they could require issuers of securities to go to the expense of publishing information included in applications for registration. Even if such data were adequate and would be helpful for investors to have, information in the state authority's files is of limited use. Certain large investors or investment advisory services might be able to take advantage of the information filed, but the general investor could hardly afford to go to the trouble of digging in these archives. Nor have states found it expedient to go to the expense of publishing this information.

In the fourth place, state regulation at best only attempts to see that an offering is not dishonest or deceptively handled at the *time* the security is to be sold. Avoidance of fraud and deception and aid to investors demand that regulation continue after the first offering. The task of regulation is only half completed when a security is offered for sale. Unless the legislative authority insists that accurate information be periodically given to investors and that the practices detrimental to investors be curtailed, the protection desired is not forthcoming.

In concluding our discussion, it should be noted that the problem of state control of security issuance is closely related to state incorporation requirements. Many American states have vied with each other in making the chartering of corporations easy. This laxness has resulted in an important privilege being given to groups of individuals, with relatively little control placed over them in return. Regulations respecting security issuance, financial practices, and adequate reports to investors, as well as other business matters now subject to separate regulation, could be made requisites of incorporation. However, as long as the business of charter-mongering is looked upon by legislators as a rich source of state income, reforms in incorporation procedure are not likely to come. It may be that control over incorporation will have to be placed in the hands of the federal government, as has been done with regulation of security issuance.

C. FEDERAL REGULATION OF SECURITY ISSUANCE

The entry of the federal government into the field of regulation of security issuance resulted from the inadequacies of state control. The decade preceding 1929 represented the heyday of speculative promotion in an atmosphere of relative *laissez-faire*, and many abuses in security sales were brought to light in the succeeding depression. Honest speculations often degenerated into promotions bordering upon fraud. The concentration of power in the hands of corporate insiders led to cases of the making and administering of policies quite inconsistent with the real interests of stockholders and bondholders. In all this time few businesses or sellers of securities felt obligated to pass pertinent information on to investors, and secrecy became one of the most important tools by which abuses in management and security sales could be protected.

In searching for means to protect the investor, the federal government undertook to regulate the issuance of new securities and to supervise the purchase and sale of old securities. The latter part of the program is embodied in large part in the regulation of securities exchanges, to be dealt with in the following chapter.

Federal regulation of the issuance of securities is found largely in the Securities Act of 1933 and in part in the Securities Exchange Act of 1934. The objective of federal regulation is to require of issuers and sellers of new securities the giving of full information pertaining to the character of the securities. Thus, the federal law does not propose to pass on securities as being good or bad for investment, and makes no attempt to protect the investor against his own folly, incompetence, or lack of considered analysis. It merely attempts to insure that investors will be fully informed of facts relating to a security offered for sale.

The legal basis of federal security issuance control is the interstate commerce power and the postal power. In view of early decisions of the Supreme Court that contracts for insurance were not commerce,[1] there was some misgiving in Congress as to the legal justification for the Securities Act. For this reason, Congress provided that the instrumentalities of interstate commerce and the facilities of the post office should be forbidden to those who refused to abide by the provisions of the law. The approach of the law was, originally, at least, not to regulate security issuance as commerce itself, but to prohibit the channels of commerce and the post office to persons who disobey the law.

Enforcement of the law was placed in a new commission called the Securities and Exchange Commission. It will be recalled that this commission was also given power over public-utility holding companies in 1935.[2] The mechanism of the law is to require that all securities to which the legislation applies must be registered with the Commission. An unregistered security or a security the registration statement or prospectus for which has been disapproved by the Commission may not lawfully be sold or offered for sale in the channels of interstate commerce or through the mails.

1. Security Issues Covered. Certain securities and transactions are exempt from the operation of the federal securities law. Securities of the following classes of issuers are exempt: (1) federal, state, and municipal governments and their instrumentalities; (2) national banks and properly supervised state banks; (3) persons organized exclusively for religious, charitable, educational, fraternal, benevolent, or reformatory purposes; (4) building and loan associations; (5) farmers' co-operative associations for marketing of farm produce and purchasing of farm supplies and equipment; (6) common and contract carriers whose securities are regulated by the Interstate Commerce Commission; [3]

[1] See *supra*, p. 519. [2] *Supra*, pp. 362 ff.

[3] Amendment of the Securities Act in 1935 by the Motor Carrier Act of that year apparently makes it apply to those securities, such as short-term notes, which are issued by railroads and motor carriers but which are not subject to control by the Interstate Commerce Commission. See Throop, A. E., and Lane, C. T., "Some Problems of Exemption under the Securities Act of 1933," 4 *Law and Contemporary Problems*, pp. 89–127, at p. 92 n. (January, 1937).

(7) trustees or receivers issuing certificates of indebtedness under court approval; and (8) state-regulated insurance companies issuing insurance, endowment, and annuity policies.

In addition to the above, the law exempts ordinary commercial paper (bank notes, drafts, bills of exchange, and acceptances) which arise from current business transactions. Also exempt are any securities the registration of which the Securities and Exchange Commission finds to be unnecessary by reason of the small size or the limited distribution of the issue. The Commission's discretion in exempting such securities is limited to issues aggregating not more than $100,000, and it may require issuers of these securities to disclose such information as seems desirable. In formulating rules under this power the Commission has exempted securities the total volume of each issue of which aggregates less than $30,000. For issues totaling more than $30,000 but less than $100,000, it required modified registration and publication of a brief prospectus until 1940. At that time its rules were changed to require only notification and filing of selling literature by the issuer.

Some securities fall outside the law because of the exemption of certain transactions. If a company issues new securities to present holders in exchange for existing ones, as is often done in a recapitalization scheme, they are exempt so long as no public offering is made. Likewise, securities are exempt which are issued in reorganization following bankruptcy and which are subject to supervision by the courts or other administrative body. Intrastate sales of securities are also removed from the law. This exemption applies to securities sold to persons resident in a state or territory by issuers who are resident and doing business in the same state or territory. If the issuer is a corporation, it must be incorporated and doing business in the state or territory and may sell only to purchasers who are resident there. As interpreted by the Commission, the purpose of the exemption is to exclude sales which are strictly local in character, and the intrastate purchasers must be persons who will ultimately hold the securities. Issuers cannot escape the provisions of the law by selling securities to intrastate dealers who will in turn sell them publicly in interstate commerce.

An important exemption in the law is the exclusion of private sales of securities. The Securities Act is intended to insure adequate and accurate information to the public, and hence is made to apply only to the "public offering" of securities. The dividing line between a private sale and a public offering is not always easy to ascertain. A private sale does involve offering the issue to relatively few buyers, by invitation and in advance. These buyers may not be dealers but must be the final purchasers of the securities. However, if the offering be made to a restricted group of a substantial number of buyers, it may be regarded as a public sale, even if not offered to the public at large. Private sale, however, may involve sale of large blocks of an issue to institutional investors, as in the case of the sale of $75,000,000 of New York Telephone Company bonds to nine insurance companies in 1939.[1]

[1] *New York Times*, September 23, 1939, p. 23.

The basis for the exemptions from the full disclosure requirements of the Securities Act is either that the regulation is unnecessary because of the character of the issuer or that the public interest in the issue is not great. The extent of the exemptions is indicated by the fact that up to 1940 considerably more than half of all new security offerings have been outside of the registration provisions. Most of these securities have been government issues, although private placements have also been quite large. The distribution of new securities between registered and unregistered issues actually sold during the past several years is shown in the following table.

TABLE XIII. NEW SECURITIES OFFERED, 1935–1940
(Estimated gross proceeds in millions of dollars)

Year Ending June 30	Total	Registered	Exempt *	Unregistered Private	Intrastate
1935	$ 3,768	$ 492	$2,920	$352	$ 4
1936	11,243	3,332	7,578	322	11
1937	7,611	3,021	4,271	303	16
1938	3,725	895	2,475	351	4
1939	6,779	1,714	4,386	671	8
1940	5,486	1,313	3,485	681	7

* Mostly government issues.
Source: 6th *Ann. Rep. S.E.C.* (1940), p. 265.

Questions have been raised respecting some of the exemptions. One authority attacks the exclusion of municipal bonds and claims that "chicanery, carelessness, and paucity of information have marked the issues of towns and cities for nearly a century." [1] Other exemptions have been criticized largely because of their indefiniteness. The question of determining the difference between a public and private offering has been mentioned. Banks chartered by states are exempt as issuers only when properly supervised, but this places the Securities and Exchange Commission in a difficult and embarrassing position in passing on the adequacy of state regulation. Exemption of intrastate issues, while perhaps necessary to insure the constitutionality of the law, leaves a gap in the act which can be subject to abuse and ought to be closed. This omission is helped somewhat by the reputation of the Commission for vigilance, the state securities laws, and the fact that if the securities are traded on national stock exchanges they become subject to federal law. With the many problems of interpretation of the exemptive provisions of the law, the Commission has shown astuteness and cognizance of realities, and has made interpretations in line with the legislative purpose of providing full disclosure of information for those issues in which there is a genuine public interest.[2]

2. REQUIREMENTS OF THE REGISTRATION STATEMENT. Except for those se-

[1] Livermore, Shaw, *op. cit.*, pp. 514–15.
[2] See Throop, A. E., and Lane, C. T., *op. cit.*

curities which may be exempt for one reason or another, all new offerings must be registered. This is accomplished by filing a registration statement with the Securities and Exchange Commission, accompanied by a fee.[1] If no action is taken by the Commission the statement becomes effective twenty days subsequent to the filing date.[2] The Commission may refuse to permit registration before the effective date or revoke registration after the effective date if it finds the statement to be inaccurate or incomplete. The stop or refusal order of the Commission may be removed by amendment of the statement approved by it. Where registration statements are deficient but show an honest and sincere effort to comply with the law, the Commission may handle the case more informally by notifying the registrant in a letter of deficiency and allowing the registration to be completed when the deficiency is satisfied. If a statement is not disapproved and if the twenty-day period lapses without action by the Commission, or if the Commission allows the period to be shortened by specific approval, the registration is completed. If the prospectus to accompany the solicitation of sale is not disapproved, the offering may proceed.

To fulfill the legal objective of full disclosure the registration statement and the prospectus must contain certain information. Since the prospectus is merely a condensation of the more pertinent information in the registration statement, the requirements of the latter document may be noted first. The law sets these forth in broad outline and empowers the Commission to devise forms and define the meaning of terms. The principal requirements may be outlined as follows: [3]

A. Information relating to promoters.
   1. Names and addresses of promoters.
   2. Stock interest of promoters.
   3. Amount and nature of payments to promoters.

B. Information relating to underwriters.
   1. Names and addresses of underwriters and other distributors.
   2. Price at which underwriters are to buy securities from the issuer.
   3. Price or prices at which underwriter proposes to sell to the public.
   4. Profits of underwriters and other distributors of securities.
   5. List of preferred buyers who are given a special price and the price they will pay.
   6. Subscriptions of securities by persons affiliated with the management of the company and the price at which they will subscribe.
   7. If security is a part of an existing substantial block, agreements made to keep existing securities off the market pending sales of new securities must be disclosed.
   8. Activity by sellers to support the market price must be described.

[1] The fee is equal to 1/100 of 1 per cent of the aggregate amount at which the securities are proposed to be offered for sale, subject to a minimum fee of $25.

[2] By amendment in 1940, the Commission is given discretion to accelerate the waiting period where it finds that the requirements of full disclosure have been met.

[3] Drawn largely from MacChesney, Brunson, and O'Brien, R. H., "Full Disclosure under the Securities Act," 4 *Law and Contemporary Problems*, pp. 133–53 (April, 1937).

C. Information relating to experts who have aided in drawing up the registration statement (accountants, engineers, lawyers, etc.).
   1. Professional qualifications of experts.
   2. Relationship of experts to issuing company.

D. Information relating to the management of issuing company.
   1. Names of directors, principal officers, and other "insiders" with some power in managing the company.
   2. Stockholdings of the management in the company.
   3. Interest of the management in property purchased by the company or in business contracts made by the company.
   4. Remuneration of the management.
   5. Business experience of management in five years previous to registration.

E. Information relating to disposition of proceeds of issue.
   1. Purposes to which proceeds will be devoted and amount to be allocated to each purpose.
   2. Priority of application of proceeds to the purposes.

F. Information relating to capitalization of issuing company.
   1. Rights investors will acquire in proposed new security (dividends, voting powers, priorities and preferences, underlying security, sinking funds, etc.).
   2. Balance sheets (where company is established) for several years in proper detail and with explanations to show the nature of the assets, liabilities, and proprietorship clearly.
   3. Income statements (where company is established) for several years in adequate detail.

Examination of the above outline indicates several things. The information required is extensive and clearly involves some material expense in compiling. By being able to hold an issuing company to the full and accurate disclosure of information called for under all these headings, the Securities and Exchange Commission has the power not only to see that much important information is made public but to exercise regulatory supervision over the financial practices of the issuing companies. While not all the information obtained is included in the prospectus published for the investor, the information is on file at the office of the Commission. Investors and investment advisory agencies can consult these files and can obtain photostatic copies of the registration statements at cost. Thus, far more investment information is made available to the public than was ever believed feasible or possible a decade ago.

The registration statement must not contain an untrue statement of material fact, or omit to state a material fact, or omit such facts as will make a statement misleading. These requirements are backed up with ample penalties and place responsibility upon those connected with issuance of securities to furnish the necessary full disclosure. The Commission has further interpreted the law to require that the registration statement or the prospectus as a whole must not be misleading. It has found that a registration statement furnishing too much or too detailed information can present a misleading picture of the enterprise. In describing assets or intended use of proceeds from an issue, issuers have sometimes given such detail as to the possibilities of the company that they

may overstate the future to the investor. Or, if information is made purposely detailed and complex to confuse the investor, the registration statement or prospectus may be declared misleading as a whole.

The regulatory functions of the Commission in its examination and approval of registration statements are worth noting. Through its definition of promoters as all persons who participate actively in the launching of a business enterprise, it is able to unearth all kinds of payments to these persons; and through its power to require that disclosure be accurate and not misleading, it is able to regulate promoters' compensation by not allowing the inflated value of such services to be entered on balance sheets as assets. The Commission has taken the position that promoters' services should be entered on the assets at their real worth and that if further stock is given to the promoters as compensation, this should be shown as donations to promoters.[1] In many other respects, particularly as regards accounting methods, qualifications of experts, and relationships of "insiders," the Commission has been able to force changes in questionable practices by insisting upon full disclosure upon the basis of its definition of such disclosure.

3. Relationship of Registration Statement and Prospectus. As has already been pointed out, issuance of a new security must be accompanied by publication of a prospectus which is made available to investors. The prospectus is the real selling document and the basis for circulating the information to investors. It is a digest of the registration statement, and while it should be readable and not too long, it should contain all the information of material importance in the statement. Supporting data, except for balance sheets and income statements, necessary for full disclosure in the statement may often be left out of the prospectus. However, the prospectus is subject to the requirement that it must not make misleading assertions or omit material facts important to the making of judgments by the investor.

The digesting of material from the registration statement to make the prospectus is left to the issuing company and the distributors of securities, subject to some suggestions and possible amendments by the Commission. An interesting dilemma has been presented by the prospectus. The Commission has desired that it be concise and plainly worded so that the investor will read and understand it. On the other hand, issuers are made liable for inclusion of untrue statements or omission of material facts necessary to make the statements in the prospectus not misleading. In order to play safe, the issuers have tended to make the prospectus lengthy, so that they may not be subject to liability under the law. The result has been that prospectuses have often been documents of two hundred or more pages, crammed full of detailed information which would leave anyone except the expert rather bewildered, even if they were read.

The answer to this dilemma is not easy to find. Information upon which an

[1] See MacChesney, Brunson, and O'Brien, R. H., *op. cit.*, pp. 137–40, and cases there cited.

intelligent investment can be made is not often capable of concise and clear statement. The fact that the prospectus is complicated and must probably continue to be so is not entirely a matter for discouragement. If investors can be encouraged to obtain prospectuses, they may at least realize the difficulties of competently selecting investment, and if they cannot comprehend the prospectus themselves, they may make wider use of expert advice and assistance than many have in the past.

4. Liability of Registrants. The registration statement must be signed by the issuer of securities, its principal executive officer or officers, its principal financial officer, its comptroller or chief accounting officer, and a majority of the board of directors or persons performing similar functions. Where a security is issued by a foreign or territorial person, the statement may be signed by the duly authorized representative in the United States, except that in the case of securities of foreign governments the signature of the underwriter is sufficient.

In addition to the power of the Commission to issue a stop or refusal order in connection with registration, the federal law provides other means of bringing about compliance with the law. These are divided between criminal and civil penalties. When a person connected with the issuance of a security willfully mistakes or omits facts, or disregards the law or regulations adopted by the Commission, the latter may bring action in a federal court to enjoin such activities; or it may transmit available evidence to the Attorney General of the United States, who may begin criminal proceedings. A fine not to exceed $5000, imprisonment up to five years, or both, may be imposed upon a person found guilty of such willful violation.

The more drastic part of the enforcement machinery is found in the civil liabilities imposed by the law. These are based upon the omission of a material fact or the inclusion of an untrue or misleading assertion in the registration statement. If such misrepresentation or omission is found, any person acquiring the security issued thereunder, unless it can be proved that he knew of the omission or misrepresentation at the time of acquisition, may sue for damages. According to the law all such purchasers would have a right of action against any or all of the following: (1) every signer of the registration statement; (2) every person who was a director of, or partner in, the issuing company at the time it was filed; (3) every person who has consented to be named therein as being or about to become a director or partner; (4) every expert who has consented to be named in the registration statement as having prepared or certified data used in it and which have turned out to be faulty; (5) every underwriter of the issue; and (6) every person who controls any of the above, unless the controlling person had no knowledge of, or reasonable grounds to believe in, the existence of the facts giving rise to the liability.

The right to sue for damages is given not alone to the first purchaser of securities but to subsequent purchasers. Damages which a purchaser can collect

are limited to the difference between the price paid for the security and the market price at the time of the suit or the price realized upon sale of the security. However, a defendant is given the right to prove that the loss in value occurred because of circumstances not related to the faulty portion of the registration statement, and to the extent that he can so prove, the damages are to be reduced. Ordinarily the purchaser need not prove that he bought the security relying upon the registration statement, and he need never prove that he read it or the prospectus. But if suit is brought after the issuing company has made available to security-holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, the purchaser must prove that he acquired the security relying upon the misrepresentation in the registration statement, even though he need not prove that he read it. In no event, however, may the damages collectible exceed the price at which the security was offered to the public.

Except for the issuing company, which has no defense against a suit beyond those previously mentioned, the law does not make the liability of other persons absolute. Persons who resign from any relationship described in the registration statement before its effective date and have advised the Commission that they would therefore take no responsibility under it may be allowed to escape liability. Public notice that a registration statement became effective without an official's knowledge may also furnish grounds for competent defense. Persons other than the issuer who can prove that, after reasonable investigation, they had reasonable grounds for believing that the data in the registration statement were accurate and complete may also escape liability. The law sets up as a standard of reasonableness that care which would be required of a prudent man in the management of his own property. In every case of a person using the above defenses, the entire burden of proof is placed upon him.

Liability for damages may also arise if a person sells a security without lawful registration and without a prospectus meeting the requirements of the law. A right of action further exists in favor of the immediate purchaser against a person who sells a security on the basis of an oral communication or a prospectus which includes an untrue statement of material fact or a misleading statement of fact. Suits in cases of this kind may be made against sellers of securities for which no registration statement is required, except governmental issues. This feature of the law, then, places practically the same requirements of full disclosure on the offering of exempt securities, except, of course, the making of a registration statement.

Actions for damages under the law may not be maintained unless brought within one year after the discovery of an untrue statement or misrepresentation. And in no event may suits be brought more than three years after the public sale of the security.

Obviously, the question of liability hinges to a great extent upon the meaning of "material." The law imposes liability only for the omission of *material*

fact or misrepresentation of *material* fact. The Securities and Exchange Commission has defined "material" as the information of "which an average prudent investor ought reasonably to be informed before purchasing the security registered." [1] Such definition is probably as accurate as one can expect, even though a seller of securities may never feel sure that he has included such information. However, with the tendency of sellers to burden registration statements and prospectuses with too much, rather than too little detail, the honest and scrupulous business man has little to fear from the elasticity and indefiniteness of the term.

In spite of the declaration by many business men that the liability provisions of the securities law place intolerable burdens even on the honest and careful seller of securities, the record of successful suits for civil damages has been so negligible that the original fear of the act does not seem justified. Its main purpose was to force full disclosure by terrorizing sellers with the liabilities which *might* be incurred if the registration statement, prospectus, or other means of sales solicitation were untrue or misleading; the act was not designed primarily to give security purchasers machinery for recouping their losses. In accomplishing its main purpose, the law has been successful.

5. Specific Prevention of Fraud. The provisions of the securities law have been treated as establishing only requirements of full disclosure of information. It is true that the law aims to protect the investor by putting accurate and complete information at his disposal, and that the Securities and Exchange Commission is not concerned with the speculative character of a security. If the information be adequate and accurate, the Commission has no power to refuse registration of a security no matter how risky it may seem.

Nevertheless, the law does go beyond full disclosure by outlawing fraudulent sales of securities in interstate commerce or by use of the mails. It forbids the employment of fraudulent devices as well as practices, transactions, or courses of business which would operate as a fraud or deceit upon the purchaser. It provides that none of the exemptions of the act apply in cases of fraudulent sales. Included, therefore, in its scope are attempts to defraud in sale of securities, whether such securities are new or not.

6. Correlation with State Laws. The federal securities act does not supersede the state blue-sky laws. As a matter of fact, it specifically declares that nothing shall affect the jurisdiction of the various state commissions. The federal government has not taken control over purely intrastate security sales, and the state governments have not often attempted to regulate interstate aspects of security issuance. Consequently, there is a certain part of the new security business in which the regulations of the two levels of government do not overlap. On the other hand, the offering of new securities by a corporation in one state through underwriters and dealers in another state places the

[1] Dean, A. H., "The Lawyer's Problems in the Registration of Securities," 4 *Law and Contemporary Problems*, pp. 154–90, at p. 156 (April, 1937).

issue under the federal government, and because the actual sales are likely to be made between a seller and purchaser within the state, the transaction often falls under the state law. Consequently, the larger portion of the new securities subject to federal control are also under the jurisdiction of the states.

Even where overlapping jurisdictions exist, regulation is not necessarily duplicated. Many state regulations are based upon control over sellers, elimination of fraud, and qualification of securities for investment. These are matters only incidentally subject to federal control. Only in those state laws which require registration of the securities before issuance is there serious duplication.

In this last class of legislation, some confusion and needless expense to sellers of securities exist. Many sellers have to go to the expense of registering under several state laws and the federal laws; they also have to be sure that they are complying with both regulations. In cases of this kind, it might well be wise for Congress to exert its superior power and remove such interstate transactions from the registration requirements of state law.

7. Constitutionality of Federal Control of Issuance. Although the United States Supreme Court had not sustained the program of federal security issuance regulation up to 1941, the constitutionality of the law is hardly open to doubt. Many lower federal courts have upheld it [1] and the United States Supreme Court has denied certiorari in a number of cases.[2] The courts have almost invariably upheld the Securities and Exchange Commission where review of its orders has been sought.[3]

The constitutional power of the federal government to regulate the issuance of securities stems from the authority to police the channels of interstate commerce and the mails. Prohibition of interstate shipment of lottery tickets, stolen automobiles, and impure foods, all of which have been upheld by the Supreme Court, furnishes excellent precedents for sustaining the federal securities law.

8. Federal Security Regulation: Conclusions. When the Federal Securities Act was passed in 1933 the framers of the legislation could hardly have foreseen the magnitude of the task they were imposing on the Securities and Exchange Commission. The above brief analysis of the law is sufficient to show the tremendous administrative and quasi-judicial burden which the Commission has to carry. While being charged with the responsibility of regulation of public-utility holding companies and regulation of securities exchanges and trading, the Commission has made an enviable record for efficient and fair administration of the securities law. Few regulatory laws have been more opposed than this one, and few commissions have been more respected by those upon whom its regulations fall.

The record of the Commission cannot be fully stated in objective terms, nor

[1] See, for example, *S.E.C. v. Wickham*, 12 Fed. Supp. 245 (1935), and *Jones v. S.E.C.*, 79 Fed. (2d) 617 (1935).

[2] See 5th *Ann. Rep. S.E.C.* (1939), pp. 114–15.

[3] *Ibid.*, p. 3 and pp. 96–115, and 6th *Ann. Rep. S.E.C.* (1940), pp. 292–313, where are listed numerous proceedings where the Securities and Exchange Commission has been upheld.

can the caliber of its membership and staff be measured mathematically. In making up the many forms necessary for registration, in scrutinizing the information filed on these forms, and in drawing up rules for interpreting the requirements of the law, the Commission has competently done a difficult piece of work. In the six years ending in 1940 it received 4453 registration statements, of which 3529 became effective, 704 were withdrawn, 172 were halted by stop or refusal orders, and only 48 were pending.[1] For abuse of the confidence of investors, 775 firms and individuals were permanently enjoined from further violation of the law and 615 persons were convicted of the crimes of fraud and deceit by the Department of Justice.[2]

The provisions and the operation of the securities law have not been beyond criticism. Obviously, any person who finds his freedom interfered with is likely to be critical. While many criticisms are not worth noting, several fairly important criticisms have been advanced. In the first place, it has been claimed that the registration requirements necessitate going to great trouble and expense and that this places an unneeded burden upon well established corporations. Question may be raised, however, whether the expense of selling securities has really been increased, although it must be conceded that probably the care and detail needed for the registration statement impose troublesome burdens. Some writers have even pointed out that the costs have been lower under the securities law, and have shown that the spread between the public offering price and that received by the corporation has been less since 1933 than it was in the previous decade.[3] But the size of the underwriting spread does not necessarily measure the cost of selling new securities under the law. Prior to 1933, the cost of investigation of an issue was generally borne entirely by the underwriting firm, and the profit to the underwriter naturally had to allow for this cost. Since 1933 there has been a tendency for the issuing corporation to do a large part of the investigation work, and consequently the spread for underwriters need not be so large. The question of whether the law has materially increased the cost of selling securities is rather inconclusive. In cases of well-established corporations where underwriting firms in the past felt little investigation to be necessary, the requirements of the law have probably increased the cost of selling securities. In other cases the investigation required by law is no greater than that made by the better underwriters before it was enacted. As for that group of issues which previous to 1933 were handled by underwriters who did not make as thorough examination as circumstances of the issue would properly demand, the fact that the cost of selling has increased may often be of no consequence, since this cost may be amply justified by the purposes of the law.

The law has been criticized for its strictness and for its leniency in respect to its civil liability provisions. On the one hand, it is claimed that directors and

[1] 6th *Ann. Rep. S.E.C.* (1940), p. 124. [2] *Ibid.*, pp. 140, 151.

[3] Gourrich, P. P., "Investment Banking Methods Prior to and Since the Securities Act of 1933," 4 *Law and Contemporary Problems*, pp. 44–71, at p. 69 (January, 1937).

others cannot know whether they have included all matters of material fact, especially in the light of subsequent developments, and that the law is too hard on them. On the other hand, critics have declared that most persons subject to liability under the law can too easily escape it through the defenses provided. It is said that the proof that a person had no reasonable grounds for believing a registration statement to be inaccurate or inadequate may be rather easy in view of the requirement that reasonableness is only the care taken by an ordinarily prudent man in the management of his own property. The restriction of liability to a period of one year after detection of an untrue or misleading statement and to a period of three years from public offering of a security, the legal requirement that after an annual income statement the purchaser must prove that he relied on the untrue or misleading statement, and the provision that damages may be reduced if it can be shown that losses resulted from causes other than the deficiency in the statement, are also pointed to as elements of leniency. Whether the law is too strict or too lenient has not in reality been a serious matter. The fewness of liability cases and the success of full disclosure have as yet made these arguments of little more than academic importance.

The exemptions of the law have been criticized as being too broad. Particularly criticized has been the exemption of state and municipal issues. As an authority connected with one large institutional investor has pointed out, "sins of omission and commission have occurred in this field as flagrantly as in any other." [1] Changes in political administrations, a lack of business responsibility, a tendency to blame mistakes on previous administrations, and a traditional secrecy in reporting financial information make many state and municipal issues difficult for the investor to judge. Perhaps full-disclosure requirements of at least a modified kind could be imposed upon these governmental units. The constitutional barriers do not seem to be very great in view of the sales of these securities in interstate commerce. Only political barriers exist, and these may be resolved by carefully convincing legislators of the need for higher standards of publicity in local and state government financing.

The securities law has further been criticized because it does not really attain its principal objective of building up a group of adequately and accurately informed investors. The complicated mass of information included in the registration statements and prospectuses do not inform the investor unless he reads it and understands the inferences from it. There are those who claim in this connection that a positive danger exists by having the investor believe that he is trading in securities which are approved by the government or which must necessarily be good because of the detailed information made public.

As a matter of fact, the effect of the law on the investor group is of the utmost importance. If it fails to inform the investor, it has failed in its primary purpose. Granting that few investors read registration statements or prospectuses, and that fewer still are capable of drawing accurate inferences from them, can

[1] Kuhn, C. J., "The Securities Act and its Effect on the Institutional Investor," 4 *Law and Contemporary Problems*, pp. 80–88, at p. 86 (January, 1937).

we say that the federal securities law has been fruitless? This writer does not think so. The disclosure requirements of the law have made available much pertinent information to financial advisory agencies and to the small distributor of securities, information which was generally closely held before 1933. Pertinent data and interpretations are often passed on to investors by these parties. Some of this information finds its way into the financial columns of newspapers and magazines, and the average investor often becomes better educated thereby. Furthermore, the investing group cannot avoid being helped by the improvement in accounting standards and financial practices which the administration of the law has brought about. Unsound accounting, deceptive reporting of financial information, and unscrupulous financial practices have caused loss to many investors in the past. If security issuance control can eradicate any of these practices, as it has shown evidence of doing, the position of even the average investor is improved. This benefit is made greater by the introduction of a degree of uniformity in a field previously characterized by diverse state laws. While state laws have not lost their diverse nature, superimposing a uniform federal law upon them has reduced the opportunity for defrauding or deceiving investors.

Where the greatest harm may result from the securities law is in the building up of a feeling among investors that risks of investment are virtually eliminated. No full-disclosure law can protect the investor against investment losses caused by other things than the lack of adequate information. With the course of progress relatively uncontrolled and the fallibility of human judgment in business matters unchanged, investment losses are sure to continue. Moreover, the get-rich-quick promoter has not been stamped out. Exemptions of intrastate and small issues place many of them beyond the federal law, and state laws are not always adequately enforced. Even if the laws were comprehensive and well enforced, the possibility of making an easy, albeit dishonest, dollar will ever encourage unscrupulous promoters to risk the penalties of the law. The investor cannot forget that the buyer, as well as the seller, must beware.

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CHAPTER

23

REGULATION OF ORGANIZED EXCHANGES

A MARKET may be described as an area in which buyers and sellers make exchanges with each other. Wherever goods are bought or sold a market exists. This may be a retail store or it may be a country-wide network of communication services used for bringing buyers and sellers together. Some markets are far more organized than others. Perhaps the most thoroughly organized of all markets are those which are referred to as organized exchanges. These are associations of individuals organized for the principal purpose of furnishing a place for the transaction of purchases and sales in a certain few kinds of goods. In order to make the process orderly, such associations restrict to their own members the privilege of trading in the market-place they furnish. The members may buy and sell on their own account, or, as is more usual, as agents of parties outside the exchange membership; in other words, members of organized exchanges may be dealers or brokers. With a centrally located market-place and a membership making it a business to execute orders from outsiders, the organized exchange can facilitate the transfer of title to a large volume of goods under circumstances where the forces of demand and supply exert free play.

The most widely used and best-developed exchanges are the stock and commodity exchanges. The stock exchanges furnish facilities for buying and selling not only common and preferred stocks of business corporations, but other types of securities as well. The commodity exchanges provide a place for organized trading in such goods as wheat, oats, rye, and other grains, cotton, hides, sugar, coffee, copper, rubber, and other raw materials.

The operations of organized exchanges have greater public significance to the economic organization than the mere fact that many people use them. The prices paid for securities and raw materials have their effects upon the efficient operation of the economic system. Just as fair stock or bond prices facilitate the flow and transfer of capital resources in business enterprises, fair commod-

ity prices, by influencing cost and price, affect the flow of raw materials into production and consumption. The function of the organized exchange is to furnish facilities for making exchanges at prices fairly determined by demand and supply. The public interest in these exchanges is based on the desire to see that practices by individuals will not impede the orderly setting of fair prices by the market. In any system relying in large part upon free private enterprise, price is of the utmost importance, and the conditions under which it is set, including facilities for transfer, bargaining, and buyer and seller information, are filled with a public interest.

The relationship between regulation of security exchanges and that of new security issuance is particularly close. Under the federal program of regulation, full disclosure of information is required of new issues only. This requirement is supplemented by the regulations connected with trading which apply to all securities handled by registered exchanges. In the case of both security and commodity exchanges, virtually all the governmental regulation has been under the federal government.

A. REGULATION OF ORGANIZED STOCK EXCHANGES

Most of the dollar volume of security purchases and sales is handled through twenty-seven organized security exchanges in the United States; a larger number of issues, but a smaller dollar volume of business, is traded by some seven thousand security dealers. The transaction of security sales and purchases by these dealers, without use of organized exchanges, is called the "over-the-counter market." Since special regulation has been provided for this vast unorganized market, it will be touched upon in the succeeding section.

The organized security exchanges are private associations furnishing a market-place and other facilities for the exclusive use of their members, the majority of whom act as brokers in the sale or purchase of securities for the public. By far the largest and most important security exchange is the New York Stock Exchange, which does approximately eighty-five per cent of the business done by all exchanges.[1] So large is this organization that whenever regulation of security exchanges is considered, that of the New York Stock Exchange seems to be uppermost in the minds of people. Furthermore, this stock exchange has become the leading subject of regulation after which most other exchange controls have been patterned.

Government regulation of security exchanges was not undertaken until 1934, when the federal legislature passed the Securities Exchange Act. While it may seem strange that these organizations in which the public had such a great

[1] Twentieth Century Fund, *Stock Market Control* (New York: D. Appleton-Century Company, 1934), p. 19. See also 6th *Ann. Rep. S.E.C.* (1940), p. 276.

interest should have escaped government regulation for so long, the degree of self-regulation by the leading exchanges, particularly the New York Stock Exchange, made government control seem unnecessary. Being voluntary associations, the stock exchanges had full control over their members, could set up regulations for trading and member activities, and could enforce these rigorously, without resort to the courts, by their powers to penalize, suspend, or expel members. As a matter of fact, the question of regulating the stock exchanges was the subject of a legislative investigation as early as 1912; the committee recommended against government control on the ground that the exchanges themselves could better regulate their membership through the informal but adequate powers they held.[1] The constitution of the New York Stock Exchange and the administration of many regulations by its governing body have presented a good record of control in the public interest by a business association. The recent history of this exchange, even before 1934, has indicated that ethical standards and fair dealing by members have been higher than in many businesses long regulated by the government.

The end of the speculative orgy of the 1920's with the stock market crash of 1929 brought in its wake a renewed demand for regulation of the stock exchanges. A large part of the impetus for control came from those disillusioned speculators who sought to place the blame for the collapse of security prices upon the exchanges, particularly the New York Stock Exchange. Most of this demand for regulation came from those hundreds of thousands of persons who felt that somehow the stock exchanges were responsible for the distortion of security values, and who failed to realize that a speculative mania which lost all sight of fundamental business values was the primary cause of the rapid upswing and violent drop in security prices. Another part of the drive for government regulation came from those who felt that security speculation should be brought under control, that the stock exchanges were too important public institutions to be under private regulation, and that certain practices had crept into the trading of securities which should be modified or eliminated by government intervention.

1. NEED FOR GOVERNMENT REGULATION. In spite of the fact that most stock exchanges had provided high-grade self-regulation and that many of the evils of speculation cannot be laid at the door of the exchanges, which merely furnish the facilities for trading, there have been several considerations which pointed to the need for federal regulation. In the first place, if regulation were to be adopted at all, the control should be undertaken by the federal government. Not only have stock exchanges done business on a national scale, but varied state regulation would place a premium upon moving exchange facilities to those states with the least restrictive laws.

One of the aspects of security market operation which appeared in need of

[1] *Investigation of Financial and Monetary Conditions in the U.S.* (Pujo Report), Pursuant to House Resolutions 429 and 504, 62d Cong. (1913).

regulation in 1934 was margin trading.[1] Purchasing stocks on the margin increases the volume of purchases any individual can make with the same amount of capital and thereby contributes to the activity of a market. Because the credit base in the American banking system is capable of great elasticity, and because loans on stock as collateral have been regarded as very safe, brokers have generally had no trouble in obtaining adequate funds for margin trading. The result has been that, especially in a rapidly rising market, loans have been expanded to furnish funds for security purchases. But increased security purchases contribute to rising prices, and higher security prices make more collateral value for larger loans. This spiral of increasing prices and increasing credit has a tendency to be self-generative and to lead to an inflated level of security prices and credit. When adverse circumstances cause prices to fall, collateral values decline, and loans must be liquidated, causing further price declines, falls in collateral value, and loan liquidation. The distress selling of securities causes a rapid credit deflation and a more than normal depression of security prices. The criticism of margin trading, then, is that it contributes to market instability and is instrumental in causing detrimental credit expansion and deflation. The criticism of exchanges in the operation of margin trading is that they have not insisted upon high enough margin requirements to minimize its dangers.

Upsetting to the normal equilibrium of markets has been the practice of short selling,[2] which has been subject to more criticism and complaint than has margin trading. The reason, of course, is that most speculators among the general public purchase for a rise in the market and hence are likely to feel that short sellers, by offering a supply of securities on the market which they do not own, tend abnormally to depress market price. Ordinary short sales do not have material effects upon the normal functioning of markets, and are even necessary to eliminate abnormal fluctuations caused by occasional large purchases; but there has been a feeling that excessive short selling may interfere with the proper functioning of a market, particularly if it is aimed at a certain stock or is performed on a certain day.

[1] The criticisms of stock exchange operation given here are drawn from Twentieth Century Fund, Inc., *The Security Markets* (New York: The Twentieth Century Fund, Inc., 1935), chap. XVII. Margin trading is the purchase of securities by the aid of borrowed funds. The usual procedure is for the purchaser to put up a portion of the cost of securities bought through his broker, and for the latter to use the purchased securities as collateral in borrowing funds to finance the rest of the cost. So long as the market value of the securities is above the amount of borrowings, the loan is well secured and easy for the broker to get. When the market price falls below the purchase price, the broker may ask the purchaser to contribute more funds or may sell the securities to satisfy the loan. The amount the purchaser contributes is called his "margin." Thus, if he buys a share of stock at $100 and makes a payment of $30, his margin is said to be 30 per cent. Obviously, the amount of margin varies with the subsequent market price of the security.

[2] One sells short when he orders a broker to sell a security which the seller does not own. In order to consummate the sale, the broker borrows the security and holds the selling customer responsible for replacing it at some time in the future. This device has possibilities of profit (and loss) to the seller. If he sells, say, at $50 per share and purchases the same security later at $30 per share, he has made a profit. However, should the security go up in price, he would stand to lose.

Security exchanges have also been criticized for not exercising better control over manipulative operations. Manipulation involving deliberate interference with the free action of demand and supply is generally carried on by pools.[1] Its purposes vary from a desire to make a profit for a certain group of speculators by forcing the price of a security up, to a desire to sell a large block of securities without causing their price to fall unduly. Some of the operations of pools may be perfectly legitimate, such as the support of a market while a new issue of securities is being distributed, or while a large block of securities owned by an individual or an investing institution is being methodically liquidated.

The objection to the manipulation of security markets has been that a false activity may be created and that investors and speculators may be deceived by it, the market thus being subjected to artificial controls and not being allowed to reflect genuine demand and supply forces. It has been objected that the exchanges not only failed to do as much as they should have to curtail unreasonable manipulation, but did not give publicity to cases of justifiable manipulation.

Those in charge of security exchanges before 1934 have been severely criticized for not publishing more adequate data of interest to traders, and for not requiring companies whose securities were listed on the exchanges to publish financial information helpful to investors. Besides the desire of investors to have justifiable manipulative transactions well publicized, it was held that exchanges should publish data concerning the extent of margin and short trading, the purchases of securities of their own corporations by officers and directors, and other information useful to traders in understanding the movement of the market. While many stock exchanges, of which the New York Stock Exchange was an outstanding example, insisted upon publication of income statements and balance sheets, proper reporting of information to corporation investors still left something to be desired. Reports needed to be more complete, more frequent, issued more promptly, and based upon sound and uniform accounting practices.

The need for regulation of security exchanges became more apparent after the program of control over new security issuance was adopted in 1933. By requiring full disclosure of information at the time a new security was issued, the government could do much to help investors make sound security selections and to eliminate financial practices which might delude them. But for securities already issued and those outside the classification of a new issue, the program provided no means of continuing and extending the principle of full disclosure. The Securities Exchange Act of 1934 did much to fill this gap.

[1] Pools are usually formed by a group of speculators banding together for the purpose of buying or selling large blocks of securities. The resources of the group are usually placed at the disposal of a manager. If the purpose of the pool is to drive the price of securities up, its members mass their buying, create an active market which encourages others to buy, and when the price is high enough liquidate their securities. In order not to cause the market price to fall, pool managers are generally forced to sell cautiously and to make purchases during the process of liquidation in order to support the market.

2. Securities Exchange Act of 1934: General Objectives. The Securities Exchange Act of 1934 brought under federal control the large security exchanges of the nation and placed most of the regulatory authority in the care of the Securities and Exchange Commission, with jurisdiction over a few matters in the Board of Governors of the Federal Reserve System. There are three principal objectives of the law. One is to prevent the excessive use of the nation's credit facilities to finance speculation, with its disturbing effects upon security prices and the entire economic system; the second is to provide for regulation of those unfair practices in security trading which interfere with the orderly establishment of security prices; the third is to make available to the average investor accurate and adequate information about the financial affairs of the companies whose securities he may buy or sell.

The legal basis upon which the law rests is the power of the federal government over interstate commerce and the mails. The approach of the law is to require registration of security exchanges and of the securities listed on them. By means of such registration, control is facilitated and full disclosure of information obtained. In addition, the law provides for definite regulation of exchange practices and of the members trading on exchanges. However, the exchanges are not deprived of their incentive for self-government; in fact, the law virtually insists on its continuance, subject to government supervision. The regulation of exchanges, consequently, furnishes an interesting example of supervised business self-regulation.

3. Registration of National Exchanges. The Securities Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the instrumentalities of interstate commerce or the mails for the purpose of effecting security transactions through an exchange, or reporting such transactions, unless the exchange is registered with the Securities and Exchange Commission or exempted from registration by it. The Commission is empowered to grant exemptions to any exchange if it finds that the volume of transactions is so limited as to make registration impracticable, unnecessary, or inappropriate for the protection of the public interest.

There are several requirements for registration of a national security exchange. With the exception of the right to contest the constitutionality of rules or regulations, it must agree to comply with and aid in enforcing the rules and regulations of the law and the Commission. Data as to organization, rules of procedure, and membership must be filed with the Commission, along with such other information as the latter may find to be necessary or appropriate in the public interest and for the protection of investors. Copies of the constitution, articles of incorporation, by-laws or rules, and all amendments to any of these must be filed with the Commission. The rules of the exchange must provide for the expulsion, suspension, or disciplining of members whose conduct is found inconsistent with just and equitable principles of trade or with the rules or regulations approved by the Commission. However, a registered

exchange is permitted to adopt and enforce rules beyond those set up by the law or the Commission, provided they are not inconsistent with federal or state law or the regulations of the Commission.

If the Commission finds that the applicant exchange is so organized as to be able to comply with the law and its own rules and regulations, and that the rules of the exchange will insure fair dealing and protection to investors, it is empowered to register the applicant as a national security exchange. Under this power, by 1940, the Commission had registered twenty security exchanges and had granted exemption from registration to six.[1]

4. REGISTRATION OF SECURITIES. The law forbids exchange members, brokers, and dealers to make any transaction in any security, other than an exempted one, on a national security exchange unless the security has been properly registered with the Securities and Exchange Commission. The law applies to all securities bought and sold by exchange members. Although the requirements for unlisted [2] securities traded by exchange members are for all intents and purposes the same as those for listed securities, there is some leeway in the requirements for the former through a measure of discretion granted to the Commission.

a. Exempt securities. Certain securities are exempt from the registration requirements of the law. These exemptions are similar to those of the Securities Act of 1933 applying to new issues, but are somewhat more limited. Insurance policies, receivers' certificates, and securities of building and loan associations are not exempt, probably because they are seldom traded on the exchanges. Securities authorized by a court in reorganization or by the Interstate Commerce Commission are also not exempt. This difference is probably due to the belief that registration may not be needed for these securities at the time of their issuance, but that continued publicity of corporate affairs after issuance may make registration on the exchanges desirable.

b. Registration requirements. The requirements for registering securities for trading on stock exchanges are somewhat similar to the registration requirements for new issues. They undertake to force disclosure of information of

[1] 6th *Ann. Rep. S.E.C.* (1940). The Commission notes (at p. 88) that the following exchanges had been registered: Baltimore Stock Exchange, Board of Trade of City of Chicago, Boston Stock Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, Cleveland Stock Exchange, Detroit Stock Exchange, Los Angeles Stock Exchange, New Orleans Stock Exchange, New York Curb Exchange, New York Real Estate Securities Exchange, New York Stock Exchange, Philadelphia Stock Exchange, Pittsburgh Stock Exchange, St. Louis Stock Exchange, San Francisco Mining Exchange, Salt Lake Stock Exchange, San Francisco Stock Exchange, Standard Stock Exchange of Spokane, and Washington (D.C.) Stock Exchange. The following exchanges have been exempted by the commission: Colorado Springs Stock Exchange, Honolulu Stock Exchange, Minneapolis-St. Paul Stock Exchange, Richmond Stock Exchange, Seattle Stock Exchange, and Wheeling Stock Exchange.

[2] A "listed" security is simply one which may be traded on the floor of an exchange. Listing involves furnishing the exchange with certain information regarding the issue and promising to keep this information up to date, making reports to stockholders, and other matters designed to keep the investing public informed as to the issue. An "unlisted" security is one which is traded by members of the exchange but which has not met its listing requirements. For some years the New York Stock Exchange has not permitted trading in unlisted securities.

interest to investors. Under the law, the Securities and Exchange Commission may require information on the following matters:

(1) organization, financial structure, and nature of the business;
(2) terms, position, rights, and privileges of the different classes of securities outstanding;
(3) terms on which securities of registrant are to be, and during preceding five years have been, offered to the public or otherwise;
(4) directors, officers, and underwriters, and each security holder of record holding more than 10 per cent of any class of stock, their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by the issuer;
(5) remuneration to others than directors and officers exceeding $20,000 per year;
(6) bonus and profit-sharing arrangements;
(7) management and service contracts;
(8) options existing or to be created in respect of the securities of the issuer;
(9) balance sheets for not more than three preceding fiscal years, certified if required by rules and regulations of the commission by independent public accountants;
(10) profit and loss statements for not more than three preceding fiscal years, certified if required by the rules and regulations of the commission by independent public accountants;
(11) any further financial statements which the commission may deem necessary or appropriate for the protection of investors.

In addition to information on the above matters, the issuer must file such copies of article of incorporation, by-laws, trust indentures, underwriting agreements, voting trust agreements, and similar documents as the Commission may deem necessary for appropriate and adequate protection of investors.

The registration requirements under the 1934 law are in general higher than the listing requirements of security exchanges before its passage. Yet with a few exceptions, such as the data on remuneration of officers, directors, and others, the requirements were not much more extensive and strict than those which the New York Stock Exchange had had. A security registered for issuance under the Securities Act of 1933 encounters little difficulty in qualifying for registration on the exchanges. The information demanded is much the same, and the forms are also similar. Securities which escape registration under the securities law are often brought under the full-disclosure requirements of the exchange law if they are later traded on national security exchanges. For example, bonds of the Brooklyn Manhattan Transit Corporation which were privately issued in 1934 to investment banking houses were resold to the public. When listing was applied for later, the Commission held that these bonds should have been registered under the securities law, and held up registration on the New York Stock Exchange until this was done.[1]

The registration provisions of the Securities Exchange Act have resulted in widespread publicity for most of the important business securities. In 1939, the Securities and Exchange Commission announced that 4315 listed issues of

[1] *In the Matter of Brooklyn Manhattan Transit Corporation*, 1 S.E.C. 147 (1935).

securities and 2033 unlisted issues of securities were registered for trading on national stock exchanges, and that full disclosure of information was available to investors in these securities.[1]

c. Periodical reports. Issuers of securities registered for trading on national stock exchanges are required to file periodical and other reports with the Commission. These reports are intended to keep the information in the registration statements reasonably current. In addition, the Commission is empowered to require such annual and quarterly reports as it may prescribe. It is given full authority to prescribe forms for these reports and the methods to be followed in preparing them. In this connection it may prescribe methods of appraising assets and liabilities, accounting for depreciation and depletion, and other methods whereby financial information is derived.

The power over accounting and other business practices which the commission has is broad. Under its authority to pass upon the adequacy of information for registration or periodical reports, it may go beneath the reports themselves and require that information be stated in such manner as seems to it to be in the public interest. The exercise of this power tends to bring about uniformity in accounting practices, and exerts a strong deterrent influence upon those business practices which are deceptive and unsound.

d. Liability of registrants. The Securities Exchange Act provides for civil liability of persons responsible for false or misleading statements, but is not quite as strict or as specific in the matter of liability as is the Securities Act of 1933. Any person may be held liable for damages if he makes or causes to be made in any application, report, or document filed under the Exchange Act or its regulations any statement which, at the time it was made and in the light of the circumstances, was false or misleading with respect to any material fact. Any person may sue for these damages if he, not knowing the statement to be false or misleading, relies on the statement and purchases or sells a security whose price is affected by it. The amount of damages for which the injured person may sue is not referred to in the law.

While the Exchange Act is broad in that it includes liability for any information required by the Commission, it is perhaps a little more generous than the Securities Act. The person suing must prove that he relied upon the misleading or fraudulent statement and that it affected the price of the security so as to cause him loss. Under the Securities Act, it will be recalled, the injured party need not prove that he acquired the security relying upon the false or misleading statement until after an earnings statement, covering a period of twelve months following issuance, has been made public. Moreover, the defense of those responsible for a false or misleading statement is a little less specific, the requirements of reasonable care not being stated in the law.

e. De-listing of securities. Besides the civil liabilities for inadequate investment information, a security may be withdrawn from listing or registration.

[1] 5th *Ann. Rep. S.E.C.* (1939), pp. 49, 54.

The law allows this to be done under the rules of an exchange or under such regulations as the Securities and Exchange Commission may wish to impose for the protection of investors. Non-co-operation of an issuer in the making of reports in sufficient and accurate detail and with adequate frequency is the most usual basis for the de-listing of securities.

5. REGULATION OF EXCHANGE PRACTICES. An important part of the Securities Exchange Act of 1934, and of the regulations made under it by the Securities and Exchange Commission, refers to the practices involved in exchange transactions. These regulations are designed to reduce speculative excesses and the use of credit for them, to eliminate practices which keep the market from acting freely, and to prevent the unfair use of information obtained by corporation "insiders" in trading in securities of their own companies. Regulation of exchange practices may be summarized under controls over margin trading, short selling, manipulation, and trading by corporate officers, directors, and principal stockholders.

a. Margin trading. Brokers are forbidden by the law to extend credit to a customer without collateral. In making loans to customers for trading on a margin, the brokers are subject to regulation under rules established by the Board of Governors of the Federal Reserve System. The law gives the Board power to fix margin requirements from time to time, and it has raised or lowered the percentage of margin required as it feels that speculative activity should be increased or decreased. Although margins of approximately 45 per cent of market price were established temporarily under the law, this was reduced by the Board of Governors to 40 per cent in 1937. This provision was in effect in 1940, meaning that the minimum margin a broker could require was 40 per cent of the market price of the security, and the maximum loan that could be made on securities as collateral amounted to 60 per cent of the market price. These requirements are substantially higher than the customary margins of the 1920's.

Control over funds going into speculative security purchases is further strengthened by the legal requirement that brokers may borrow only from member banks of the Federal Reserve System or non-member banks who have agreed to credit restrictions made by the Board of Governors. Adequate provision is made for inspection of bank and brokerage house records to see that these provisions are observed.

b. Short selling. Many persons have strongly advocated the abolition of short sales. In the 1934 act, however, Congress wisely refrained from prohibiting them and instead placed supervision of them in the hands of the Securities and Exchange Commission with instructions to eliminate abuses. Pursuant to these powers, brokers have been required to obtain the permission of an owning customer before borrowing a customer's stock for use in making a short sale. To restrain short selling on a falling market, the Commission for several years permitted it only at a price *above* the last sale price. In 1939, at

the suggestion of the New York Stock Exchange, this rule was amended to permit short sales at the price of the preceding sale, provided that the last sale price was itself higher than the last different price which preceded it. Under this rule, short sales may only be made on a fairly stable or rising market and short sellers are not permitted to "raid" a rapidly falling market. This meets most of the criticism of short sales, and still preserves them as a safety valve for too rapid price rises in buyers' markets.

c. Manipulation and deception. Several methods of trading are either banned by the law or placed under the supervision of the Commission in order to avoid manipulation of security prices. Placing orders to buy and to sell at the same time for the purpose of creating a false appearance of market activity is made unlawful. So is effecting a series of such transactions alone or in concert with others to raise or lower prices artificially. Also unlawful are the circulation of rumors that security prices are likely to rise or to fall because of the market activity of certain persons, and the making of false or misleading statements of material fact by purchasers or sellers to induce a sale or purchase.

Placed under regulation of the Commission are several manipulative practices. Any attempt to stabilize the price of a security by a series of purchase or sale transactions must be in accordance with the rules and regulations of the Commission. This provision recognizes that in certain circumstances, especially when a block of new securities is being sold by underwriters and dealers, price stabilization activities may be necessary. The Commission allows them to be undertaken by an underwriting group for a limited time and with provision for publicity of the pegging operations. The acquisition and making of options are also subject to Commission supervision to safeguard against their abuse.[1] Performance of the business of arbitrage is likewise subject to its rules.[2] Just to make sure that no device which ingenious traders may find advantageous to use in the future is overlooked, the Commission is given power to regulate any manipulative or deceptive device or contrivance when necessary or appropriate in the public interest or for the protection of investors.

The penalties for willfully violating any of the portions of the law respecting manipulation are fairly severe. Besides the danger of criminal prosecution for disobeying any rules and regulations of the Commission, guilty persons may be sued for damages by persons injured by the manipulation. Such actions must be brought by persons who purchased or sold a security whose price was affected by the manipulation, and must be brought within one year after the discovery of the violation and within three years after the violation. If any person is found guilty of manipulation, his possible damages are large, for he may be sued by a multitude of speculators who were affected by the manipulated price. Strangely enough, however, the prohibitions against manipula-

[1] Options are devices whereby a person, for a consideration, agrees to deliver or buy securities in the future at a price fixed in the agreement.

[2] Arbitrage is the practice of buying a security on one exchange and selling it on another.

tion do not apply to any exempted security, and such activities in government issues, while unlikely by private parties, would be outside the scope of the law. This exemption may have been granted, partly at least, to protect the federal reserve banks in their purchases and sales of government bonds to control the prices of these securities.

d. Trading by officers, directors, and principal stockholders. For the purpose of preventing the unfair use of corporate information by insiders of a corporation, special regulations are provided for trading in its stock by officers, directors, and persons owning directly or indirectly more than 10 per cent of any class of the company's stock. These insiders must file information monthly with the securities exchange and with the Commission showing their ownership interest in the company and any changes which have occurred during the month.

Any profit realized by such insider in buying and selling a security, or selling and later buying it, within a period of six months becomes recoverable by the company. If the transaction is made within the six-month period, it is assumed that it was made because of the advantage obtained from the knowledge of advance or confidential information, irrespective of the real reason for it. The only exception is the circumstance where the security is acquired through a previously contracted debt. Suit to recover may be brought by any stockholder or by the company, but must be brought within two years after the date that the profit was realized.

This provision of the law does hinder insiders from using their favored position to profit in security transactions. It has sometimes been contended that this limitation is too strict and that the market is deprived of the speculative activities of a group of informed buyers and sellers. However, the law only restrains purchases or sales in the stocks of the companies in which the insiders have an interest, and allows them to buy and sell at will in other securities. Moreover, if a person wished to use his inside position for profit, there would seem to be little doubt that he could evade the restrictions by advising a "friend" to buy and sell for him.

6. Regulation of Exchange Members. The Securities Exchange Act requires dealers and brokers who transact business in securities not registered on a regulated exchange to register with the Securities and Exchange Commission. Brokers or dealers doing business only through a registered exchange are not required to register, but they are effectively controlled through their membership in the exchange, the control of the exchange over membership, and the supervision of the Commission over the rules of the exchange.

Obviously, all the regulations of the law applicable to manipulation or deception include members of exchanges within their scope. Most of the special regulation of members is left to the exchange, but a few definite restraints are placed in the law. Since a broker acts as an agent of the customer in executing a sale or a purchase, and a dealer is naturally interested in selling securities which he carries, members of exchanges and others who transact business

through them, who are both brokers and dealers, may not extend credit to a customer to purchase a security in the distribution of which the dealer participated, until a period of six months beyond the offering date has passed. Brokers who are dealers as well must also disclose to customers in writing the capacity in which they are acting when they sell them securities which they offer as dealers. This restriction seems to be wise in safeguarding the customer against being influenced, or being charged unduly, for a security which the combined broker-dealer is selling.

The Commission also has power to regulate and prescribe functions of members of security exchanges, to regulate floor trading, and to prevent excessive speculation by members. It may prescribe such rules as are found necessary for increasing the solvency of dealers and brokers, rules regarding the commingling and pledging for loans of customers' securities held by the member, and regulations governing the keeping of books and records by brokers and dealers.

The Commission has relied to a great extent upon the self-regulation of exchanges in controlling member activities. It has often informally suggested changes to be made in the regulations of exchanges, and has accepted suggested changes made by them. No better example of the encouragement of self-regulation under government supervision can be found than the changes instituted following the failure of the famous firm of Richard Whitney and Company in 1938. This failure followed use in speculative transactions of securities deposited by customers by the leading member of the firm. The Commission made an extensive investigation into the failure and disclosed that improvements might be made in the Stock Exchange rules respecting the safeguarding of customers' accounts. After a series of informal discussions between officers of the New York Stock Exchange and the Securities and Exchange Commission, several new rules were added to the regulations of the exchange. These included provisions that indebtedness of brokers to other persons be not more than fifteen times the net capital investment of the broker, that loans between exchange members be fully secured by readily marketable collateral, and that regular financial statements audited by independent accountants be required from members.[1]

The practice of regulating member conduct by co-operation of the exchanges and the Commission is especially commendable in this field of business. Security exchanges customarily have complete control over membership, and rules may be enforced without resort to legal process or other complicated procedures. Moreover, the regulation of security trading is a highly intricate task. Wise and competent government control does well to rely upon the knowledge and experience of those in the exchange business.

7. Security Exchange Regulation: Conclusions. The security exchange regulations represent a very important development in the struggle for honest and informed investment. Those engaged in security dealing and brokerage

[1] 5th *Ann. Rep. S.E.C.* (1939), pp. 232–35.

are clearly in a business charged with great public interest, and those who are in the management or control of a business corporation are in a position of public trust. With the great number of investors, drawn in large part from the masses of small and moderately large savers, investment in the modern business corporation has lost its private character. It has become popular with the many, partly because of the ready markets for securities which have been built up in this country.

The Securities Exchange Act seems to fulfill its objectives reasonably well. Thousands of companies are making important information available to the investing public that was published by only a few prior to 1933. The Securities Exchange Act has insured that these data will be kept current and that pertinent financial information can become the basis for sound comparisons and conclusions which were not possible a few years ago. Recognizing the great strides made by such private organizations as the New York Stock Exchange to make security trading honest and not detrimental to the best public interests, the Securities Exchange Act consolidates and advances these gains by extending the controls and making them more uniform over the country.

What may be some of the economic effects of this broad program to shield the investor from ignorance and deception? These are not easy to note, in view of the short period that security and exchange regulations have been effective; but several effects seem apparent. The share of the national income which has gone to fraudulent or unscrupulous promoters and traders will surely decline. The pyramiding of credit with its effects upon prices, production, and the rate of consumption should be lessened, even though many other means for credit expansion still exist. If a more informed investment class results from these regulations, as seems likely in spite of the realization that many investors will be unwilling or unable to use available information, the supply of capital funds may be affected. To the extent that investors can find wherein their greatest profits lie, capital available for private investment should tend to go into those enterprises showing the greatest promise for efficiently satisfying the most pressing demands for goods.[1]

The security exchange regulations, as well as control over security issues, have not escaped criticism. Some criticisms are justified. The fact that thousands of security issues are not covered under either set of laws may lead the investing group to assume a completeness of regulation that does not exist. Moreover, the law cannot guarantee that the purchase of a listed security on a registered national security exchange will always be a wise investment. The writer doubts that it would be either desirable or possible for a law to attempt that. But the advent of such strict regulation as is now imposed may mislead investors into believing so.

[1] The writer realizes that demands are not the same as desires, owing to the importance of purchasing power, but a system under private enterprise can do no better than to furnish those goods most demanded at the least cost.

The law has been criticized on the ground that it does not make speculative excesses impossible. While controls over credit and margin requirements place restrictions on such excesses, this does not mean that dangerous speculation cannot occur. For one thing, the law still allows use of credit in the purchase of securities, and one cannot be sure that the Board of Governors of the Federal Reserve System will be willing or able to stop the impetus of a rising market. Furthermore, if people want to speculate wildly or to gamble, neither the law nor the sincere attempts of exchanges to abide by it can prevent them from doing so.

The exchange restrictions have also been criticized on the ground of having so impeded the orderly conduct of markets that markets have become "thin." It is true that the volume of security transactions has been lower in recent years than it was a little over a decade ago; it is true that this reduced volume often makes it impossible to sell or buy a large block of securities without unduly affecting prices. The validity of this criticism cannot be assessed accurately yet, however. The depressed condition of many industries and the withdrawal of a large part of the public — the small investor or speculator — are enough to account for a "thinness" in the market. Moreover, even if the exchange regulations have accounted in any material degree for the decline in trading volume, the restraint upon honest trading is so small that its effect will undoubtedly diminish or disappear. If the loss in volume is due to the decline in the kind of trading which is now unlawful, perhaps the social gain far offsets the loss of market stability.

B. REGULATION OF THE OVER-THE-COUNTER SECURITY MARKET

As was pointed out in the previous section, a large number of security issues are traded outside the organized exchanges. This unorganized trading, referred to as the over-the-counter market, is carried on by nearly seven thousand individuals who buy or sell unlisted securities either for their own account or for customers. Over-the-counter brokers are also ordinarily dealers in that they may purchase securities and hold them for possible resale at a higher price. As brokers, these individuals keep in constant communication with each other, and when an order to sell or to buy comes from a customer, the possible market price to be expected is obtained by telephoning or writing traders who are believed to have a market in the security. Some large over-the-counter houses maintain a file of thousands of issues with data as to the persons owning or desiring to buy them, and their probable sales or purchase price.

The very individualistic nature of the over-the-counter market makes abuses possible and causes regulation to be difficult. Customers should know whether a trader is acting as a dealer or as a broker in a certain transaction, so that they can weigh the fairness of the price offered and the expense involved in making

the deal. Because of his position of trust in security trading, the over-the-counter dealer should be a person of integrity and financial soundness. The fact that over-the-counter traders deal in many relatively unknown securities has in some instances led them, with or without intention, to foist highly speculative or fraudulent securities on an unsuspecting investing public. Moreover, since the companies whose securities they handle are often obscure and do not publicize their affairs for the investor, the public interest in a well-informed class of investors necessitates that some scheme for requiring full disclosure be worked out. With the market for such securities so unorganized, this is extremely difficult.

If the over-the-counter market were left unregulated, a means of evading regulation of securities and trading on the organized exchange would be furnished. Since regulation of this market appeared to be so complicated and expensive, the Securities Exchange Act of 1934 made no effort to prescribe rules for its regulation. Instead, the law gave the Securities and Exchange Commission broad authority to regulate in the public interest and to investigate and report upon further possible legislation. This the Commission has done, with the result that the act was amended in 1936 and 1938 to provide for more definite regulation. The problem has been approached through requiring registration of over-the-counter traders and by providing for supervised self-regulation under an organization of these traders.

1. Registration of Brokers and Dealers. All security brokers and dealers not members of a national security exchange must register with the Securities and Exchange Commission if they use the mails or instrumentalities of interstate commerce, unless their business is exclusively intrastate or entirely in securities exempt from exchange regulation. In applying for registration, traders must file information about themselves, their business, and the securities in which they deal. The Commission is empowered to require these brokers and dealers to keep such information current, and is thus placed in a position where it can obtain needed information about securities not traded on organized exchanges. This broad power is supplemented by the legal provision that issuers of new securities aggregating more than $2,000,000 and registered under the Securities Act of 1933 must file supplementary information and make periodical reports such as those made by issuers with securities registered on national security exchanges.

Most of the regulation of registered brokers and dealers is left to the code provisions of a national organization. A few specific regulations are provided in the law. Brokers and dealers are forbidden to use the mails or instrumentalities of interstate commerce to effect or induce any purchase or sale of securities by means of any manipulative, deceptive, or fraudulent device or contrivance. Other rules have been set up by the Commission. These include the definition of manipulative and deceptive devices similar to those forbidden to members of exchanges, and the requirement that dealer-brokers must disclose to cus-

tomers whether they are acting as a dealer or as a broker in any given transaction.

The registration of any broker or dealer may be denied or revoked by the Commission whenever it finds that such action would be in the public interest and that the applicant or registrant is guilty of certain objectionable practices. Such practices include infractions of the rules for fair and equitable trading which the Commission or the association has provided.

2. SELF-REGULATION THROUGH ASSOCIATIONS. The detailed regulation of over-the-counter brokers and dealers is left to the traders themselves under Commission supervision. The amendment to the Securities Exchange Act passed in 1938 provides for a system of regulation through formation of one or more voluntary associations of investment bankers, brokers, and dealers doing business in the over-the-counter markets. As a result, the National Association of Securities Dealers, Incorporated, filed application to become a national security association in 1939. The Commission granted the application, finding that the Association was national in scope and that it had formulated rules for the protection of the public interest and the investors. While this association does not embrace all persons in the market, and other associations may be formed, it does promise to be the most important organization and to include a substantial portion of the traders throughout the United States.

The National Association of Securities Dealers has adopted rules for its members and has provided for the financing of the expense of self-regulation through a schedule of dues. It is thus somewhat similar to the organized exchanges in its controls over members. The rules which have been adopted aim to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to provide safeguards against unreasonable profits and charges. They have been approved by the Securities and Exchange Commission, and the Commission has undertaken a series of informal conferences with the association to study the need for further rules and regulations.

C. REGULATION OF COMMODITY EXCHANGES

In many respects the characteristics of trading on the organized commodity exchanges are similar to the transaction of business on the security exchanges. As a result, much of the regulation of the two types of exchange corresponds. However, trading on commodity exchanges is accompanied by widespread use of the futures contract. Commodities may be bought or sold for immediate or future delivery. If the deal calls for future delivery, a futures contract is made and there is said to be trading in "futures." For example, a person may purchase wheat through a broker in February at a price fixed in that month but for delivery on a specified date in May. Trading in futures is primarily speculative in nature in that purchases or sales are not made for imme-

diate use or disposal, but for the purpose of gaining through future changes in commodity prices. Even contracts for future delivery are in fact seldom delivered, but speculative accounts are closed out by offsetting purchases and sales. Because not every agricultural product is capable of accurate grading, durable, and produced in large enough quantities to engage wide public interest, only relatively few of these commodities are systematically traded for future delivery on the organized security exchanges. However, those so traded include the leading agricultural produce of the country, such as wheat, barley, corn, oats, rye, rice, cotton, flaxseed, wool, butter, eggs, and potatoes.

The public interest in organized commodity exchanges arises from the number of important commodities traded on them, and the fact that the prices established there are used as the basis of pricing these products throughout the nation. The interest of farmers in the fair determination of commodity prices is obvious. But others have a vital business interest in such prices. The merchant buying or selling these commodities and the business man furnishing storage service have a direct interest. The manufacturer or processor is not only affected by the price he pays for raw materials, but his business stability is affected because he often finds it economical to deal in futures.

Dealing in futures is of economic significance to these producers and to society in general because of the device referred to as a hedge. Prices of finished goods tend to reflect those of raw materials. If a processor buys raw materials in November and cannot effect sale of finished goods until the following May, his ordinary business profit may be wiped out if raw material prices are substantially less in May. To eliminate this risk and to safeguard his manufacturing profit, the processor would sell for delivery in May a quantity of his raw material equal to his purchase for immediate delivery in November. If the price fell by delivery time in May, he would make a profit by purchasing the commodity at that time. This profit would tend to counterbalance the loss he would probably incur on the sale of his finished goods. If the price rose, he would lose on his short sale, but make a profit from the selling of the finished goods. In either case, he would protect his manufacturing profit. Obviously, unless short sales or dealing in futures existed the processor would have to assume the risk of price changes in the basic raw material.

Trading in commodities has been highly speculative and has attracted many individuals who like to pit their judgment or luck against gains or losses to be made from future prices. The result has been that speculative transactions on the commodity exchanges have been voluminous. It has not been unusual for them to be far greater in a year, before a crop has ever reached the market, than the entire year's output; for example, market transactions in wheat in a year may be fifteen or twenty times the year's crop. The chance of gains from commodity speculation have arisen out of the violent fluctuations which occur in commodity prices, and these very fluctuations have often been magnified by speculative activity. Occasionally speculators have been able to band to-

gether and systematically drive prices of commodities up or down to suit their plan for profit.

As a result of the extensive speculation and the violent changes in commodity prices, the public has long believed in the regulation of commodity exchanges. When agriculture suffered depression after the first World War, and prices never thereafter even approximately satisfied the mass of farmers, the commodity exchanges were one of the institutions for which regulation was insisted. Irrespective of the motives which crystallized the insistence of the public for regulation, however, the control of commodity exchanges is definitely in the public interest, since the free and fair fixing of prices of such importance can hardly be entrusted to private business.

1. Evolution of Commodity Exchange Regulation. Government control of trading on commodity exchanges was inaugurated with the passage of the Future Trading Act in 1921. This act placed a tax of twenty cents a bushel on all contracts for sale of grain for future delivery, but exempted all transactions upon a "contract market." Any grain exchange could receive the designation of contract market if it registered with the Secretary of Agriculture and submitted to certain regulations of its business. This law was declared unconstitutional by the United States Supreme Court in 1922, on the grounds that it was not a valid use of the taxing power and that it did not limit itself to trading in interstate commerce.[1]

Congress immediately set to meeting the objections of the Supreme Court and passed the Grain Futures Act in 1922. Under this law, regulation of trading in grain futures was established as a means of removing obstructions and burdens upon interstate commerce. As in the Future Trading Act of 1921, the Secretary of Agriculture was empowered to limit to contract markets trading in grain futures which affected or were in interstate commerce. The designation of contract market was given only to those exchanges trading in grain futures in interstate commerce which would agree to provide information as to market transactions and to prevent unfair and deceptive market practices. The Secretary was authorized to define the grains to which the regulation of future trading might apply. The constitutionality of the Grain Futures Act was upheld by the United States Supreme Court in 1923 as a proper regulation of interstate commerce.[2]

Although passed as an amendment to the Grain Futures Act, the Commodity Exchange Act of 1936 is practically a new law governing trading on commodity exchanges. The scope of the regulation was extended to cover trading in a large list of commodities, including cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, and Irish potatoes. Wool tops were added to this list in 1938 and fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, and soybean meal were added in 1940. The 1936 act placed regulation of the commodity exchanges in the care of the

[1] *Hill v. Wallace*, 259 U.S. 44 (1922). [2] *Board of Trade v. Olsen*, 262 U.S. 1 (1923).

Commodities Exchange Administration, a semi-independent agency under the supervision of the Department of Agriculture. The requirements of the Grain Futures Act as to contract markets were kept in the law, along with its other provisions, but the character and application of commodity exchange regulation were extended.

2. CONTRACT MARKETS. Under the Commodity Exchange Act all persons are forbidden to use the mails or instrumentalities of interstate commerce for future trading in the products covered by the law, unless they are members of a commodity exchange designated by the Commodities Exchange Administration as a contract market. In order to obtain this designation, a commodity exchange must register with the Administration, furnishing copies of its by-laws and regulations, agreeing to keep its records in a form prescribed by the Administration, and agreeing to co-operate with it in the enforcement of the laws regarding manipulation and misrepresentation. The exchange must also agree to admit farmer's co-operative marketing associations as members, if any such association meets the qualifications imposed upon other members of the exchange.

Up to 1940, seventeen commodity markets had registered and been designated as contract markets.[1] These include all the leading commodity exchanges of the country in which future trading in agricultural produce is carried on. Some exchanges are permitted to do such trading in four or five commodities covered by the act, while others are limited to one commodity. Thus, the Chicago Board of Trade may deal in futures on wheat, corn, oats, rye, and cotton, while the Seattle Grain Exchange may handle such transactions only in wheat.

3. REGISTRATION OF COMMISSION MERCHANTS AND FLOOR TRADERS. The law requires that all commission merchants dealing in futures and all floor brokers on the contract markets register annually with the Commodities Exchange Administration. These exchange members must make periodical reports to the Administration on such matters as the volume of business they do, the volume and character of future trading, and the quantities and grades of commodities delivered on future contracts. In 1940 the Administration reported the registration of more than fifteen hundred merchants and traders.[2]

4. REGULATION OF COMMODITIES TRADING. Besides the extensive information of the nature and volume of commodities trading required of exchanges and their members, the dealings on commodity exchanges are subject to close governmental regulation. These regulations may be classed as those designed

[1] These are the following: Chicago Board of Trade, Chicago Mercantile Exchange, Chicago Open Board of Trade, Duluth Board of Trade, Kansas City Board of Trade, Los Angeles Grain Exchange, Milwaukee Grain and Stock Exchange, Minneapolis Chamber of Commerce, New Orleans Cotton Exchange, New York Cotton Exchange, New York Mercantile Exchange, New York Produce Exchange, Portland Grain Exchange, St. Louis Merchants Exchange, San Francisco Grain Exchange, Seattle Grain Exchange, and Wool Associates of the New York Cotton Exchange. See *Rep. Com. Ex. Ad.* (1940), pp. 34–35.

[2] *Ibid.*, p. 35.

to prevent manipulation of prices, to prevent excessive speculation, and to protect customers from unethical practices of commission merchants and floor traders.

The regulation of manipulative practices is similar to that provided for the security exchanges. Fraudulent devices are prohibited, as is the dissemination of false or misleading information. Manipulation of the market by causing false activity from such fictitious transactions as wash sales is prohibited.[1] Manipulating prices by getting a corner on a commodities market is also outlawed.[2]

Control over excessive speculation is provided for in the power of the Commodities Exchange Administration to fix limits in the amount of trading in futures that can be done by one person. In 1938, it set a limit to the permitted extent of individual speculative activities; in each of the grains (wheat, corn, oats, rye, barley, or flaxseed), the speculative purchase or sale of more than 2,000,000 bushels of futures in a single day was forbidden.[3] Moreover, individual traders buying for speculation are not allowed to hold at one time a total of more than 2,000,000 bushels of futures in one market or 3,000,000 bushels in all markets of the United States. These restrictions apply only to purely speculative transactions. Hedges are specifically exempted. The restrictions have been defended as eliminating unusually large operations which might tend to force the price of grains above or below proper levels, with injury to farmers and customers.

Closely allied to the government's regulation of excessive speculation is that undertaken by the exchange organizations themselves. Several exchanges have undertaken to rule against excessive speculation. Regulations have been made, for example, to protect traders caught in a "squeeze" in making good on delivery under futures contracts, by extending the allowable time during which such contracts may be met. Perhaps the most striking instance of exchange regulation for reducing excessive speculation has been the fixing of limits allowable for daily price fluctuations. On the basis of a rule adopted in 1925 and invoked from time to time since, the Chicago Board of Trade, for example, has prohibited trading in wheat futures in any one day at a price more than five cents higher or lower than the closing price of the previous business day.[4] The prescription of this limit means that in a falling or rising market for wheat futures, traders may not drive the price up or down by taking advantage of the momentum gained.

[1] Wash sales are transactions involving the purchase and sales of a commodity at the same time by the same party.

[2] A corner occurs when one party or a co-operating group obtains a quantity of a good large enough so that those desiring to buy must purchase from it.

[3] *Report of the Secretary of Agriculture* (1939), p. 84. Daily trading and net position limits in cotton of 30,000 bales were announced in 1940. See *Rep. Com. Ex. Ad.* (1940), p. 38.

[4] U.S. Dept. of Agriculture, *Wheat Futures*, Stat. Bull. No. 54 (1937), p. 9 and *idem*, Stat. Bull. No. 72 (1940), p. 10. At certain times and under certain circumstances, the limit has been placed at eight cents and ten cents.

The price limitation regulations of the Chicago Board of Trade and other exchanges, and other rules adopted by exchanges looking to reducing speculation, represent cases of business self-regulation. However, it is well known that many such rules are instituted at the request of the government regulating agency, as well as by the mere pressure of public opinion. Such a drastic rule as the price limitation regulation may almost surely be traced to governmental influence. As such, it might be regarded as a kind of regulation by government itself.

Members of the commodity exchanges are forbidden to enter into a transaction at any other price than the true one existing on the exchange at the time of the transaction, thereby protecting customers against traders charging or giving a price not in accordance with the market. Commission merchants often handle money that has been deposited by customers for the fulfillment of a contingent obligation arising under a futures trade. The law requires that the commission merchant must separate such deposited funds from his own assets and that he may not use the funds of one customer for temporary loans to another customer. Defrauding customers in any way is forbidden, as is the willful making of false reports of transactions either to the customer, to the exchange, or to the Commodities Exchange Administration.

In the enforcement of the regulations against the members of the exchanges, particularly that respecting the segregation and caring of customer deposits, the Administration must make a comprehensive audit of the member's books. In order for these audits to be as effective as one might wish, they should be made frequently. However, according to a recent report they are not made, in the absence of a complaint, as frequently as would seem desirable.[1]

5. Enforcement of the Law. The Commodities Exchange Administration is given adequate authority to enforce the law against commodity exchanges. Their registration, or that of their individual members, may be revoked or suspended. For most violations of the law or any rules made under it, the Administration may issue a cease-and-desist order against the offending person. If compliance is not forthcoming, it may go before a federal court and have the offender fined as much as $10,000 or imprisoned for one year, or both. Furthermore, it should be remembered that commodity exchanges, like security exchanges, are generally voluntary associations with rules and regulations and with adequate powers to punish members for misconduct. There is also fairly reasonable assurance that their rules will be complete enough for most purposes, and that they will enforce these rules as best they can, because the right to grant or withhold designations as contract markets gives the government a strong basis for supervising the elements of self-regulation in exchange administration.

6. Regulation of Commodities Exchanges: Conclusions. The objectives and many of the means of regulating commodity exchanges parallel those

[1] See *Rep. Com. Ex. Ad.* (1940), p. 38.

found in the case of security exchanges. The principal gain of such regulation to the public is a free and accurate determination of commodity prices. No one can deny the benefit to producers and consumers alike of having the exchange mechanism free from manipulation or excessive speculation which makes prices inaccurate and unstable. If the market becomes a playground for speculators to match their wits against each other and against the future for their own chance of gain, the public interest in free price determination is subordinated to the selfish interests of a small group.

On the other hand, there is danger that restrictions on the markets may become so great as to make the price determined in them an inaccurate reflection of supply and demand forces. Nevertheless, most of the regulations are clearly justified as being necessary for the public interest, even if it can be shown that they may introduce some inflexibilities into the price-fixing process. Furthermore, the question of accurate competitive price determination in a free market is broader than the mere matter of control of commodity exchanges. Some aspects of the general regulation of production and marketing of farm products have a far greater and more disturbing effect upon the determination of price.

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Part Six

REGULATION OF THE EXTRACTIVE INDUSTRIES

CHAPTER

24

GOVERNMENT AND AGRICULTURE

CERTAIN of the more important extractive industries have been set aside for special governmental controls and aids. The greatest advances of governmental intervention in these industries have occurred in the fields of agriculture, coal, and oil. Here government aids and controls have been so closely interwoven that, while emphasis in this section of the book is placed upon regulation, an analysis of governmental policies must touch upon the program of assistance as well.

The primary bases for government intervention in the extractive industries are somewhat different than those found in other government controls. In the transportation industry government has attempted to protect shippers and consumers against the abuse of power which comes from monopolistic elements; at the same time, its policies have been aimed at the maintenance of an adequate and efficient transportation system. With other public utilities, the government has in general espoused monopoly as a means of attaining efficiency, and has then controlled the utilities to protect this efficiency and to protect users from abuse of monopoly. In most private industries, the government program has been designed to maintain an adequate and fair level of competition in the face of monopoly and imperfect competition, and the tendency of rival sellers to use economic power to harm each other and the public generally. The danger of unfair or dishonest use of economic power has also prompted the regulation of financial and exchange institutions. But in the extractive industries, the control by government has come because competition has been so vigorous that it has brought results regarded by many as unsatisfactory. As may well be recognized, however, the unsatisfactoriness is due in large part to the fact that the extractive industries have been "islands" of competition in a "sea" of monopoly and monopolistic competition.

The large number of producers in many extractive industries, particularly in agriculture, and the fact that the products of these industries have been capable

of a high degree of standardization, have led to conditions approaching pure competition in the buying and selling of the unprocessed products. This has in turn resulted in conditions which have had much to do with the adoption of government control. From the point of view of individual producers, competition has often brought about prices lower than cost of production, as demand and supply have shifted. Although such prices are merely the way a system of free private enterprise and competition tells producers that output should be curtailed, there are reasons why production in the extractive industries is not quickly reduced in response to prices below cost.

Farmers generally cannot liquidate their capital investment or turn their labor to uses other than agriculture, and consequently they continue to produce in the hope that prices will rise. Coal and oil producers usually have too much invested in land and equipment to stop production, so long as prices are above out-of-pocket costs, even though total costs of production are not covered. As a result, the curtailment of output in response to prices below cost of production, envisaged in the long run by the action of free competition, occurs in too long a "long run." In the meanwhile, producers eke out a bare existence or go bankrupt. Since they are so numerous, the political and economic implications of their fate are so great that government cannot afford to wait for the "long run."

From a social point of view, unbridled competition in the production of goods in the extractive industries presents grounds for government action. The extractive industries are, of course, those businesses exploiting natural resources. The United States has been endowed with a remarkably large supply of natural resources. For many years these were thought to be unlimited, and the eighteenth and nineteenth centuries furnish many examples of their wasteful use. At the beginning of the twentieth century, concern over such exploitation came to be felt by the public; it was translated into a demand for conservation, and, as a result, the government policies of control over the extractive industries have been justified by the desire to conserve ebbing resources.

A. THE AGRICULTURAL PROBLEM AND THE BASIS OF CONTROL

Agriculture is the largest single industry in the United States. No other can compare with its $41,000,000,000 investment in land, buildings, livestock, and machinery.[1] Twenty-two per cent of the gainfully employed persons of the country are found in agriculture, and the farm population is nearly 25 per cent of the total population.

Agriculture is generally regarded as being the foundation of our economic

[1] Spahr, W. E., and others, *Economic Principles and Problems* (New York: Farrar and Rinehart, 4th ed., 1940), vol. II, p. 348.

structure. It furnishes the materials by which human beings are able to survive, and in addition many of the raw materials used for production of shelter, transportation, and other goods of general use. The extent of specialization and roundabout production depends in large part upon the efficiency of the agricultural industry. The fact that a relatively small part of the working population can produce food, clothing, and other necessaries for themselves and all others releases the large majority of that population to other tasks. The importance of agriculture to the entire national economy and the political influence of such a large segment of the population easily account for the advent of government policies to remove elements of general dissatisfaction in the industry.

While farmers have long been the recipients of many governmental favors and much political solicitude, the development of widespread government controls is a phenomenon of the last decade, and the growth of government programs to solve agricultural problems dates, for the most part, from the first World War. The reason is found in the fact that the so-called agricultural problem reached extremely serious proportions in the 1920's. Until the World War ended in 1919, the chief problem was one of increasing production. Emphasis of the government and of industry generally was upon the stimulation of farm output by adopting means for more efficient utilization of agricultural resources. While farmers have seldom been satisfied with their economic position, the era preceding the end of the World War was one of relative prosperity, culminating in the "golden age" of American agriculture in the war years of 1914–1919.

Since 1919, agriculture has been a depressed industry, the depression reaching serious proportions after 1929. This condition has generally been ascribed to overproduction and the existence of a surplus in nearly all agricultural products. However, it would be more accurate to say that it has been due to the existence of prices below total cost of production in most products during many of the years since the war. Perhaps there has occasionally been a real surplus of agricultural products in the sense that total crops would not be taken off the market at any price. But generally, the problem has not been to sell the crops but to sell them at a price which will cover the cost of production. The drop in prices of farm products and farm income in the last two decades has been greater than the fall in prices of other goods, so that the ratio of prices received by farmers to prices paid by farmers, which was 105 per cent in 1920, dropped to 82 per cent in 1921, was 95 per cent in 1929, 61 per cent in 1932, and was still only 83 per cent late in 1940.[1] The price problem, then, is not entirely one of prices in general, but is one of the material lag of farm prices behind other prices. And when it is considered that the farm costs arising from taxes and interest on mortgages are even more inflexible than the costs of things bought, the seriousness of the decline in farm prices is readily apparent.

[1] Department of Agriculture, *Agricultural Situation* (April, 1938, and January, 1941).

What has caused this reduction? For an answer, one may look at the factors which have influenced the supply of and demand for farm products. From the point of view of supply, several circumstances explain both the increase in supply in the last three decades and its inelasticity. In the first place, the high prices for produce of American agriculture during the first World War brought about a tremendous expansion in output. Total crop production increased by nearly 20 per cent between 1916 and 1920.[1] Acreage used for the production of crops increased by approximately 10 per cent over the pre-war acreage. But the increase in production followed more from changed methods of farming than from the increase in acreage. Mechanization of farming was given a strong impetus, so that in the past two decades millions of acres of land previously used for the support of horses and mules became available for marketable crops. Research of the Department of Agriculture, universities, and other agencies in pest control, seed selection, fertilization, and livestock breeding and care brought striking improvement in the efficiency of production. Moreover, the increased prices of certain staple commodities caused by the war and government encouragement in productive methods resulted in a trend away from diversified to more specialized farming. Not only did this increase the possible efficiency in production of certain crops, but it made the supply of each crop rather more inelastic. Farmers fitted to produce a single crop tended to keep producing it irrespective of price changes, so that even over a period of several years the supply tended to be more inelastic.

Once agriculture has attained a certain level of production, as it did during and immediately after the first World War, there are certain factors which make this production relatively insensitive to price changes. The development of specialized farming has already been mentioned. In addition, a large part of the farmer's costs, such as taxes, interest, and depreciation of equipment, is fixed, and there is little incentive to curtail output so long as prices remain above out-of-pocket costs. Moreover, certain costs generally regarded as variable, such as fertilizer, may actually be fixed over a period of several years, since the benefits carry over for several years.

The length of the production cycle also has its effect on supply. Farmers must plan and plant well in advance of actual sales, and once the planting is made or even prepared, the quantity which is produced is not affected by price. The quantity offered for sale tends to be identical with that produced, since the ordinary farmer has neither the facilities nor the economic means to postpone the sale after the time of harvest.

The very competitiveness of the agricultural industry, with its millions of individual producers, means that in the absence of government regulation little possibility for controlling supply exists. So far as the individual farmer is concerned, he can sell all he produces at the going market price. Acting alone, he could not materially affect this price if he undertook to restrict his production

[1] *Statistical Abstract of the U.S.*, 1938, p. 643.

or sale. Even if he entered an agreement with other farmers to restrict production, in the absence of effective sanctions to enforce the agreement, the temptation to let the others raise price by restricting output while he himself gained by maintaining or increasing it has meant the failure of co-operative crop-restriction plans.

The supply side of the picture would not be complete without mentioning the immobility of farm labor. Most farms are owner-operated or are operated by tenants who customarily renew leases annually. The farm is not only a place to work but the home of the worker. Leaving the farm involves leaving home. The farmer, because of his specialized training and his generally independent temperament, does not easily acclimate himself to other jobs and working conditions. There is also a sort of immobility in moving from one farm to another farm, or in changing the character of farming on the same farm. The associations which are built up about the farm and the habit of engaging in a certain type of farming make it difficult for the ordinary farmer to move.

Several things which have affected the demand for agricultural produce have contributed to the problem of low prices. In the years following the first World War, foreign agricultural produce increased under the influence of the strong nationalistic spirit dominating many countries. Nations which had been an important market for the products of American agriculture undertook to make themselves as self-sufficient as possible, irrespective of the comparative costs involved. The American tariff policy on imports of manufactured goods from foreign countries has been notably restrictive for many years, and following the first World War increasingly discouraged imports at a time when foreign producers sought to sell their goods in this country. For a while, loans of American investors and the government to these countries substituted for imports as a means of paying for the exports of American agricultural products. But as these loans were restricted in volume and imports of foreign goods were discouraged by American tariffs, the power of foreign countries to purchase agricultural goods from this country declined, with resultant lessening of demand. Wheat, grain, and flour exports declined from 366,000,000 bushels in 1921 to 131,000,000 bushels in 1931, to 16,000,000 bushels in 1936, and, in spite of heavy export subsidies, rose only to 118,000,000 bushels in 1939.[1] Corn exports fell from 179,000,000 bushels in 1922 to 3,000,000 bushels in 1931.[2] Material declines in exports of tobacco, cotton, hogs and pork products, and many other agricultural goods have also occurred.

The demand for agricultural goods has declined also because of the mechanization of farming. Corn, oats, wheat, and other products once consumed in large quantities on the farm for horses and mules have had a lessened demand

[1] *Statistical Abstract of the United States*, 1935, p. 645; *idem*, 1938, p. 682; and *Report of Secretary of Agriculture* (1939), p. 22. Exports for 1940 were almost two thirds less than in 1939. See *Agricultural Situation* (November, 1940), p. 8.

[2] *Statistical Abstract of the United States*, 1923, p. 215, and *idem*, 1935, p. 649.

for farm use. To some extent, also, the changes in habits and standards of living have affected domestic demand. Consumption of coarse foods has given way to more sparing use of lighter and more refined foods. Improvement of home heating methods has shifted a part of consumer clothing demand from wool and cotton to rayon and silk. These consumer shifts are of minor importance relative to the loss of foreign markets, but they do have a material influence on the demand for agricultural produce. Exceedingly important, too, has been the decline of urban income and employment after 1929, with resultant diminution of demand for many foodstuffs.

The fact that the demand for most agricultural produce is relatively inelastic has contributed to the price problem in agriculture. The consumption of grains, potatoes, meats, and other agricultural products does not vary a great deal with changes in prices. The result is that if supply increases materially, in a competitive market not supported by government programs the inelasticity of demand tends to cause an extremely low price. It is a commonplace in agricultural economics to note that bumper crops often bring a lower gross income than do poor crops.[1] This is, of course, due to the relatively inelastic demand which makes the decline in price, with increases in supply, greater than the increase in quantity taken.

In addition to the price difficulties which make up so large a part of the agricultural problem, there are several other conditions of importance to society. One-crop farming, inadequate rotation of crops, and poor methods of plowing and planting have led to soil erosion both by water and by wind. Poor farming methods and inadequate fertilization have also caused some lands to be so "worked out" that they have lost their value for the farming for which they have been used, and perhaps for any profitable cultivation.

Of importance to consideration of the agricultural problem is the fact that many farm purchases have been accomplished through borrowing upon mortgages. The acquisition of a farm involves generally a rather large financial outlay, and mortgage financing is to be expected. But the fixed interest charges which mortgages impose in a business so subject to ups and downs are always a threat to the solvency of agricultural borrowers. Moreover, many mortgages have been incurred when farm prices were high, and with the drop in prices of agricultural goods and in farm values, the problem of mortgages has increased in intensity. Whether the farms were acquired on mortgage as a kind of land speculation during the boom years of farming has little to do with the seriousness of the problem, even though there may be little reason for sympathizing with the avarice of the country land speculator.

[1] For example, the year 1932 witnessed the largest harvested acreage in the country's history and was also a year of fairly good yield, but the crops had the lowest cash value on record.

B. CONTROL THROUGH TARIFFS

One of the first measures suggested in the positive program of government to help agriculture in the post-war depression was the use of tariffs on imported agricultural products. These were justified as being a means of stopping the dumping of products from foreign countries after they had recovered their pre-war production standards. They were justified too as being only fair to the farmer because of the long-standing tariff protection given to industrial goods. It might be mentioned in addition that Congress welcomed the tariff device as an easy means of satisfying farmers who pressed for their "fair share" of the national income.

1. TARIFF LEGISLATION. The Emergency Tariff of 1921 applied the protection principle to certain foreign agricultural produce which had been dumped on the American market shortly after the close of the World War. By levying high duties on corn, meat, sugar, wheat, and wool, the tariff did succeed in halting disastrous competition and stabilizing the prices of these commodities for a time. It was also successful in making American agriculture an ally of manufacturers in espousing the cause of protection.

The Fordney-McCumber Tariff Act of 1922 undertook in part to augment the success of the 1921 act by further increasing duties on agricultural products and by putting more products under its protection. Although many increases and extensions of tariff protection were provided for manufactured articles, agriculture received prominent attention with high tariffs on dairy products, fats, and oils, plus the products protected in 1921. In addition, certain manufactured goods were placed on a "free list" to help reduce costs to farmers. But, as it turned out, most of these goods were articles produced more cheaply in domestic industry and the bounty to the farmers did not materialize.

Farmers, disillusioned as to benefits expected from the tariffs of 1921 and 1922, pressed for upward tariff revision, which was enacted into law by the Hawley-Smoot Tariff Act of 1930. This act increased tariff rates and protection on agricultural products and on manufactured goods as well. The law was apparently based on the principle that if a little protection is good, much more protection is better; that if one producing group is to be protected, all producers should be protected.[1]

The failure of agricultural tariffs to aid agriculture materially and the coming of a new political party to power in 1933 brought about their revision in 1934 and 1940, when a system of reciprocal tariff-making came into existence. Under this device, the President is empowered to reduce tariffs by 50 per cent on any article, without subsequent approval of Congress. These tariffs have been made by special treaty on a reciprocal basis with leading foreign export-

[1] In addition to tariff laws of the period, Congress enacted inspection legislation which effectively kept out many foreign products. For example, "sanitary" regulations have made it difficult for Argentine beef to come into the country except when canned.

ers and have been negotiated with understanding and serious effort by Secretary of State Cordell Hull. In many instances, agricultural tariffs have been reduced. Although a number of tariff revisions have been negotiated, the reduction has not been large and the disturbed state of international affairs after 1938 has made its effect of negligible importance. With the exception of the small-percentage decreases on a rather small volume of agricultural goods and a few additions to the free list, the agricultural tariffs still remain high.

2. Effects of Agricultural Tariffs. As a means of bringing agriculture out of its depressed status, tariffs on agricultural goods represent about the most hopeless type of government program that has been adopted in this country. In the first place, where a surplus of products exists in the domestic market, as has been the case with many agricultural products, it can only be sold in the world market. In such an event a tariff would not be effective, since the normal flow of the surplus goods is out of the country and not into it. The agricultural industry is for the most part an export industry. Import duties cannot raise the domestic price above the world price, so long as exports continue, because they do not restrict domestic supply. It has been estimated that in 1929 the tariff was ineffective on cotton, jute, most grades of wheat, rye, oats, corn, barley, cottonseed oil, pork, and pork products, and that it was effective only on sugar, wool, flax, olive oil, and soy bean oil.[1] On other products, the tariff was only partially effective.

In the second place, a tariff policy applied to manufactured goods and semi-finished materials is often effective and the domestic price tends to be higher than the world price. But these are often goods which the farmer purchases for consumption or use on the farm. Hence, he bears the brunt of price increases on many goods for which the tariff is effective without receiving higher prices on most goods which he produces. A study made by the American Farm Bureau Federation in 1924 indicated that while farmers as a whole gained on a few products for which the agricultural tariff was effective, the net annual loss because of the operation of the tariff on goods which the farmer buys was about $375,000,000.[2]

A third disadvantage of a tariff policy to agriculture is found in the shrinking of the export market. If the United States discourages imports, foreign purchasers find that their power to buy goods from us is curtailed because dollar exchange becomes scarce. Furthermore, the imposition of high tariffs by the United States has brought about retaliation. Since the agricultural industry has been so largely an export industry, the imposition of import duties by foreign countries has impaired the market for agricultural exports from this

[1] Hibbard, B. H., Commons, J. R., and Perlman, Selig, *Agricultural Tariffs* (Freeport, Ill.: The Rawleigh Bureau, 1929), p. 43.

[2] Wiley, C. A., "Economics and Politics of the Agricultural Tariff," 5 *Southwestern Political and Social Science Quarterly*, pp. 264–78 (December, 1924).

country. The decline in exports of many important American agricultural products can be traced in large part to the fact that American tariffs have caused retaliation by foreign countries and have made them encourage agricultural production to avoid the necessity of importing from the United States.[1]

3. AGRICULTURAL TARIFFS: CONCLUSIONS. There can hardly be any doubt that the American tariff policy has harmed agriculture in this country. Yet a large segment of the agricultural population remains firmly protectionist. One reason for this strange attitude is the belief that tariffs mean higher prices for all things, including agricultural products. While the tariff may aid in holding up prices on some agricultural goods, it is generally ineffective for the great mass of staple agricultural products. Another reason for the persistence of protectionism among farmers is the vocal efforts of the few who might be harmed slightly by a reduction of tariffs. Thus, when a reciprocal trade agreement with Canada promised to bring in certain dairy products, a small group of farmers in Wisconsin and lobbyists who earn their living stirring up trade protests were able to publicize the evil effects of tariff reduction, with the implication that it impaired agriculture generally.

The clear answer to disposal of agricultural surpluses of this country at better prices is to obtain better export markets. If the domestic supply could be reduced thereby, the upward effect on domestic price would follow. But the recapture of export markets goes beyond the problem of agricultural tariffs to that of reducing trade barriers generally. A sudden reduction of industrial tariffs might result in a too abrupt fall in prices, with consequent dislocation of debts, purchasing power, and industry. Moreover, a reduction in tariffs may not be feasible in the light of the disturbed world political situation. Nevertheless, the removal of trade barriers is the best means for returning the export market to American agriculture.

C. DISPOSAL OF SURPLUSES

One line of approach of government in dealing with the agricultural problem has been to provide means for disposing of the surplus of agricultural products. This approach involves removing a certain portion of the supply of such produce from the general market, thereby reducing the amounts offered for sale and increasing the market price. One should note that "surplus" is a relative term, the actual surplus depending upon the amount believed to be necessary to force the market price to a certain level. If prices were allowed to fall freely, there would almost always be some price at which total production could be taken off the market. In disposing of surpluses, the government

[1] It is interesting that all these economic results were foreseen by 1028 economists who protested the high Smoot-Hawley Tariff of 1930. In spite of this protest, Congress passed the bill and President Hoover approved it. The disastrous effects upon agriculture are now history.

has tried many devices, most of which were still in effect in 1941 and will probably continue to be used in the future.

1. THE FEDERAL FARM BOARD, 1929–1933. The first positive program for disposing of surpluses of agricultural products was the plan of the Federal Farm Board, established by the Agricultural Marketing Act of 1929. While this Board passed into history in 1933, the experiment is so important in terms of its effect upon subsequent legislation that it should be well understood. The purpose of the act was to aid in preventing and controlling surpluses of agricultural commodities so as to maintain prices of these commodities on remunerative levels. In addition to stabilization operations in the market, the act provided for government assistance in the organization of co-operative marketing associations and for government investigation and reporting upon crop prices, supply and demand, overproduction and means for avoiding it, land utilization, reduction of acreage of unprofitable marginal land, methods of expanding markets for agricultural products, and transportation conditions. Thus, the law established a broad system of economic planning for agriculture, with the notable exception of any outright controls upon production policies. To carry out the law, the Federal Farm Board was established with a revolving fund of $500,000,000, with wide powers for its use and for carrying out the purposes of the act.

The principal purpose of the law was to keep farmers from marketing more than an amount which could be sold at a profitable price in the foreign and domestic markets. While the Farm Board had power to advise restriction of production and methods of increasing sales, it had no power to require the adoption of any of this advice. The most significant power which the Board had was that to engage in price stabilization by purchasing and selling surplus agricultural produce. It is with the operation of this power that the present discussion is concerned.

a. Operation of the Federal Farm Board. The Federal Farm Board undertook price stabilization through two types of agencies. Co-operative marketing associations of agricultural producers were encouraged, and the Board co-operated with them in holding stocks of produce off the market when prices threatened to sink below a "fair" level. While these co-operatives often borrowed from the banks to purchase products in the support of market prices, the Farm Board also made loans to them with the stored produce as collateral. The second type of agency which engaged in stabilization operations was corporations set up by the Farm Board with powers to buy, sell, and hold agricultural products. The more important of these corporations were the Cotton Stabilization Corporation and the Wheat Stabilization Corporation. Whether stabilization operations were carried on by co-operatives or by Farm Board corporations, the Board soon became involved in the operations by its advances of funds to carry on the purchase of agricultural products.

The stabilization operations were designed to be self-liquidating. It was

generally believed that the fluctuation of agricultural prices was due to annual shifts in supply, and that over a period of several years the good and poor crops tended to equalize and the average supply of goods would be small enough to cause a fair market price. Hence, in good years produce might be purchased and stored, thereby maintaining price, and in poor years it might be taken out of storage and sold to keep prices from going too high. The only expense was thought to be buying and selling and storage charges; and even these might be liquidated through profits made by such operations.

Because storage is necessary, the principal operations of the Federal Farm Board were in cotton, wheat, corn, wool, tobacco, and certain meats; those of the most importance were in cotton and wheat. A brief analysis of the operations with these two commodities will serve to illustrate the work of the Board.

When control operations in cotton were begun, the Federal Farm Board found prices higher than they had been before the first World War, but somewhat lower than was believed desirable in view of non-agricultural prices. This same situation prevailed with respect to wheat. In 1929, the price of cotton in New York was 19 cents per pound and the price of wheat $1.25 per bushel. With a drop in prices in the fall of 1929, caused by a good crop and the decline in world prices as the depression gained momentum, the Federal Farm Board undertook to support the market. Acquisitions of cotton were made practically entirely through loans to marketing co-operatives, and at the peak of control operations in 1932, approximately 3,500,000 bales of cotton were held by the Cotton Stabilization Corporation and the co-operatives.[1] All these holdings were supported by the Federal Farm Board. Purchases of wheat were made for the most part in the open market by the Grain Stabilization Corporation and by June, 1931, it had accumulated more than 257,000,000 bushels.[2] In spite of the volume of these holdings, equivalent to a large percentage of annual production, the price of cotton sagged to 5 cents per pound in 1932, and that of wheat to less than 50 cents per bushel.

The failure of the Federal Farm Board to maintain prices and the acquisition of huge stocks of goods caused practical abandonment of the plan in 1931 and 1932. In order to avoid unduly depressing the already low markets, the stocks held by the Board were distributed in several ways. Approximately 850,000 bales of cotton were given to the American Red Cross for relief purposes and a few hundred thousand bales were sold on the open market. When the Agricultural Adjustment Administration was set up by legislation in 1933, nearly 2,400,000 bales were turned over to it, which, in turn, got rid of the cotton by offering options on it at an advantageous price to cotton producers who agreed to restrict production under the new program of control.[3] The

[1] 3d *Ann. Rep. Fed. Farm Board* (1932), pp. 64–66.

[2] 2d *Ann. Rep. Fed. Farm Board* (1931), p. 43. The Corporation stopped adding to its accumulations in April, 1931.

[3] Backman, Jules, *Government Price-Fixing* (New York: Pitman and Sons, 1938), p. 115.

wheat stocks were liquidated by sales on the open market of about 115,000,000 bushels, by gifts to the Red Cross of about 85,000,000 bushels, by trade to Brazil for coffee of 25,000,000 bushels, and by sales under notes to China and Germany of about 23,000,000 bushels.[1] The loss incurred by the government in these two operations has been estimated at nearly $300,000,000 and the loss of the Federal Farm Board in all operations at approximately $375,000,000.[2]

b. Reasons for failure of the Federal Farm Board. The dismal failure of the Federal Farm Board to meet the avowed objectives of the law are generally admitted. There are several reasons for this failure. In the first place, the operations were conducted at a time when conditions were exceedingly unfavorable to stabilization. The world-wide depression beginning in 1929 caused prices of agricultural products to fall far below normal levels. In the second place, stabilization of prices can hardly be attained if the approach is entirely from the demand side of the market, unless the government is prepared to buy commodities unsparingly and to keep these commodities off the market indefinitely. Real price stabilization must also reduce the supply offered on the market, and this can be accomplished only through control over production. In an industry so individualistic and competitive as agriculture, methods of persuasion are not adequate, real controls over production being needed to keep farmers from producing when the price is high enough to promise profitable production. Moreover, control schemes which aim at buying at one time and selling at a later time are almost bound to fail. So long as the government agency purchases commodities and supports the market, no objection is offered by sellers. But, irrespective of how high prices may rise, they are never high enough to satisfy sellers, and when an agency undertakes to sell its accumulations, farmers benefiting from the high price are bound to complain. Furthermore, a large holding of a commodity by a government agency tends to have a depressing effect upon market price, since operators in the market never know when the supply will be increased by sales of government holdings.

2. COMMODITY LOANS. Since the arrival of the New Deal in 1933, many schemes for solution of the agricultural problem have been provided by a number of laws. A great many of these plans have involved disposal or withholding of surplus products. Although one cannot always trace these plans to any particular law, through the maze of legislation since 1933, they may be perceived as carried out by commodity loans, crop insurance, export stimulation, and relief distribution.

Under the Agricultural Adjustment Acts of 1933 and 1938 and other legislation, a system of commodity loans has been established with the objectives of keeping products off the market and giving producers a cash income. Loans have been made to farmers by the Commodity Credit Corporation on the promise that the commodities offered for collateral will be placed in storage

[1] Backman, Jules, *op. cit.*, p. 117.,

[2] *Ibid.*, pp. 115, 117, and 13 *Congressional Digest*, pp. 291 ff.

and that the farmer will join the production control program set up by law. At first offered only to producers of corn and cotton, commodity loans were extended after 1937 to include wheat, barley, rye, tobacco, wool, peanuts, butter, gum turpentine and resin, raisins, figs, dates, and prunes.

Loans have been made "without recourse" at a rather high value. If the market price of the commodity rose above the loan value, the commodity could be sold and the loan paid. If the market price should stay below the loan value, the government simply took the commodity in storage and canceled the loan without holding the borrower to the difference between the loan value and the market price. What the plan of commodity loans has really done is to allow the farmer to sell his products to the government at a fixed price, set by the loan value, and to receive in addition any profits which might accrue if the market price rose above the loan value. The character of the loans makes them similar to the stabilization operations of the Federal Farm Board, with the exception that goods may be stored on the farm and that farmers obtaining loans must be co-operating in the program for restriction of production. While non-co-operators may receive loans, the value allowed them is only 60 per cent of that given to co-operators, and with such reduction the loans are generally not attractive.

The commodity loan program has been adapted to the "ever-normal granary" idea incorporated in the Agricultural Adjustment Act of 1938. Under this variation, loans are made to participants in production-control agreements when the prospect is for a crop in excess of a normal year's domestic consumption and exports, or when the market price is below a certain percentage of the parity price.[1] Loans are then made at a figure equal to or above this percentage. They are designed to cause commodities to be carried over from one year to another, when the supply is so large as to depress the price. And, if the production does not appear to be small enough to maintain the loan price in the future, the government may undertake to curtail production under its crop-reduction program.

With the notable exception of cotton and the high loan stocks of corn in 1940, the commodity loan plan has not yet caused the government any serious difficulties. The effect of production control by the government and of droughts in 1934 and 1936 was to raise the prices of most staple products, so that loans have been liquidated without the government's having to take over too large supplies. In the case of cotton, however, the drop in exports and the large crops in recent years, coupled with loan values that have been too high, al-

[1] The "parity price" for a commodity is a price which would make the purchasing power of a unit of the commodity equal to the purchasing power which existed in the five years ending in July, 1914. The 1938 law provides that such loans must be made when the market price is less than 52 per cent of parity for wheat and cotton, and 75 per cent for corn. The minimum percentage for corn may be lower, however, declining to 52 per cent where estimated crop exceeds estimated market by 25 per cent. In case of loans on other commodities, the minimum is subject to the discretion of the Secretary of Agriculture, the Commodity Credit Corporation, and the President.

though the lowest allowed by law, have resulted in the piling up of large supplies by the government. The total carry-over of cotton from the 1938–1939 production year in the United States amounted to more than 14,000,000 bales, of which the government held under loans more than 10,000,000 bales.[1] During 1939–1940 increased exports under the stimulus of export subsidies and high domestic consumption caused the carry-over to fall to less than 10,000,000 bales. The expected reduction in exports and the large crop looked for in 1940–1941 will probably cause it to rise again.[2] Such tremendous holding of cotton by the government, equal to nearly half the annual world consumption, and much larger than the maximum holding of the earlier Federal Farm Board, creates a problem difficult of solution, and one which may threaten the whole future of commodity loans.

The increased production of corn in 1939 and the loss of some export markets also caused the loan program for corn to reach serious proportions. By the middle of 1940, loan stocks of the government aggregated approximately 550,000,000 bushels. This large holding was equal to 30 per cent of the usual annual production of corn for grain purposes, and was practically equivalent to the amounts normally sold each year in the cash markets of the United States.[3]

There are several aspects of commodity loans which may be questioned. If the loans are placed high enough to be effective, supplies tend to be built up in storage, unless crop restriction by government or by Nature is effective enough to cause prices to rise above loan values. If large supplies become stored, they must be disposed of eventually and an early beneficial effect upon prices becomes a later threat to price stability. Where the loans are made on commodities sold in the export market as well as in the domestic market, the higher loan values tend to put domestic prices above world prices and make the export of the commodities difficult or impossible in the absence of export subsidies. If the domestic price is higher than the world price, foreign importers tend to purchase from other countries and foreign production tends to be stimulated. Unless the government is prepared to accumulate supplies indefinitely or to subsidize their export, the increased quantities held by it becomes a threat to the domestic market and the price-supporting effect of the loans tends to disappear.

Where prices happen to rise above loan values so that loans can be liquidated, farmers often believe that the government can support prices at almost any level and pressure is brought to bear for ever higher loans. Even where the

[1] *Ann. Rep. Secretary of Agriculture* (1939), p. 96. Much of this carry-over can be traced to 1937–1938, during which year between the Supreme Court decision of 1936 and the new law of 1938, there was no crop control law in effect.

[2] The Department of Agriculture has estimated that in August, 1941, the loan stocks will be 12,000,000 bales. See *Agricultural Situation* (January, 1941), p. 4.

[3] *Agricultural Situation* (May, 1940), pp. 16–17, and Department of Agriculture, *Agricultural Statistics, 1939*, p. 50.

loans have to be taken over by the government, this pressure for higher values is likely to be maintained as long as farmers believe the price they are receiving to be unsatisfactory. The result is that a vicious circle is set up. Higher loan values tend to discourage export and to increase domestic supplies, which in turn has a depressing effect on domestic prices. But unless domestic prices respond upward to levels regarded by farmers as satisfactory, the pressure for more liberal loans tends to increase.

Aside from the effect of commodity loans on the export market and the problem of accumulated surpluses held by the government, certain ethical considerations may be considered. Lending funds to farmers on commodities under conditions which give them the benefit of price rises and protect them from the risk of decreases becomes a dole to American agriculture. The drugging effects of such gifts upon the risks and incentives of free private enterprise are exceedingly dangerous for the future of our political and economic system.

3. Crop Insurance. A variation of the commodity loans is the system of agricultural crop insurance provided for by the Federal Crop Insurance Act of 1938. Applied to wheat only for the crop year of 1938, the extension to cotton is planned for 1941 and to other crops in the future. The plan, administered by the Federal Crop Insurance Corporation, involves the payment of premiums for an all-risk insurance in the commodity insured and the accumulation of reserves of the commodity in storage. The amount of insurance which may be taken is from 50 to 75 per cent of the actual or appraised yield of any farmer in bushels or pounds, and the amount of the premium is calculated in bushels or pounds in accordance with an actuarial study of the loss experience for the farm for a base period. In case of an unavoidable loss which reduces the insured crop below the amount of insurance, an indemnity is paid out of the reserve, equivalent to the difference between the actual production and the insured yield. All calculations, premium payments, and indemnities are figured in bushels or pounds, although indemnities may be paid for the sake of convenience in the cash equivalent.

What the crop insurance plan really does is to take a part of the surplus of good years, through the payment of premiums, and place it in reserve against deficiencies in crops in poor years. Or the plan may take a part of the good crops in one area and distribute them to farmers in areas where conditions have resulted in poor crops. In this case, there would be no effect upon surpluses of the entire crop.

The crop insurance plan involves a great amount of difficult and detailed administrative work. Farm yields must be appraised, loss records studied, premium rates calculated, premiums collected, indemnities allowed, and payments made. Moreover, the Crop Insurance Corporation must provide for storage of the commodity, and if premium or indemnities are paid in cash equivalents, as is usually the case, it must buy and sell an equal amount of the insured commodities. Since farmers would take advantage of the plan by

dropping insurance if the planting promised well, the collection of premiums in advance of planting is essential.

In the first year of its operation with wheat, the crop insurance plan worked quite well, with more than 105,000 growers insuring yields of 63,000,000 bushels of wheat in 1939; in 1940, 379,000 contracts involving 108,000,000 bushels of wheat were made. If insurance premiums are calculated accurately, the plan should continue to work well and the subsidy to agriculture involved can be kept at a minimum. This fact is due largely to the feature that crop yields are insured, rather than declines in monetary value of products, as in the case of many other surplus schemes. From the point of view of removal of surplus crops, however, the very economic soundness of the insurance may leave something to be desired by agriculture. The most that the plan can do is to remove surpluses of one year and return them in another year. Even if premium rates should be so high as to cause surpluses to accumulate over several years, the cost of these accumulations would rest upon the participating farmers rather than upon the government. As a plan for caring for long-time agricultural surpluses, crop insurance does not involve the advantages to agriculture, or the dangers to government, that such devices as commodity loans or market stabilization operations incur.

4. Export Encouragement Plans. As has been noted previously, one of the problems facing American agriculture is to increase its export of commodity surpluses, and one of the drawbacks to commodity loans is that exports are discouraged. To meet this deficiency, the government has abandoned traditional opposition to export subsidies and has subsidized shipments to foreign nations.

Until 1938 export facilitation was engaged in rather cautiously. In 1933, the Reconstruction Finance Corporation lent some $15,400,000 to the Chinese Government for wheat, flour, and cotton purchases, and made small loans to exporters to finance shipments of cotton to Russia. In 1933–1934, the Agricultural Adjustment Administration, by agreement with sellers in the Pacific Northwest, spent some $6,500,000 in "facilitating" wheat and flour exports to the Philippines.[1] In a few other minor cases export assistance was provided before 1938.

In order to obtain a "fair share" of the export market, large-scale assistance to wheat exports was adopted by the Department of Agriculture in 1938. This assistance has been accomplished by purchases of wheat by the Federal Surplus Commodities Corporation in the domestic market, with exports at a loss in the world market, and by outright subsidies to flour exporters for sales abroad below domestic prices. The extent of this program is indicated by the fact that the Department of Agriculture reported in 1939 that some 94,000,000 of the 118,000,000 bushels of wheat exported in 1938–1939 were assisted by the

[1] Nourse, E. G., Davis, J. S., and Black, J. D., *Three Years of the Agricultural Adjustment Administration* (Washington: The Brookings Institution, 1937), pp. 190–94.

export subsidies. The subsidies per bushel have ranged from 25 to 36 cents.[1] In 1939–1940, export sales of 35,000,000 bushels were assisted at an average cost of 30 cents per bushel.[2]

Export assistance for cotton became effective in 1939 when exporters of raw cotton and cotton textiles were granted subsidies equivalent to 1.5 cents per pound. This assistance received credit for a sharp upturn in cotton exports late in 1939 by reducing somewhat the differential between world prices and domestic prices of cotton occasioned by the commodity loan policies. However, low foreign stocks and wartime accumulation were probably more important factors in stimulating exports.

The government has expressed the hope that export subsidy plans will be temporary and that other means may be found to solve the problem of agricultural surpluses. In the case of wheat, the crop-reduction program is expected to make subsidies unnecessary, but in the case of cotton doubt has been expressed whether further restriction in acreage and production can be expected. As a matter of fact, as long as government policy is designed to place domestic prices above world prices in the face of a surplus, about the only feasible way is to subsidize the export market.

If high domestic prices are desirable, the other alternative is to reduce the surplus available for export. This may be done either by diverting commodities into channels at home which are non-competitive to the regular domestic market, or by so reducing production that no surplus exists. But the reduction of surpluses at home means the virtual abandonment of the export trade until world prices rise to what are regarded as fair domestic prices. The loss of the export market would seem further to dislocate the marketing of American agricultural products. Yet if export subsidies are continued, the American consumer is not only forced to pay a higher domestic price through local control but to contribute funds to foreign purchasers of agricultural products. This seems like a rather heavy toll to be exacted for the benefit of one group of American producers. Furthermore, an export subsidy program may meet with retaliation by foreign exporters who find this additional competitive element in the market.

5. Diversion and New-Use Programs. The government agricultural policies since 1933 have included many programs which have sought to develop and encourage new uses for farm products and to divert excess supplies in channels outside the main use of the products. These programs, most of which have been administered by the Agricultural Adjustment Administration, have really attempted to increase the demand for agricultural products and to reduce the supply used in established channels. A number of such plans have been financed by the government out of agricultural appropriations. Money has been spent to induce peanut producers to feed their crop to livestock and to sell to oil processors for the diversion of peanuts from the

[1] *Ann. Rep. of Secretary of Agriculture* (1939), p. 90. [2] *Idem* (1940), p. 115.

nut market to the oil market. Allocation of funds have been made to encourage potato growers to feed their output to livestock. Expenditures have been made to pay for experimental use of cotton in bituminous road construction. Financial encouragement for the diversion of potatoes to the production of starch and alcohol has also been given. While these diversion programs have been relatively limited and have occasionally disturbed prices in competitive fields, they often represent a commendable kind of government activity. It is said that the use of cotton in producing writing paper and for house insulation, originally encouraged by the government, may soon become commercially feasible. If the government can show the way to profitable new uses of agricultural products, the surplus problem will be helped and the consumer will be benefited by a new or cheaper product.

6. Relief Distribution of Surpluses. One of the most important means of disposing of surplus agricultural products by the government has been the distribution of these surpluses to persons on relief. The giving of these products free to needy persons was started by the Federal Farm Board as early as 1931, but relief distribution has been vastly extended since 1933 by the Agricultural Adjustment Administration. Most of the gratuitous distribution has been administered by the Federal Surplus Relief Corporation, organized in 1933, and converted into the Federal Surplus Commodities Corporation in 1935.

The direct allocation of goods to persons on relief, handled by the Surplus Commodities Corporation, has been effected by purchases of goods made by that corporation and by distribution to state relief agencies, which in turn apportion the goods to persons on relief or certain needy non-relief persons. In the latter group are such persons as old-age pensioners, work-relief employees, and other similar needy individuals. These commodities are given in addition to regular relief allowances and distributed in such a way and for such foods as to interfere the least with ordinary sales of commercial foods. Under the direct purchase and distribution plan, nearly 3 billion pounds of foodstuffs were given away in the year ending June 30, 1940, to an average of about 3,000,000 families each month. The forty-odd commodities distributed included flour, corn meal, dairy and poultry products, fruits, and vegetables.[1] In addition to relief distribution, the government undertook a national school-lunch program by which free school lunches were made possible to some 14,000 schools in low-income areas in 1939 and 35,000 schools in 1940.[2]

The food-order stamp plan was put into effect experimentally in the summer of 1939 in six cities, and has since been widely extended to many other cities and county areas. The plan aims to have the surplus commodities distributed through regular commercial channels, rather than through relief agencies. Relief families are permitted, although not required, to buy from $1.00 to $1.50 worth of orange-colored stamps per week per member of the family from

[1] *Ann. Rep. of Secretary of Agriculture* (1940), p. 50.

[2] *Agricultural Situation* (August, 1940), p. 20.

the funds which they receive as a relief allocation. With each dollar's worth of orange-colored stamps, fifty cents' worth of blue-colored surplus stamps are given to the family. Both kinds of stamps may be used in the same way as money in any grocery store in the area where the plan is in operation. Orange-colored stamps may be used for any food purchase permitted by relief regulations. Blue-colored stamps may be used to purchase only foods which the Secretary of Agriculture currently designates as being surplus foods. In this way the food-purchasing power of relief families is increased and the commercial channels of food distribution are undisturbed.

The relief distribution of foods is one of the more cheerful aspects of the agricultural control program of the government. If surpluses are to be disposed of, it is obviously more in the public interest to use them to raise the material standard of living of sub-standard groups in the United States than to subsidize exports. Moreover, local consumption of surpluses raises no problem of interference with the balances and policies of foreign governments in international trade. To the extent that agricultural products can be used in this country, relief disposal of surpluses would seem to be preferable to production control as a means of raising agricultural prices. Of course, there is a danger that the government's bounties to the millions of people on relief may disturb ordinary business sales. But the food-stamp plan and the fact that these surpluses have for the large part been additions to consumption make this consideration of minor importance. As some authorities have pointed out, danger exists that if such a plan works well pressure will be brought on the government to increase the prices at which the goods might be sold, thereby increasing the cost to it to benefit the agricultural producers.[1] While this danger is real, it has shown no definite tendency to materialize, and there is question as to whether the relief distribution contemplated will dispose of such a large part of the surpluses as to make the encouragement of further surpluses feasible. However, unless surplus purchases are limited to a small list of commodities not ordinarily bought by low-income groups, the plan may not have the desired effect of surplus removal of particular crops.

D. CONTROL OF AGRICULTURAL PRODUCTION

Perhaps the most publicized and disputed aspects of the government policy toward agriculture in recent years have been the production control plans. So long regarded as individualistic and competitive, agriculture finally succumbed to government control of production when the Agricultural Adjustment Act of 1933 was passed. The ultimate adoption of control by which government regulation has permeated the farms of the nation came because it was realized that, if price-raising for agriculture was to be effective, the supply of produce offered for sale must be limited. The failure of the Federal Farm

[1] Nourse, E. G., Davis, J. S., and Black, J. D., *op. cit.*, p. 212.

Board to stabilize prices of certain agricultural products was attributed to the tendency of farmers to increase or maintain production, irrespective of surpluses, if prices were maintained at a level at all near to their out-of-pocket costs. The Federal Farm Board recognized this fact when it said in its last annual report in 1932 that

> Experience with stabilization thus demonstrates that no measure for improving the price of farm products other than increasing the demand of consumers can be effective over a period of years unless it provides a more definite control of production than has been achieved so far.[1]

Informal attempts to control farm production were made by the Federal Farm Board. As early as 1930, the Board aggressively undertook to obtain farmer co-operation in production control. Through special reports and personal campaigns by its members and staff, the Board tried to persuade wheat, cotton, and other farmers to reduce their production. These efforts met with little or no success. Some cynics remarked at the time that the campaign to reduce production actually brought about increases, because individual farmers, thinking that others would be reducing their output, decided to take advantage of a future favorable market by increasing their own.

Definite control of agricultural production has been undertaken by two kinds of government policies. One approach has been to contract with farmers for limitation in acreage planted or units produced. This is what is generally thought of as production control. Another line of attack has been to limit the amount which a farmer can offer on the market. While this is, strictly speaking, not production control, but marketing control, the effect is practically the same as limitation of production. For, if a farmer can market only a certain amount and contracts to do so, he does not find it advantageous to produce more. As a matter of fact, acreage reduction or other restriction in volume has been suggested to those who enter into marketing agreements. As we shall see, the principal reason for employing the marketing agreement device has probably been that it is superior to direct controls from the point of view of constitutionality.

1. AGRICULTURAL ADJUSTMENT, 1933–1936. Government control of agricultural production was provided by the Agricultural Adjustment Act of 1933. This act at first established production control only for the "basic" commodities, wheat, cotton, rice, tobacco, field corn, hogs, and milk. By legislation in the following two years this list was increased to fifteen "basic" commodities by the addition of rye, flax, barley, grain sorghums, cattle, peanuts, sugar, and potatoes. In all these cases, the technique of control was practically the same, with slight variation of method in the case of cotton and tobacco. The main variation in techniques was that participation in a government control scheme was supposed to be voluntary for most products, but with cotton and tobacco high tax penalties for non-conformance made participation virtually

[1] 3d *Ann. Rep. of Federal Farm Board* (1932), p. 62.

compulsory. Since the objectives and techniques of regulation of all these laws were so similar, they may be grouped together for the present discussion.

Under the act of 1933, the Secretary of Agriculture was also given the power to enter into marketing agreements with processors, associations of producers, and others engaged in handling any agricultural product in interstate or foreign commerce, with a view to restricting and regularizing the supply of any commodity offered for sale in the market. Although the marketing agreement device was established to control commodities not designated as basic in the law, agreements could be entered into in respect to any agricultural commodity moving in interstate commerce.

The immediate objective of all these laws was to raise prices. While commodity loans and surplus removal programs were integral parts of the programs contemplated by these laws, perhaps the principal objective of the laws was to restrict production so that farm prices might rise to a parity with nonfarm prices.

a. Technique of production-control contracts. The Secretary of Agriculture was empowered to enter into agreements with producers of basic commodities by which, in return for benefits, producers agreed to cut down acreage or livestock production by a certain amount. The amount of benefits payable and the amount of reduction allowed under all contracts were left to the determination of the Secretary of Agriculture. Obviously, the benefit payments had to be high enough in all instances to induce farmers to live up to the planned production. The cost of benefits was to be financed by taxes levied upon processors of agricultural products. The amount of the processing tax was practically left to the Secretary of Agriculture to determine in each individual case, although the law rather vaguely said that the tax should be equal to the difference between the current average farm price of a commodity and the commodity's fair exchange value. The latter figure was apparently the parity price. The Secretary could, however, change the tax if the amount fixed by the formula would cause consumption of the commodity to be reduced too much.

b. Technique of marketing agreements. The marketing agreement was really a method of control alternative to the production control, or "adjustment," contracts. The law of 1933 did not define what a marketing agreement was, nor did it lay down any stipulations as to what an agreement might contain. It did permit the Secretary of Agriculture to issue licenses to processors, associations of producers, and others, permitting them to engage in marketing of goods moving in interstate or foreign commerce. It allowed him to set up requirements, as a condition for licensing, for the removal of those unfair practices which might prevent the operation of a marketing agreement. The power of the Secretary to issue licenses gave him authority to enforce marketing agreements upon recalcitrant minorities of producers, simply by not licensing them to market goods.

c. Experience with production control contracts. Although the production control contracts were applicable to fifteen basic commodities, the fact that acceptable programs were not developed and that the processing tax was found unconstitutional in 1936 led to the formation of contracts only in the case of eight basic commodities.[1] Since none of these crop restriction plans could become effective until the season of 1934, the Agricultural Adjustment Administration, impelled by the feeling that emergency action was necessary in 1933, undertook the destruction of some of the 1933 production. Growing cotton and tobacco were purchased by the administration and plowed under. Small pigs and pregnant sows were purchased and slaughtered, and the pork was turned over to government relief agencies for distribution to the unemployed. Other important plantings were left untouched, as it was believed that the probable surpluses from 1933 crops did not present such great problems in these cases.

Contracts were made with producers of eight basic commodities for restriction of production in 1934 and later seasons. Curtailment in output in 1934 amounted to about two fifths of the cotton acreage of the base period,[2] 20 per cent of the corn acreage, 15 per cent of the wheat acreage, and 25 per cent of hog production.[3] Similar reductions were contracted for tobacco and rice and slightly smaller reductions were effected for peanuts. In the case of sugar the acreage reduction attempted was small and the program did not go into effect until 1935. Because the severe drought in 1934 sharply reduced the stock of wheat, corn, and hogs, the restriction contracts for the season of 1935 called only for about a 10 per cent reduction in these commodities. Production contracts for cotton called for approximately the same reductions in 1934 as in 1935.

It is a little difficult to measure the effects of the production control contracts because of the influence of other factors, such as the weather, on production. The drought of 1934 is generally believed to have had far more to do with the reduction of wheat, corn, and hog production than the government program. In the case of peanuts, the acreage reduction was more than offset by the increased plantings of farmers who did not participate in the program. While substantial reductions were effected in cotton acreage, the program did not reduce the surpluses of cotton nearly to the same extent, because of the decline in cotton exports.

d. Experience with marketing agreements. Numerous marketing agreements were put into effect after 1933 for several basic commodities as well as for general crops. These agreements called for a variety of controls, including restrictions upon the marketing of products of low grade, shipping holidays in

[1] These were wheat, cotton, rice, tobacco, corn, hogs, peanuts, and sugar.

[2] The "base period" differed for individual commodities but was usually a year, or an average of two years, in which production of farmers seemed to be normal.

[3] Nourse, E. G., Davis, J. S., and Black, J. D., *op. cit.*, pp. 93–103.

which shipments were held up for brief periods of market gluts, quotas which could be shipped in a season or portion of a season, diversion of sub-standard grades to low-value or by-product uses, special collective price bargains between producers and processors, and even price-fixing agreements. Most of the marketing agreements were local or regional in scope, and only two — those for dried and evaporated milk — were placed on a national basis. Many marketing agreements were temporary in nature and were succeeded in 1934 and 1935 by adjustment contracts for production control. The lack of producer solidarity in many fields, the fear that definite controls under agreements were illegal, the fact that marketing agreements did not impose controls on production, and the too ambitious coverage of many plans made the experience in marketing agreements between 1933 and 1936 not too significant in solving the basic agricultural problem.

e. Constitutionality of the early program. The early agricultural adjustment program met with legal difficulties, and the principal portion of the program was declared unconstitutional by the United States Supreme Court in 1936 in the famous Hoosac Mills case.[1] The Court found that the processing tax and benefit provisions involved a system of regulation of agriculture, and, as such, represented an invasion of states' rights. The majority of six justices claimed that the tax and benefit provisions did not involve a lawful use of taxing and spending powers in that they coerced local producers to yield to government regulation. The minority of three justices, on the other hand, insisted that the tax was for general welfare and that the hope of gain by compliance with the program did not result in economic coercion.

f. Effects of agricultural adjustment, 1933–1936. Because the unconstitutionality of production control under the Agricultural Adjustment Act of 1933 and similar legislation did not bring an end to such regulation, and because the court did not pass on the validity of marketing agreements in the Hoosac Mills case, the effects of agricultural adjustment during the three years before the Supreme Court decision are important to note.[2]

(1) *Effects upon farm prices and production.* The production of basic crops in 1934 and 1935 showed considerable reduction from the average production of previous years. Wheat production was approximately 40 per cent lower in 1934 and 30 per cent lower in 1935 than in the years 1927–1931.[3] Cotton production fell by more than 25 per cent in 1934 and 20 per cent in 1935 from the production in the same base period. Reductions in corn production from the earlier average were over 40 per cent in 1934 and 13 per cent in 1935, while decreases in tobacco production amounted to more than 26 per cent in 1934 and 11 per cent in 1935. Other crops showed fairly significant decreases,

[1] *U.S. v. Butler et al.*, 297 U.S. 1 (1936).

[2] For a comprehensive analysis of the adjustment program for these three years, the student is referred to Nourse, E. G., Davis, J. S., and Black, J. D., *op. cit.*

[3] From *Statistical Abstract of the U.S.*, 1937, pp. 637–41. Data following are also from this source.

although in a few cases, such as peanuts, production increased, owing in part to a shift from cotton production.

Farm prices increased considerably from 1933 to 1935. An index number of farm prices, with 1909–1914 equal to 100, rose from 65 in 1932 to 108 in 1935.[1] These price rises were greater than the increases in non-agricultural prices, and the ratio of farm prices received to prices paid by farmers rose from 61 per cent in 1932 to 86 per cent in 1935. Some of the rises in individual prices were striking. For example, the weighted average of wheat prices rose from 38.0 cents in 1932 to 84.7 cents in 1934–1935.[2]

Farm income also showed material gains. Cash farm income from marketing of products and benefits under the adjustment program increased from 4.4 billion dollars in 1932 to 5.4 billion dollars in 1933, 6.7 billion in 1934, and 7.5 billion in 1935. Thus, between 1932 and 1935, cash income of farmers rose by more than 70 per cent. The government payments in 1935 for benefits accounted for $573,000,000 of the total farm income for that year.

The improved picture of agriculture in 1935 over 1932 should not be taken as an indication of the success of the adjustment program alone. For one thing, other government programs than the production control contracts influenced this rise in income and decline in production. Perhaps the most important cause for production decrease and price rises was the severe drought and dust storms of 1934. In the case of most crops, except cotton and tobacco, the weather accounted for the major portion of production control. Furthermore, the return of general business from the low levels of the depression in 1932 indubitably contributed to an increased demand for farm products, with resulting effects upon prices.

Just what was the influence of the adjustment program? The complexity of forces affecting price and production make it exceedingly difficult to ferret out the effects of one of the many causes. Experts estimate that the cotton control contracts probably caused crops to be reduced by one fourth, the wheat adjustment contracts had a negligible effect, the corn contracts brought reductions of less than 10 per cent, and restriction of hogs was probably no larger.[3] Of course, had the poor weather not occurred, the effects of the adjustment contracts would probably have been greater. As to the influence of the production control on farm income, it has been estimated that during the three years of the early adjustment program the total gains to farmers were somewhere between 1.8 and 2.0 billion dollars.[4]

(2) *Effects upon other industries.* The processing taxes levied to support the benefit payments were passed on by processors wherever possible. However, relatively elastic demands and the existence of customary prices and consumer resistance to changes often meant that a portion of the tax fell on processors.

[1] U.S. Dept. of Agriculture, *The Agricultural Situation* (August, 1940), p. 24.
[2] Nourse, E. G., Davis, J. S., and Black, J. D., *op. cit.*, p. 289.
[3] *Ibid.*, pp. 123 ff. [4] *Ibid.*, p. 323.

Moreover, processors and handlers of agricultural products — transportation agencies, warehousemen, merchants, and others — suffered some losses because of the reduced volume of business. On the other hand, the improvement of farm income had some advantageous effects. Banks gained by the increase in income available for interest payments and by the rise in farm values. Merchants and producers of consumer goods and farm supplies benefited from the expanded farm purchasing power. To a large extent, these increases in purchasing power were offset by increases in costs to consumers of farm products, since the system of processing taxes and benefits represented a kind of redistribution, rather than a creation, of purchasing power.

(3) *Effects upon the general public.* The effects upon the general public may be divided between those which fell on the consumers and those which fell upon taxpayers. The increase of prices caused by production restrictions and processing taxes inevitably fall to a large extent upon the consumers. This is true whether they are forced to consume less of the product whose price has risen, or whether their purchasing power for other things is reduced. The consumers, of course, on whom the burden falls are those persons outside the farming population. The adjustment program definitely increased the purchasing power of farmers, but just as definitely reduced the purchasing power of others. Nor is there any evidence that the stimulus to prosperity increased general purchasing power enough to offset the imposed scarcity of agricultural products.

The farm adjustment program was designed to be self-sustaining so that no burden would fall upon the taxpayers. This plan was seriously disrupted by the decision of the Supreme Court invalidating processing taxes in 1936. But even if the processing taxes had not been invalidated, the program would not have been self-sustaining. As it turned out, the three years of adjustment cost the treasury around $900,000,000, or approximately one half the cost of the program.[1]

2. The Soil Conservation Program. To replace the production control measures found unconstitutional in 1936, the Department of Agriculture has developed two principal lines of attack. One is the soil conservation program, the other is the program of marketing controls. The soil conservation program owes its beginning to a relatively obscure soil conservation act passed in 1935, while the marketing control program stems from the marketing agreements of the original Agricultural Adjustment Act of 1933. This latter development will be discussed presently.

The Soil Conservation Act of 1935 attempted to bring together the several features of previous government plans to curb erosion, prevent floods, and otherwise preserve the soil. Shortly after the invalidation of processing taxes and adjustment contracts, Congress adopted the soil conservation approach to production control by passing the Soil Conservation and Domestic Allotment Act in 1936. This act appropriated $500,000,000 and authorized the Secre-

[1] Nourse, E. G., Davis, J. S., and Black, J. D., *op. cit.*, pp. 416–19.

tary of Agriculture to restore the pre-war purchasing power of agricultural products to farmers who would agree to participate in soil conservation. Until 1938, the law authorized the Secretary of Agriculture to expend up to $500,000,000 in making payments for soil conservation. After 1937, federal payments were to be made only to persons organized into conservation districts under state laws which met with the approval of the Secretary. With the passage of the Agricultural Adjustment Act of 1938, the soil conservation program was enlarged and integrated with the marketing controls of the law.

a. Administration of soil conservation policy. In carrying out the soil conservation program, the Secretary of Agriculture has established two kinds of payments for soil conservation activities. By far the most important of these are payments made to farmers, organized in conservation districts of twenty-five or more farmers, for decreasing acreage in "soil-depleting" crops and increasing acreage in "soil-conservation" crops. The second kind of payments are made to farmers to aid them in adopting approved methods of restoring soil fertility such as strip-cropping, terracing, new seeding of leguminous plants and grasses, and the use of limestone. These payments have been open to farmers on compliance with the provisions set down by the Secretary.

It is hardly surprising that the crops classed as "soil-depleting" have been the basic crops for which production control was provided under the first Agricultural Adjustment Act. The expenditure of sums for benefit payments and the reduction in acreage in such important crops as cotton, wheat, corn, and tobacco have followed the precedents of the earlier production control scheme. About the only changes are that the processing taxes are not tied up with the scheme, the objective is soil conservation, and the plan is regarded as permanent rather than temporary.

Under the law, state legislation must be passed providing for the setting up of conservation districts through which the conservation benefits and controls are administered. By 1940, 38 states had enacted legislation suitable to the Secretary and 314 conservation districts covering 190,000,000 acres of farm land had been organized. The benefit payments which have been made under the program have ranged from a total of $326,000,000 in 1937 to $500,000,000 in 1938 and 1939. Nearly 6,000,000 farmers were co-operating in the plan in 1939 and 1940, and in these years this co-operation had resulted in about 10 per cent of the acreage being diverted from soil-depleting crops.[1]

b. Conclusions regarding conservation policy. The soil conservation policy is, of course, a thinly veiled substitute for the production control instituted under the 1933 law. It is, however, somewhat to be preferred to the 1933 law in that farmers are paid for activity, rather than inactivity. Its constitutional prospects are greatly enhanced by the plan to place control in the hands of state authorities under federal supervision and with the employment of federal

[1] *Ann. Rep. of the Secretary of Agriculture* (1939), pp. 14–17 and *idem* (1940), p. 29.

funds. Lacking the direct exercise of power by the federal government, especially the taxing power, and not placing the burden of taxation on persons likely to oppose the law, the plan would appear to be constitutional.

Although the objective of soil conservation is laudable, the primary purpose of the plan is to control production and enhance farm prices. From the point of view of such control, it is open to many of the criticisms which can be aimed against the earlier Agricultural Adjustment Act. The soil conservation plan has also been subject to criticisms which were not leveled at the earlier program. In the first place, soil conservation and production control are in some respects inconsistent. Soil renewal and control of erosion tend to increase the productivity of land. By financing the building up of soil productivity, the government may be creating a production problem when farmers come to realize that it may be more profitable to use the soil for production of soil-depleting, or cash market, crops than to accept benefits to conserve the soil further. To meet this problem, additional production controls will have to be instituted (as has actually happened under the marketing laws) or benefits for soil conservation will have to be increased. In the second place, there is some question as to whether the program, by subsidizing one type of agricultural crop, may not cause surpluses of certain commodities. Planting crops in grasses and leguminous products may lead to increased dairying with depressive influence on that industry. A third criticism which has been advanced is that soil fertility is not necessarily lost through utilization. Proper fertilization and planting methods may stop depletion, even if the production consists of those basic crops regarded as soil-depleting.

3. The Marketing Control Program. To supplement the regulation of production under the soil conservation plan, marketing controls have been widely employed by the government. The use of marketing agreements under the original Agricultural Adjustment Act has already been noted. These were carried forward by the government after the processing tax and benefit provisions of the law were invalidated in 1936. The Agricultural Marketing Act of 1937 and Agricultural Adjustment Act of 1938 set up in addition an elaborate plan of controlling the amounts of products flowing into the interstate and foreign channels of trade. Besides the power of co-operating groups of producers to do by marketing agreement what they were able to do under the 1933 law, the new legislation provides two interesting devices for making effective control of the marketing of surpluses of agricultural products. One is the system of marketing quotas, the other is the plan of acreage allotments.

a. Marketing quotas and acreage allotments. According to the law, whenever an "overproduction" of farm products of a particular kind exists or is threatened, the Secretary of Agriculture may poll the producing farmers, and, if two thirds of those voting in the referendum approve, the Secretary may set up compulsory marketing quotas. Overproduction is declared by the law to exist whenever the supply of a commodity is or promises to be a certain percentage above

"normal." [1] If the referendum is approved by the requisite two thirds, the Secretary calculates the production requirements to make the supply normal, and apportions this to individual states, counties, and farms. All producers are forced to comply, or face the danger of losing benefit payments under the conservation plan, and commodity loans, as well as the imposition of penalties to market their goods.

The individual farmer may consequently sell only the quota of goods allocated to him. If he wishes to sell more, he must meet penalties ranging from 2 cents per pound for cotton to 15 cents per bushel for corn and wheat. Commodities produced in excess of the quota may not be given away, used for feed on the farms, or bartered for other goods, but must be placed in storage for future sale within quota allotments, unless the penalty tax is paid to market them.

To aid farmers in producing only the quantities allowed by their quotas, the marketing control provisions create a system of acreage allotments. Farmers are not bound to produce in accordance with these allotments, but they find it practically necessary to do so in order to be sure that production will keep within marketing quotas. Thus, while the marketing quota control does not directly regulate production, the practical effect is to restrict the quantities which will be produced by farmers.

There would appear to be every reason for farmers to vote for marketing quotas whenever the Secretary of Agriculture finds overproduction to exist. Commodity loans are either reduced materially or suspended and benefit payments under the conservation plan are taken away from those producing groups who turn down the system. In general, imposition of marketing quotas has been approved by producers. However, in 1938, the rice-growers and three classifications of tobacco-growers turned down the plans by not voting the necessary two-thirds majority. A large enough group of these producers apparently believed that their individual advantages in being allowed unlimited production outweighed the advantages of a possibly higher price through restriction in market supply.

b. Relation of marketing quota plan to marketing agreements. It should be noted that the marketing quota plan is supplementary to the plan of marketing agreements set up by the law of 1933. Marketing agreements can be established by any producer group with the approval of the Secretary of Agriculture.

[1] Under the law, this allowable departure from normal supply is 7 per cent in the case of corn, 7 per cent for cotton, 10 per cent for rice, 30 per cent for wheat, and from 0 to 5 per cent for tobacco. Note, however, that the law defines "normal supply" to be a normal year's domestic consumption and exports of the commodity plus 7 per cent in the case of corn, 40 per cent in the case of cotton, 10 per cent in the case of rice, and 15 per cent in the case of wheat, as an allowance for a normal carry-over. The "normal supply" of tobacco is a normal year's domestic consumption and exports plus 175 per cent of a normal year's domestic consumption and 65 per cent of a normal year's exports as an allowance for a normal carry-over. The normal year's domestic consumption and exports are calculated for yearly averages ranging from five to ten years.

They may cover a wide range of matters from control over the supply allowed to be marketed in interstate commerce to various kinds of grade and size regulations. Through the contractual nature of the agreements and the power of the Secretary to order compliance with the agreement by all handlers,[1] an approved agreement may be made widely effective. However, it can only apply to shipments in interstate or foreign commerce, and the Secretary will not approve an agreement unless two thirds or more of the producers and the handlers of at least half the volume concerned vote for it. Agreements may be made effective by special presidential proclamation, however, even where the requisite percentage of handlers is not obtained.

The marketing agreements often deal with the same problems as the marketing quotas, but the quota restrictions apply only to quantities offered for sale in the interstate market, while the marketing agreements generally do much more.

Besides the quotas in effect for cotton, corn, wheat, and certain classes of tobacco, there were more than forty-six marketing agreement programs in effect early in 1941. These covered a wide range of farm products, such as milk, milk products, vegetables, nuts, fruits, and hops. In 1940, there were approximately 1,300,000 farmers affected by such agreements.[2]

c. Constitutionality of marketing controls. Both the marketing agreements and the quota control system have been upheld by the United States Supreme Court. In 1939, the Court upheld the New York and Boston milk marketing agreement programs and confirmed the constitutionality of the Agricultural Marketing Act of 1937 under which the agreements were made.[3]

In the milk marketing cases, the Supreme Court upheld the enforcement of marketing agreements which fixed minimum prices for purchase of milk from producers. The Court declared that the authority of the federal government over interstate commerce is complete and that, since most of the milk under agreements moved in interstate commerce and the intrastate milk was inextricably mixed with interstate milk, the regulation of prices of all milk in the New York and Boston markets through marketing agreements was a valid exercise of the commerce power. Moreover, the majority of the Court refused to find that determination of reasonable prices and other matters by the Secretary of Agriculture was an unwarranted delegation of power.

The marketing quota provisions of the Agricultural Adjustment Act of

[1] In 1935, Congress substituted "Secretary's orders" for licenses which had been required of handlers under the act of 1933. A Secretary's order is simply an order by the Secretary of Agriculture that an agreement is approved by him, by the requisite two thirds of growers, and by handlers of one half of market volume, and that henceforth all handlers of products covered by the agreement are to comply with it. Even if handlers of less than one half of the market volume do not concur with the agreement, it may still be put into effect upon approval by the President.

[2] *Agricultural Situation* (January, 1940), p. 16 and *ibid.* (December, 1940), p. 22.

[3] *U.S. v. Rock Royal Co-operative*, 307 U.S. 533 (1939), and *H. P. Hood and Sons v. U.S.*, 307 U.S. 588 (1939).

1938 were also upheld by the Supreme Court early in 1939. In a case testing the quota restriction as applied to the marketing of tobacco, the Court held the regulation to be a proper use of the power to control interstate and foreign commerce.[1] It pointed out that the statute does not purport to control production, but merely aims to control the sales of tobacco in interstate commerce so as to prevent the flow of commerce from working harm to the people of the nation. The Court refused to find the motive of Congress in controlling marketing to be relevant to the question as to the existence of the power over interstate commerce.

With the favorable decisions of the Supreme Court in the case both of approved marketing agreements and the quota system of control, the program of agricultural control seems at last to be placed upon a sound constitutional footing. While neither of these approaches involve direct control of production, their indirect effects are such as to make control of the supply of the important agricultural products fairly complete. To be sure, production and marketing within a single state are outside the scope of either type of law. But handlers of both interstate and intrastate agricultural production can be brought under the control of the marketing laws. And, the technique of control is to place the enforcement of marketing agreements and quotas in those first handlers of the product. Few of the warehousemen or merchants handling the more significant agricultural crops deal exclusively in intrastate commerce.

d. Marketing controls: conclusions. The marketing agreements and quotas fit well into the other production control features of the government agricultural program. Non-co-operators are in danger of losing the benefits of other parts of the agricultural program, and strong pressure is brought on them to ratify and comply with agreements and quotas. Although the selection of these marketing controls is, strictly speaking, left to growers, and has been referred to as a sort of "economic democracy," actually the benefits for entering an agreement or quota are so strong an invitation to approval that few farming groups can resist.

At the same time, the very fact that farmers may, for some reason or another, turn down an agreement or quota represents an element of weakness in the marketing control program. If prices of agricultural goods become, or promise to become, favorable, farmers are likely to avoid marketing control and take their chances on a larger production. This tendency to drop the protection of these programs may defeat the scheme of supply restriction to raise prices, unless the government increases the prizes to be gained from compliance. If the marketing controls should fail, more restrictive regulation may be enacted. As a matter of fact, proposals have been made to have the government fix agricultural prices at a cost-of-production level, and to have the Secretary of Agriculture sell the surplus created at any such price abroad.

[1] *Mulford v. Smith*, 307 U.S. 38 (1939).

Marketing controls are probably preferable to any such kind of regulation.

Unless marketing agreements are closely supervised, there is the constant danger that agreements will be made which will harm the public. Undue restriction of sales or price-fixing at wholesale or resale sometimes creeps into marketing agreements. These are policies of especially great public interest, and the consumer point of view should be well represented in supervising their inclusion in agreements.

Even if the marketing agreements prove to be successful as a device for controlling production and sales of agricultural products, and for raising the prices of such goods, the question still may be raised as to whether a scarcity policy of that kind is in the interest of the general public.

E. AGRICULTURAL POLICY: CONCLUSIONS

Most of the agricultural policies of the government in the last few years have been regarded by some persons as emergency measures. In view of the fact that most aspects of the agricultural problem would be present in nearly as great intensity today as in 1933, if these measures were repealed and no substitutes enacted, the extensive controls and aids[1] to agriculture must be regarded as a relatively permanent part of the government program. The government agricultural policies have as yet done little to increase the demand for agricultural produce. Any increase in exports has been caused largely by government aid. The research in new methods of using agricultural products has not had a material effect upon the demand for them. From the supply side of the picture, most of the government's actions have brought about supply restrictions by devices which must continue in operation if decrease of supply is to be maintained.

Recognizing the probable permanence of some plan for agricultural controls, irrespective of the political group holding the reins of government, this writer believes that few of the more significant features of the agricultural program developed in the last two decades will be abandoned or greatly modified. If this is a reasonable assumption, then it may be pertinent to look into some of the legal, economic, and social implications of the relationships of government to agriculture.

1. LEGAL ASPECTS OF AGRICULTURAL POLICY. Ten years ago the federal government, and even the state governments, were believed not to have the power to regulate agricultural production and sales. The expenditure of government funds to aid agriculture was also subject to doubts as to constitutionality, in spite of the fact that relief gifts and other subsidies had long existed. Within the last ten years any doubts as to constitutionality have been resolved. The United States Supreme Court admitted in 1936 that the spend-

[1] Certain special credit aids and facilities for agriculture are discussed in Chapter 29.

ing power was broader than the other delegated powers, and included the power to spend government funds for anything so long as it was for the general welfare.[1] Promotion of agriculture is probably in the general welfare, and the conditions upon which subsidies may be given to it are apparently open to a much broader interpretation now than in 1936. Furthermore, the avowed object of spending has recently been soil conservation. It is doubtful that the Supreme Court could find such a motive not to be for the general welfare.

The indirect regulation of agricultural production and marketing has been supported on the grounds of the commerce clause. Through finding the quota system and marketing agreements constitutional, the Supreme Court has allowed government regulation of agricultural production to be almost as effective, through the medium of the commerce clause, as direct regulation of production would be. The principal drawback to this practice is that production for intrastate sales is not covered. However, most staple agricultural products move in interstate commerce, and even where they do not, the power to withhold benefits under the soil conservation plan is adequate to fill in this gap. Although the federal government may not yet have the power to regulate local agricultural production and trade directly, any lack of such power has proved to be an insignificant handicap.

2. Economic Aspects of the Agricultural Policy. The economic implications of the government farm program are so considerable and far-reaching that only a few principal issues can be noted here. Perhaps the whole program can be divided between subsidy policies and production-restriction policies. Even this classification is not mutually exclusive, since subsidies are used in some instances to encourage production restriction.

The economic aspects of subsidy policies depend upon the purpose of the subsidies. Where exports are subsidized, the effect is to reduce domestic supply and increase demand in the world market, both results being favorable to domestic prices, in the absence of retaliatory measures abroad. But the incidence of this subsidy policy is upon domestic consumers and taxpayers to the benefit of domestic farmers and foreign consumers. If the subsidy is used to increase local consumption through purchases by persons on relief, the effects appear to be changed somewhat. Relief families gain by increased consumption and taxpayers may have a lower load due to possible reduction in demands for higher relief payments.

If, however, the subsidies are used to improve soil fertility, methods of farming, or the nature of farm land under cultivation, the result may be a more efficient farming industry. Yet if the farming industry is already overexpanded,

[1] *U.S. v. Butler*, 297 U.S. 1 (1936). While the Court held in this case that the granting of benefits and the imposition of processing taxes were both part of a scheme to regulate local production, the minority of three and the reconstitution of the Court since 1936 would seem to make probable the position that subsidies to agriculture are constitutional. Even as the case was decided, the Court offered no objections to benefit payments, but objected to the conditions attached by the government to receipt of benefits.

increased efficiency may aggravate that overexpansion and make necessary further attempts to solve the so-called problem of overproduction. Moreover, the subsidies which improve efficiency may impede a natural economic tendency toward readjustment by making it possible for the least efficient farm producers to stay in the industry. Even though these producers may improve their efficiency, they may still be within the group which should be forced out of the industry in order to bring economic equilibrium between costs and selling prices.

When subsidies are granted indiscriminately to farmers needing aid, as is the case with the grant of loans below cost to the government, the effect may be to place an "umbrella" over the inefficient producers. By aiding such producers, economic readjustment of production is interfered with, and these producers stay on the farm to harm the more efficient farmer through the increase of supply of agricultural products.

Many subsidy policies undertake to maintain or increase production, either by aiding farmers to produce or by furnishing means for disposal of farm surpluses. While these policies may alleviate the suffering caused by inability of farmers to produce and sell at prices to cover their costs (that is, overproduction), such programs do not effect a reduction in quantity produced.

As a result, two kinds of programs have been instituted for reduction of production. One is the reduction of production of basic crops in return for benefit payments under the soil conservation plan. The other is reduction in production by limiting quantities which may be offered for sale, the inducement being found in the higher possible prices and the right to participate in soil conservation and commodity loan programs. Production control, then, is generally a subsidized control. Its economic effects are to reduce supply and increase prices. Where the demand for agricultural products is relatively inelastic, the increased prices may bring a higher total revenue to producers of the controlled products. Even where the demand is relatively elastic, the total revenue received by producers is probably not any smaller at the higher prices, since the revenue from sales is supplemented by revenue from benefit payments. This improved farm income does not, of course, come from some sort of magic. The higher prices are a direct burden upon consumers, although some burden may fall upon middlemen through restricted profit margins, and although the burden of benefit payments may fall upon taxpayers.

3. Agricultural Policy and Society. Underlying most of the government agricultural program is the assumption that society owes to one particular producing group a share of the national income equal to that share which it had in its most prosperous days. This assumption is of doubtful validity. Had it been adopted with horseshoers, carriage-makers, and stagecoach drivers, society might still be taxing the more efficient producers in other fields to support these groups. If an economic system is to work according to principles of competition and free private enterprise, prices must be allowed to seek their

level freely, and prices below cost of production become signals to producers that society desires something else more than those things which these producers are selling.

On the other hand, unless competition is allowed to work freely in a wider field than the marketing of farm products, farmers have a reasonable objection to paying controlled prices while receiving competitive prices. Moreover, the political and social implications of an economically depressed farm population cannot be overlooked. If the working of free competition causes prices to fall, farm living standards to be endangered, farm homes to be foreclosed, and farm tenancy to increase, the discontent of those in agriculture may be expressed through political action, whereby purveyors of crackpot schemes may be placed in control of the government. Criticize as one might the government farm program, there are many schemes more disruptive to an orderly economic system which could be introduced.

The farm program is distinctly one where benefits are bestowed upon one class to the detriment of other classes. Perhaps the benefits received by agriculture are out of proportion to the political strength of six million farmers and the advantages gained through government policies by other groups in the United States. Before one criticizes farm legislation as class legislation and appropriations as gifts to favored persons, one should be prepared also to denounce raids upon the treasury of the government by war veterans, silver producers, and other groups, and the special advantages obtained through the protective tariff by a small group of domestic manufacturers.

The government agricultural program should nevertheless arouse concern on the part of persons interested in the public welfare. In the first place, the program makes little attempt at the long-run solution of the agricultural problem. Secondly, it is inconsistent in that it encourages increased productivity at the same time that it attempts to reduce production. In the third place, it is expensive. The cost of the federal government's aid to agriculture from 1933 through 1940 has been over $7,600,000,000 and the cost in 1940 alone was $1,567,000,000.[1] Moreover, no one can foresee the final costs of guaranteeing farm mortgages and other loans. A fourth cause for concern lies in the scarcity policy which seems to dominate the program. If a third of the population is ill-housed, ill-fed, and ill-clothed, as President Roosevelt has declared, the way to improving the standard of living of these persons and others is not through reducing total production. The efforts toward production may be directed into channels where the goods are most desired, but no nation can expect to increase its material standard of living by encouraging inactivity.

The agricultural problem is clearly related to other problems in the economic system. If competition can be made to work elsewhere, it might be made to function better in agriculture. If competition must be abandoned,

[1] *New York Times*, March 5, 1941, p. 20.

then the government will have to exercise an increasing rôle in agricultural planning and control. If such planning and control must be embraced in the future, it is hoped that means will be found and policies pursued to increase the standard of living rather than to follow the illusion that everyone can become richer by producing less.

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CHAPTER

25

REGULATION OF COAL AND OIL

IN ADDITION to the extensive government controls over agriculture, the government has placed the coal and oil industries under special regulation. This is based in part upon the public interest in conserving natural resources, as was also the case with agriculture. However, the element of conservation is far more important than in the latter, since coal and oil resources cannot be replaced as can those of land. Although all mineral resources are practically irreplaceable, certain special problems have existed in the coal and oil industries to bring about government controls, problems which are not generally prevalent in other mineral extracting industries. A possible important exception is the natural-gas industry. Many regulations to eliminate waste have existed. The federal government has provided some control over the transportation and wholesale marketing of natural gas. The state governments have provided for regulation of rates and service of natural-gas retailers, since the local distribution of this commodity is a public-utility business. These regulations have already been noted.[1] But since much of the regulation of natural gas has arisen as a part of the control over oil production, gas and oil being often produced together, no further special attention need be paid to government regulation of this industry.

Besides the fact that conservation has played a large part in motivating the regulation of coal and oil industries, as it has in agriculture, other similarities might be noted. Government controls have applied both to production and marketing of the natural resource. Machinery has been set up allowing for a high degree of self-regulation under strict government supervision and guidance. Lastly, the advent of government control has been motivated by the belief that competition, functioning too well, has worked to the harm of the producers and the general public.

[1] See *supra*, Chapters 14 and 15 and pp. 401–04.

A. PUBLIC INTEREST IN REGULATION OF COAL AND OIL

In both the coal and the oil industries, the basis of public interest has shifted. Several decades ago, although the public was concerned about obviously wasteful practices in the production of oil, it was probably far more anxious about exploitation of the consumer through monopolistic prices. In the coal industry, the situation was similar, with early public opinion emphasizing the dangers of monopolistic controls and "unholy alliances" of railroads and coal producers. In the regulations enacted at the time of the first World War, the public interest expressed itself through control to obtain adequate output at reasonable maximum prices. In the last two or three decades, this interest has shifted to stabilization and conservation, with emphasis upon restriction of production and maintenance of reasonable minimum prices.

1. Coal Production and Marketing Problems. The basis of public interest in regulation of coal production and marketing may be made clear by noting some of the economic problems encountered by this industry. Because of the strength of price leadership in the anthracite industry and the stabilization of prices there,[1] the principal problems apply to bituminous coal. Its production has been characterized by vigorous competition, and since a few years after the close of the first World War the industry has had to face the problems of greatly overexpanded productive capacity and decreasing demand with an increasing elasticity. Because of the peculiar problems in the industry and the fact that bituminous coal has been mined in many parts of the United States, in contrast to the mining of most anthracite in the state of Pennsylvania, future discussion in this chapter will refer to bituminous coal, unless noted otherwise.

In contrast to price leadership and monopolistic competition in the anthracite industry, bituminous coal production and marketing are highly competitive. The existence of some 13,500 producers, in spite of the fact that a few hundred of the larger companies produce approximately half the coal, has meant that individual producers have had to sell at the market price facing them, if they sold at all.[2] Until the advent of government regulation, the market price was fixed by the free interaction of demand and supply forces. Furthermore, the competitive character of the industry has been influenced by the fact that many localities mine coal, and in certain markets competition between coal from different places has existed. Moreover, the cost of transportation has been such a large part of the delivered cost that transportation rates have played a material part in the competition for business.

The problem of excessive productive capacity was greatly aggravated by the expansion in response to the high coal prices and high rate of consumption

[1] See Burns, A. R., *The Decline of Competition* (New York: McGraw-Hill Book Company, Inc., 1936), pp. 118–29.

[2] See National Resources Committee, *Energy Resources*, p. 73; National Recovery Administration, Division of Review, *Work Materials No. 69* (1936), p. 29; and *New York Times*, April 14, 1940, p. 8.

during and immediately after the first World War. The high prices were only partly due to increased consumption in this country during the war. The export market for coal, both during and after the war, when the French occupied the Ruhr — Germany's large coal-producing valley — was increased over the requirements of previous years. The strike of British miners in 1920–1921 caused an unexpected increase of American coal exports. The series of car shortages and labor disputes in this country in the years between 1919 and 1923 also contributed to the rise in coal prices. The average mine price in this country increased from $1.23 a ton in 1913 to $9.51 in August, 1920.[1]

The result of higher prices was a tremendous increase in productive capacity. New mines were opened and old mines re-equipped and expanded. Productive capacity increased from about 675,000,000 tons per year in 1915 to 950,000,000 tons in 1923;[2] although thousands of mines were closed in the 1920's, it still remained at about 760,000,000 tons per year in 1930. When it is considered that coal production amounted to less than 443,000,000 tons in 1915, reached a peak of 579,000,000 tons in 1918, and averaged only 514,000,000 tons between 1924 and 1930, dropping to 303,000,000 tons in 1932,[3] the extent of overproduction during those years is apparent. But this reduction in production, to a point far below capacity, did not stem the fall in prices after 1923. During the time of prosperity and stable prices in most industries, coal prices fell from an average of $3.02 per ton at the mine in 1922 to $1.78 in 1929, and coal companies as a whole showed substantial net deficits in 1928 and 1929.[4] With the coming of the depression after 1929, the already depressed coal industry sank still farther.

The existence of excess productive capacity may be coupled with certain economic characteristics of the industry in order to explain, from the point of view of supply, its recent critical condition. A large part of the costs of coal mining are fixed. Carrying charges upon investment in mines and unmined reserves to insure future operation are high and fixed. The increased mechanization of mining and the equipment needed to operate a mine also contribute to these fixed costs. Once the costs are incurred, the mine operator finds it economically inadvisable to shut down production as long as he can cover his direct costs, which are largely labor costs. Prices can sink fairly low before a substantial reduction in production follows, with the result that, over rather long periods of time, supply tends to be relatively inelastic.

The drop in prices since 1923 can be ascribed to changes in the demand for coal, as well as the increase of an inelastic supply. The demand has declined somewhat and has become more elastic. The decrease helps explain the drop

[1] Nourse, E. G., and others, *America's Capacity to Produce* (Washington: Brookings Institution, 1934), pp. 48–49.

[2] *Ibid.*, p. 53.

[3] *Investigation of Concentration of Economic Power*, pt. 1, p. 239 (1939).

[4] Lyon, L. S., Abramson, V., and others, *Government and Economic Life* (Washington: Brookings Institution, 1940), vol. II, p. 956.

in prices, and the greater elasticity aids in understanding how any policy designed to raise prices causes relatively large declines in consumption. The decline in demand has occurred in large part because of the rise in efficiency of fuel consumption. Generation of electrical energy by steam so increased in efficiency between 1923 and 1934 that coal consumption per kilowatt hour declined by 40 per cent. Better railway locomotives reduced coal consumption by 24 per cent per ton-mile.[1] Increased efficiency also caused a decline in demand for coal in many manufacturing industries.

Extremely important in explaining the decline and higher elasticity of demand is the development of competing fuels, such as oil and natural gas, and the growth of water power in the generation of electricity. In 1918, bituminous coal contributed 69.5 per cent and oil 3.8 per cent of the total power resources of the United States. But by 1934, bituminous coal accounted for only 46.1 per cent of these resources, while oil had increased its proportion to 26.7 per cent.[2] In practically every field where coal can be used, other fuel resources offer actual or potential competition.

The changed demand for coal is probably a permanent feature of our economic system. This industry, like agriculture, can hardly expect a material rise in demand for its products. It also has problems similar to agriculture in readjusting its output to the changed demand. Although such readjustment could probably be effected in the long run by simply allowing low prices to drive producers out of the market, the disorganization of industry resulting, the unemployment of miners, and the possible waste of coal resources in the meantime give rise to problems which the government has not overlooked, and probably could not have overlooked even had it wished to do so.

2. The Labor Problem in the Coal Industry. A major portion of the regulation of the coal industry has been inspired by the labor problems existing there. Because of the unusual hazards of the industry, it has long been subject to special safety regulations. But the economic difficulties of coal miners have also called forth special government regulation. It has even been said that the development of federal control since 1933 has resulted largely from a desire on the part of Congress to protect labor in the bituminous coal industry.

The factors which contributed to the problem of overcapacity have also accounted in part for an oversupply of labor. Employment dropped from 705,000 men in 1923 to 503,000 in 1929, and to 406,000 in 1932.[3] Average annual earnings fell between 1923 and 1929, and after 1929 both earnings and payrolls dropped by 1933 to approximately one half of the 1929 level.[4] In an

[1] Lyon, L. S., Abramson, V., and others, *op. cit.*, vol. II, p. 959.

[2] National Recovery Administration, Division of Review, *op. cit.*, p. 27.

[3] Lyon, L. S., Abramson, V., and others, *op. cit.*, vol. II, p. 956; Veenstra, T. A., and Fritz, W. G., "Major Economic Tendencies in the Bituminous Coal Industry," 51 *Quar. Jour. of Econ.*, pp. 106–30, at p. 124 (November, 1936).

[4] Carter, E. W., "Price Fixing in the Bituminous Coal Industry," 193 *Ann. Am. Academy*, pp. 120–29, at p. 121 (September, 1937).

industry already depressed in 1929, the subsequent decline indicates the seriousness of the employment and wage problem. Although employment has risen from these low levels and wages have increased, the labor problem is still extremely serious.

The general depression in the coal industry has not been the only cause of a difficult labor situation. This industry has been highly seasonal and the workers are employed for only a portion of the year. The industry has also been subject to technological changes which have caused unemployment, machine cutting and loading having grown steadily in the last two decades. While the numbers of unemployed have been somewhat lessened by the introduction of a seven-hour day and a five-day week in 1934, and daily wages have risen with government encouragement to unionization, the higher labor cost has served to stimulate mechanization of mining operation.

The surplus of labor gave rise to numerous problems before the government took an active interest in the industry in 1933. Low wages and low annual earnings, along with unemployment and the opposition of mine operators, made unionization difficult before that year. In the struggle to unionize the industry, however, many serious and bloody strikes have been attempted. The resistance of operators and the fact that several important mining areas could not be unionized caused these strikes to be rather unsuccessful from the point of view of the unions. With the encouragement to unionization under the Recovery Act of 1933 and the subsequent coal legislation, and owing to the softening of operator resistance to unions by the price-fixing features of these laws, the bituminous coal industry has become fairly completely unionized. Unionization, however, has not eliminated the many labor problems facing the industry.

3. Oil Production and Marketing Problems. In many respects, the economic problems involved in the production and marketing of crude petroleum parallel those found in coal and agriculture. The supply of crude oil has increased materially in recent years, as new fields have been found, new methods of production invented, and deeper wells drilled. The supply has also tended to be inelastic. These characteristics cannot be attributed so much to overexpansion of the industry in response to higher prices, although the high prices of oil during and immediately after the first World War did play a part, but the supply conditions result largely from the nature of the petroleum business.

When fields are discovered, there are certain factors which impel producers to exploit them as rapidly as possible. Oil underground is not attached to a particular acreage, but tends to move with changes in underground pressure to places of low pressure. The drilling of a well at one point and the withdrawal of oil at that point tend to make oil under other points flow to the low-pressure area caused by the withdrawal. Hence, unless a single producer has control of practically the entire surface of a field, he finds it to his advantage to

draw out the oil as fast as possible, before a person drilling on adjoining acreage can pump it. This competitive pumping has been encouraged by the so-called "law of capture," under which the courts have taken the position that underground oil is analogous to wild animals and belongs to the person on whose land it is captured, even though it might have come from land owned by his neighbor.

The rapid development of oil resources, caused by divided ownership and the capture rule, increases the cost of drilling wells by inducing operators to drill more wells than would be necessary for a leisurely withdrawal of oil, and by obliging them to speed up drilling and production, with consequent rise in costs. These costs are largely fixed costs and contribute to the operator's lack of regard for price in guiding his oil production.

The business of oil production has been rather competitive, even though purchasers of crude oil may be so few as to cause monopolistic elements on the buying side. Since the breakup of the Standard Oil near-monopoly of production and marketing in 1911 under the anti-trust laws, thousands of oil producers have been able to enter the business of crude oil production. Although in 1937 twenty large oil companies produced 52.5 per cent of the total, it has been estimated that there are from ten to eleven thousand business enterprises producing oil in the United States.[1] The number of producers and the tendency to produce oil rapidly have led to a high degree of competition in its production. In its refining, transportation, and marketing, however, the number of enterprises is much smaller and the competition on a price basis far less keen, even though the service competition to sell finished products is rather sharp.

The economic factors mentioned above — rapid production and high fixed costs — tend to make the supply of crude oil inelastic over short periods. The discovery of fields and the rush to exploit them also tend to make supply increase sporadically and to decrease only as fields are exhausted. As a matter of fact, increase and inelasticity of supply have been so influenced by governmental action or by attempted co-operative action by producers, that since the early 1920's their full effect has not been felt. Nevertheless, the underlying economic characteristics of supply have caused great difficulty in making any program of control work.

From the demand side of the picture, the crude oil industry furnishes a picture far different from that presented by the coal or agricultural industry. The increasing use of the internal combustion engine in the last two decades and the rapid rise in consumption of oil for heating fuel in homes and factories have brought about a tremendous increase in demand for it. In addition, as the rapid rise in supply has allowed prices to sink lower in later years, consumption in response to them has increased.

The price of crude oil has shown tendencies to rapid and large variations. Although it has been the practice of large producers to post prices, from which

[1] *Investigation of Concentration of Economic Power*, pt. 14, pp. 7104, 7391 (1940).

other producers take a lead, these prices are often departed from, and occasional chaotic conditions have existed. For example, the price of Pennsylvania Crude went from $4.00 a barrel in 1923 to $2.40 during the same year, and as high as $4.10 in 1929 and as low as $1.30 in 1933.[1] Texas Crude has also shown wide variations, with the price dropping as low as 10 cents a barrel on occasion. A weighted average of prices shows variation from $3.00 a barrel in 1920 to 70 cents in 1931.[2]

The rapid increase of production and the fluctuations in the price of crude oil have disrupted the refining and marketing of petroleum products. Refiners' margins have been materially affected by changes in crude prices. Increase in output at low prices has encouraged increased refining and marketing, often with a demoralizing effect upon the price structure of petroleum products. Although the latter industry has not been as subject to price competition as has that of crude oil, the result of increased oil production has been to bring about declining gasoline and refined oil prices. While the drop in gasoline prices has been largely offset by the increases in gasoline taxes, the effect has nevertheless been to cause retail prices plus taxes to fall.

4. Public Interest in Conservation. The supply and demand conditions in the bituminous coal industry have aroused some public interest in conservation of this exhaustible resource. It has been the supply characteristics of the oil industry, with its competitive production and evidence of waste, which have given rise to the strong public interest in conservation. From this point of view, the interest of the public should be much keener in the case of oil than in that of coal. Where known coal reserves may be measured in terms of centuries, the known oil reserves can be referred to in terms of years. The proved oil reserve as of January, 1939, was estimated at more than seventeen billion barrels, or the equivalent of fourteen years' supply at the 1938 production level.[3] While this estimate does not take into account undiscovered oil, or oil which might be recovered by improved methods of production, it does serve to indicate the public interest in conserving the supply.

The problem of conserving petroleum is related to that of conserving coal, since many important products now derived from petroleum would have to come from coal should the oil supply materially dwindle. Moreover, the oil conservation problem is related to that of conserving natural gas. Production of oil by hurried and wasteful methods leads to waste of natural gas, since it is produced at the same time, and each year the inability of oil producers to store, transport, and market natural gas causes billions of cubic feet to escape into the air. The value of this loss has been estimated at $450,000,000 per year.[4]

The problem of conservation has still another aspect which affects the public.

[1] Burns, A. R., *op. cit.*, p. 219.

[2] *Investigation of Concentration of Economic Power*, pt. 14, p. 7473 (1940).

[3] *Ibid.*, p. 7465. This is the official estimate of the American Petroleum Institute.

[4] Gemmill, P. F., and Blodgett, R. H., *Current Economic Problems* (New York: Harper and Brothers, 1939), p. 394.

If natural resources, such as coal and oil, are used too rapidly at too low prices in the present, the future costs may be disproportionately high. Even if new fields can be discovered, new methods devised, or substitute fuels found, the quantities needed for consumption may be obtained only at a materially higher cost. The tendency even at the present to drill oil wells thousands of feet deeper than was the case a decade ago is indicative of the increased costs which may be met. The experience of foreign nations with substitutes for oil has shown that even if these are acceptable, their cost is all but prohibitive.

5. Public Interest in Price Stabilization. While the avowed object of regulation of production of coal and oil has been their conservation, there is no doubt that one of its most important objectives has been to stabilize prices at a point which will cover reasonable costs of production. Does the public have an interest in such stabilization? Unless prices are regulated closely, stabilization often means high prices, and is almost certain to result in prices higher than the public has paid prior to it.

Some case, however, can be made for price stabilization as being in the public interest. If it is wise to conserve natural resources, then a stabilized price, if higher than prices under the free action of competition, will cause some curtailment of consumption and perhaps reduce some wasteful use of natural resources. It may also cause some savings of capital in businesses using oil or coal, through guarding against capital's being embarked in an enterprise on the assumption that prices of fuel or raw materials will be maintained at the low level existing at a certain time, when ultimately such prices must rise. If stabilization of prices will help in the stabilization of conditions within an industry, the hardships upon labor caused by unemployment in periods of shutdown may also be reduced.

But it should be remembered that price stabilization can be harmful to the consumer. Stabilized prices are almost invariably higher prices. If the latter are not necessary for conservation of natural resources, capital, or human resources, the public is being deprived of some of its ability to consume. If they are instituted to protect inefficient producers who ought to be driven from the field, then the public must pay for this shield over inefficiency by getting less for its purchasing power.

In protecting the genuine public interest through regulating production and prices, it is important to note the causes and objectives of control. If regulation is necessary, the objective should still be to obtain the most of a product at the lowest cost over a long period of time. This requires that the interests of consumers be represented along with those of producers. However, in the case of both oil and coal, although more particularly in the latter instance, the chief pressure from regulation has come from the producing groups. Altogether too often the pleas for production restriction and price stabilization come from those producers who, like farmers, find prices to be too low to get their "fair" share of the national income.

6. PUBLIC VERSUS PRIVATE CONTROLS. If competition is to be abandoned in any field of enterprise, the control of production and price should not be left to private initiative. The Standard Oil monopoly of the nineteenth and early twentieth centuries was probably an effective means for obtaining a degree of conservation in the production of oil. But it placed the public in the position of paying tribute to monopoly profits. Control of production and prices should be the responsibility of government; and government agencies should see it as their duty to conserve resources, and not to conserve a specious right to business existence for any particular inefficient producer.

B. REGULATION OF THE COAL INDUSTRY

Positive government regulation of the coal industry has been limited almost entirely to bituminous coal. This has been due to the fact that the problems discussed above do not exist to the same degree in the anthracite industry. Anthracite is limited almost entirely to a small area in Pennsylvania. If special economic regulation were necessary, the proper agency of control would be the government of that state. The industry, however, has been one in which instability in price or production seldom exists. The fewness of sellers and their tendency to follow the leader in setting prices act pretty much as a regulator of production. Since anthracite is competitive to bituminous coal and other fuels, many persons have felt that the type of self-regulation in existence in the industry is subject to adequate restraint for protection of the public. While this restraint may actually be inadequate and government regulation might be advisable, significant regulation has not come.

Regulation of the anthracite industry has been so unimportant that we may only refer to it here, and devote our attention to the bituminous coal industry. The federal wartime control of coal extended to the anthracite business. The anthracite industry also set up a code of fair competition under the National Industrial Recovery Act. The federal government has also exerted some regulatory effect through the anti-trust suits of the Department of Justice, by which breakup of control of a fairly large percentage of anthracite output by several prominent companies was attempted.[1] These attempts at regulation have not served in any material way to interfere with the informal self-regulation of the industry.

1. CONTROL OF BITUMINOUS COAL BEFORE 1933. The control of the bituminous coal industry before 1933 can be divided between a short experience with regulation during the first World War and sporadic attempts to regulate since its close. Regulation of coal production, distribution, and storage was provided by the Food and Fuel Control Act of 1917. The principal controls provided by the act and put into effect by the President and the Fuel Adminis-

[1] See *U.S. v. Reading Co.*, 253 U.S. 57 (1920), and *U.S. v. Lehigh Valley R.R. Co.*, 254 U.S. 270 (1920).

trator under the law were those of prices and of distribution. The President was empowered to set prices which would be fair and would encourage efficient production, but these were to insure to producers their cost of production, including operating expenses, maintenance, depreciation, and depletion, plus a just and reasonable profit. In the sphere of distribution, the President was authorized to make such rules and requisition such facilities as he found to be necessary in prosecuting the war.

Under the powers given to him the President fixed maximum prices and wholesalers' and retailers' margins of profits. The prices fixed were based upon the estimated cost of production necessary to obtain maximum production in each mining area, after eliminating from consideration the highest-cost producers. In regulating distribution, the President apportioned coal among the states in accordance with previous consumption, as modified by definite wartime requirements. Control of shipments was effected at starting and destination points, the movement of cars being expedited by co-operation with the wartime railroad administration. Another important function of the wartime administration by the government was the arbitration of labor disputes.

When the war ended in 1918, the program of federal regulation was abandoned. The fall in demand for coal after the Armistice caused prices to drop well below the maxima set by the government. The maximum prices so fixed were suspended early in 1919, and on June 30, 1919, the Fuel Administration ceased to function for lack of congressional appropriations.

Recurring crises after the termination of wartime control of the coal industry caused the government temporarily to exercise regulatory influence on several occasions. A strike of miners in November, 1919, led to the recall of the Federal Fuel Administrator to reapply the wartime regulatory measures. With the appointment of the United States Bituminous Coal Commission in December, 1919, to arbitrate the dispute, and the Commission's report the following March, regulation by the Fuel Administrator again ceased. The Coal Commission accepted the miners' claims for wage increases, but refused their demand for shorter hours.

The refusal of operators to renew the 1920 agreement with the miners in 1922 led to a general strike tying up 73 per cent of the industry's productive capacity. This strike was made even more severe by stoppage of work by the railroad shopmen at the same time. Until the strikes were settled in August, 1922, the federal government again instituted control over the price and distribution of coal, employing powers over car distribution which had been granted to the Interstate Commerce Commission by the Transportation Act of 1920. Some measure of control was extended after the strike by the passage of the Federal Fuel Distributor Act of 1922. This law, limited to one year, or the duration of the coal emergency, authorized a Federal Fuel Distributor to make an equitable distribution of the available supply of coal and to ascertain

facts concerning its production, transportation, and sale. The Distributor co-operated with the Interstate Commerce Commission in speeding the transportation of coal after the strike, and entered into informal agreements with operators fixing maximum prices. By the end of 1922, regulation by the Fuel Distributor had practically been abandoned.

Following the coal strike of 1922, the government also passed legislation establishing an investigatory commission, the United States Coal Commission, to look into the organization, costs, prices, and labor conditions of the industry and make recommendations for government treatment. The Commission reported to the President late in 1923 and its report was published in 1925.[1] The Commission proposed that both the bituminous coal and anthracite industries be placed under a degree of regulation through the power of the government over interstate commerce. It recommended that a coal division be established in the Interstate Commerce Commission with power to control distribution in times of emergencies and to gather current information as to costs and profits, quality of coal, and labor conditions. The Commission also recommended that all buyers and shippers of coal be licensed by the federal government, and it suggested modification of railway car-service rules to allow consideration, in times of shortage, of the ability of producers to sell coal, as well as to produce and load it. The Commission did not recommend compulsory arbitration of labor disputes, but did suggest that full investigation of the causes of any disputes be made and reported upon by the government. It is significant, too, that the Commission refused to recommend nationalization of mines, compulsory incorporation of unions, or price-fixing by the government.

The Coal Commission's regulations were forgotten as the fuel emergencies passed and prices of coal declined after 1923. Both the operators and the miners' unions opposed any system of special regulation for the industry. Further governmental treatment did not come until 1933. The experience of the government before that time, and especially before 1923, is interesting in view of the reluctance of individuals to sponsor enlargement of the sphere of regulation. Crises were treated as they arose. Moreover, the emphasis of regulation during this earlier period was upon the removal of causes leading to disruption of production and upon guarding against imposition of too high prices. As already noted, the problems facing the industry after 1923, and those which have been dealt with in 1933 and since, were decidedly different from those existing earlier.

2. Private Control Through the Joint Selling Agency. One important experiment by coal operators after 1929 represents an exceedingly interesting example of industrial self-regulation. With a view to stabilizing the coal industry, one hundred and thirty-seven producers of bituminous coal in Virginia, West Virginia, Kentucky, and Tennessee joined in a voluntary asso-

[1] *Report of the U.S. Coal Commission*, Sen. Doc. 195, 68th Cong., 2d Sess. (1925).

ciation pledged to maintain prices and orderly marketing of coal. The agency was created as an exclusive sales agent for these producers of 12 per cent of the bituminous coal mined east of the Mississippi River and was called Appalachian Coals, Incorporated. The company, owned by the producers in proportion to their normal production, was authorized to sell their coal at the best price obtainable and to collect a 10 per cent commission. If all the coal offered for sale could not be sold at prices believed by the agency to be fair, the orders were apportioned among producers according to a specified agreement.

The federal government attacked the selling agency as being in violation of the anti-trust laws, since it eliminated competition between the producing members and had enough power to control prices in certain consuming markets. On appeal to the United States Supreme Court, Appalachian Coals, Incorporated, was held not to be violating the anti-trust laws.[1] The Court pointed out that the "deplorable" condition of the coal industry and the agency's intention merely of bringing a measure of order out of chaos demonstrated that the plan was not designed to restrain trade unreasonably. It found that competition still prevailed in the industry and that the selling agency did not dominate prices. It declared that co-operative action by producers to put an end to various injurious practices was consonant with the public interest, and did not fall under the class of undue restraints banned by the anti-trust laws.

The co-operative program of Appalachian Coals, Incorporated, was in the process of being widely duplicated by other groups of bituminous coal operators when the new government programs beginning in 1933 brought these efforts to an end. While the legislation enacted in 1933 and afterward does not preclude the use of co-operative selling devices, it eliminates many of the motives for forming such organizations.

3. Coal Regulation Under the Recovery Act, 1933–1935. With the passage of the National Industrial Recovery Act in 1933, code regulation was provided for bituminous coal as it was for other industries. This experience with governmentally supervised self-regulation is rather more important in the case of bituminous coal than with many other industries, since the regulations undertaken by the government after the end of the Recovery Act re-created many features of the original code. The Recovery Act code for bituminous coal was approved in September, 1933, and with amendments remained in force until the law was invalidated in May, 1935, although its observance collapsed before that time.

For purposes of administration, the industry was divided into five geographical divisions, each with a deputy code administrator. The principal regulatory provisions had to do with prices, marketing practices, and labor conditions. The code allowed trade associations of producers or the code authorities to set minimum prices for each producing area, taking into consid-

[1] *Appalachian Coals, Inc. v. U.S.*, 288 U.S. 344 (1933).

eration the different classification of coals. When approved by the code administrator, the prices so fixed became "fair prices," and any departure from them became an "unfair trade practice," punishable by law. Before these prices might be approved, however, the law required that they reflect the consumer needs and requirements, as well as the costs of producers and the competition with other fuels.

Other practices made unfair and unlawful included secret price concessions, rebates, unearned price discounts, price or service discriminations, use of gifts or bribes to obtain business, misrepresentation of facts concerning coal, unauthorized use of a competitor's trade-mark, trade-name, or slogan, and inducing or attempting to induce a breach of contract between a competitor and his customer. It is interesting that all the unfair trade practices, except those leading to price-fixing, were similar to those which the Federal Trade Commission had previously found to be unlawful.

The labor provisions of the code at first established a forty-hour week, but were amended in 1934 to require a maximum week of thirty-five hours. Fixing of minimum wages was provided by the code, and administrators approved minimum wages which varied with each district. These wage rates varied from a low of $2.40 per day for unskilled labor in one southern district to $5.63 per day for skilled labor in a northern district.[1] As in the case of all codes, labor in the coal industry was guaranteed the right to organize for collective bargaining free from any interference by management. The code also forbade employment of persons below sixteen years of age "in or about" mines.

The coal code ceased to be operative in 1935 when the United States Supreme Court invalidated the National Recovery Act as an unconstitutional attempt to regulate local matters not in interstate commerce.[2] The pressure for the benefits of the coal code continued, however, and study of means to enforce its provisions had already been under way before the Supreme Court caused the system of code regulation to topple.[3] Although the Recovery Act code had shown the difficulties existing in securing uniform compliance in a disorganized industry, the plan of stabilizing prices and competitive behavior had a wide appeal to operators, and the wage, hour, and collective bargaining benefits had convinced labor of the desirability of special federal treatment of the industry. The coal code had increased the basic knowledge of costs and marketing, and had so implanted a desire for co-operation in the persons directly interested that the industry was ready for new control legislation in 1935.

4. The Bituminous Coal Conservation Act of 1935. The breakdown of

[1] National Recovery Administration, *Codes of Fair Competition*, vol. 1, pp. 327, 336–37 (1933). For other provisions of the code, see this source, and also United States Department of the Interior, Consumers' Counsel, *Federal Regulation of Industry*, Unit I A, pp. 15–25 (1939).

[2] *Schechter Poultry Corp. v. U.S.*, 295 U.S. 495 (1935).

[3] See *Hearings on Stabilization of the Bituminous Coal Mining Industry*, Senate Bill No. 1417, 74th Cong., 1st Sess. (1935).

code regulation even before the invalidation of the Recovery Act by the Supreme Court had brought back price-cutting and wage reductions in the coal industry, with consequent distress to operators and laborers in an industry struggling to overcome a severe economic depression. Perhaps even more pressure for new regulation came from labor than from operators, since it had benefited from the labor provisions of the codes and had come to realize that the maintenance of wage rates depended upon the ability of operators to receive an adequate price for coal. In addition, proponents of coal regulation insisted that the conservation of this exhaustible natural resource should be safeguarded by appropriate government action.

The result of this pressure for new legislation was the Bituminous Coal Conservation Act of 1935, one of the first of many measures by which the New Deal government has been able to restore the essence and advantages of the defunct Recovery Act. The act established the National Bituminous Coal Commission with wide powers to regulate the coal industry. The law, however, planned to obtain this regulation by a system of supervised district boards in twenty-three districts, acting under a coal code. To obtain compliance with the code, the law provided for a tax of 15 per cent on the sale price of all bituminous coal at the mine, but allowed a drawback of 90 per cent of this tax to all producers who complied with the code.

The duties of the Bituminous Coal Commission were to require reports and information from district boards and producers; to approve or modify minimum prices fixed by district boards; to establish maximum prices when necessary to protect consumers; to investigate conservation of coal resources, safety in mines, rehabilitation of unemployed miners, costs of distribution, and need for production control; to change boundaries of producing districts; and to formulate the bituminous coal code. The duties of the twenty-three district boards, made up of representatives of producers and employees, were to establish minimum prices; to collect information and assist in administration of the law; to set up district statistical bureaus; and to adopt by-laws and rules of procedure subject to approval of the Coal Commission. To aid in safeguarding the interests of consumers, the act also established a Consumer's Counsel in the Department of the Interior, with power to investigate and complain of actions detrimental to consumers' interests.

The price-fixing provisions of the 1935 act required that minimum prices fixed by the district boards and approved by the Commission should take into account a weighted average of costs in each district, these to include labor, supplies, power, taxes, insurance, royalties, depreciation, depletion, dues, and assessments of producers' associations and district boards, and reasonable costs of selling and administration. Classification of coals and location of mines in regard to selling markets were also to be considered. In approving the minimum prices of each district board, the Commission was authorized to give weight to the co-ordination of minimum prices by different districts selling in

a common consuming area, so that the prices would not be prejudicial to producers in a given district.

As in the Recovery Act code, various unfair trade practices were forbidden and labor was granted rights of organization without interference. Employees were permitted by the law to choose their own check-weigh-men. In addition, the act provided that wage agreements, negotiated in any district or group of districts between employer representatives of more than two thirds of the annual tonnage of a district or group of districts and representatives of a majority of the mine workers in such area, should be binding upon all code members in the area covered by the agreement. Agreements for fixing maximum daily and weekly hours of work, made in the same way, were also to be accepted by code members. These labor provisions were placed under a special Bituminous Coal Labor Board.

The 1935 act also authorized the establishment of combinations of producers through joint marketing agencies. Such agencies, if approved by the Coal Commission, were to be exempt from application of the anti-trust laws.

The Bituminous Coal Conservation Act of 1935 is an interesting example of code regulation of an industry under governmental supervision. The labor provisions are particularly worth noting, since they give a strong union the power to bind employers of non-union workers to conditions set up by the union under the process of collective bargaining. Yet the act seems to be entirely logical in tying price-fixing and wage-fixing in the same piece of legislation. If labor was to obtain better wages and working conditions in the coal industry, the economically disorganized status of the marketing of coal had to be remedied.

What this particular law would have accomplished is difficult to tell, since the United States Supreme Court found it to be unconstitutional less than a year after it was passed. Even during the time the law was technically in effect, its practical operation was hamstrung by injunctions and the general belief that it was unconstitutional. In 1936, the Supreme Court found that the Coal Conservation Act attempted to regulate the wages and hours of labor in a business which was not in interstate commerce.[1] Moreover, the Court declined to find the regulation of labor directly related to the protection of the flow of interstate commerce. The price-fixing provisions of the act were found not to be separable from the labor provisions, and without answering the question of their constitutionality, the Court invalidated them also. It quickly disposed of the possibility of the law's being constitutional under the taxing power, pointing out that the tax was really for penalty purposes, rather than for revenue.

5. Bituminous Coal Act of 1937. Undaunted by the failure of earlier legislation to survive constitutionality, and encouraged by the change in temper of the Supreme Court after the Carter Case of 1935, miners and operators again succeeded in having special legislation passed by Congress to stabilize the

[1] *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936).

chaotic condition of the coal industry. The Bituminous Coal Act of 1937 was passed by Congress and provided for four years, before extended in 1941, a system of regulation similar to that of the Recovery Act codes and the control under the 1935 law, but seeking to omit the legal defects of the earlier plans.

On the whole, the new law follows the 1935 act. Provisions for enforcing minimum wages and maximum hours of labor were omitted, and coal labor was given only the rights to collective bargaining guaranteed by the National Labor Relations Act. An independent National Bituminous Coal Commission was set up, although it was transferred to the Department of the Interior as a division of that department in 1939. District boards were established with authority to institute minimum prices and to assist in enforcement of the law. The tax and drawback provisions of the 1935 act were abolished, and in their place is a straight 19½ per cent tax on the sale price of coal at the mine, levied on all producers who do *not* obtain and maintain code membership. Intrastate transactions in coal are exempt from the act unless it can be shown that they directly affect interstate commerce.

The power of the Coal Commission, now the Coal Division, was somewhat enlarged by the law. It was given the power to prescribe minimum and maximum prices and marketing rules for code members, although district boards were permitted to propose changes. In the earlier act the district boards set the minimum prices and made the rules, subject to the Commission's approval. The remainder of the provisions are practically identical to those of the earlier act, including such matters as the formula to be followed in fixing prices, the gathering of cost and other information, the list of unfair methods of competition, and the establishment of co-operative marketing agencies.

Unlike the previous attempts to regulate the coal industry since 1933, the United States Supreme Court upheld the 1937 act in 1940.[1] Declaring that it applied only to sales or transactions in or directly affecting interstate commerce, the Court held it to be within the competence of Congress under the commerce clause. In view of the need for protection of the demoralized trade of the coal business, the Court pointed out that price regulation did not infringe the due-process clause of the Fifth Amendment, since control over prices was held to be a means available to government in its encouragement of the welfare of the people. The Court refused to make a legal distinction between the task of fixing prices in the coal industry and in industries, like the railroads, long regarded as affected with a public interest.

Practically all of the commercial bituminous coal mined in the United States is represented by the operations of the 12,300 code members.[2] These members have been divided into twenty-three geographical groups for administration of the law, although the Coal Division has created ten coal-producing areas for price-fixing. Except for a brief period between December, 1937, and Febru-

[1] *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940).

[2] *Ann. Rep. Secretary of the Interior* (1940), p. 459.

ary, 1938, when the minimum prices fixed by the Commission were hampered by court injunctions which caused it to rescind its price orders, no minimum prices were fixed until April, 1940. At that time the Coal Division announced its findings of average mine income and cost per ton in the ten areas, and established minimum prices on the basis of these data. The data were obtained after detailed study of cost records, invoices, tonnage, freight rates, and marketing areas. They required analysis of hundreds of thousands of records of various kinds pertaining to coal production and marketing. The weighted average costs varied from $1.485 per ton in Montana to $3.608 in Arkansas and part of Oklahoma. The prices fixed covered thousands of kinds of coal from different areas and mines, and ranged from 10 cents per ton for an inferior grade of coal dust produced in the midwest to $4.80 per ton for a high grade of lump coal produced by certain mines with a high production cost.[1]

The fixing of minimum coal prices is a tremendous task. Prices must be fixed for each grade of coal produced at each mine of the members of the code. Deviations from prices must be allowed at the mines to reflect differences in transportation costs and competition of the producer with coals of competitors and other fuels in the consumption area. The prices fixed in April of 1940 and put into effect in October are not to be considered final. Every producer is given the right to a hearing with a view to change if any price seems to place him at a disadvantage. Price changes must be allowed whenever marketing conditions vary, as they do from month to month, and with changes in competitive prices of other fuels.

The Coal Division has made progress with other portions of the coal control law. A few marketing agencies have been approved. Although the number of such agencies has not been large, they have represented producers of about one fourth of the national output. The largest of these marketing agencies has been Appalachian Coals, Incorporated, revivified after the demise of the National Recovery Act. At the time prices were set in 1940, there had been no complaints of unfair methods of competition filed with the Division. While this may seem curious in the light of the well-known existence of such practices in the past, it may be explained by noting that the coal industry is interested primarily in price regulation, and only the unfair practices arising from price discrimination will probably cause complaint. These practices could not, of course, arise until prices had been fixed.[2]

By far the largest portion of the Coal Division's work has been in the computation of costs and fixing of prices. The Division and the Consumers' Counsel have, however, engaged in a multiplicity of other tasks. They have appeared before the Interstate Commerce Commission in cases affecting railroad rates on

[1] *New York Times*, April 14, 1940, p. 8. These prices actually did not go into effect until October, 1940.

[2] For discussion of this point, see the Attorney General's Committee on Administrative Procedure, *Bituminous Coal Division*, Monograph No. 23, vol. 2, p. 95 (May, 1940).

coal. The Coal Division has appeared before the Federal Power Commission in opposing extension of natural-gas pipe lines, and before the Department of State in opposing importation of Venezuelan fuel oil. The Consumers' Counsel has intervened in hearings of the Division to safeguard rights of consumers, and has undertaken study and publicity to aid consumers in their purchase and utilization of coal.

6. Coal Regulation: Conclusions. After years of experimentation, it seems probable that regulation of the coal industry will continue to follow the general pattern of the valid Bituminous Coal Act of 1937. Because the law was not held to be constitutional until 1940 and development of regulatory technique takes a long time in an industry as complex as the coal business, it is far too early to assess the work of the Coal Division. Except for the railroad industry and the motor-carrier industry, the job of regulating the pricing and marketing of bituminous coal is one of the most difficult and intricate tasks which a government agency has attempted. The depressed and disorganized status of the industry, the sharpness of competition, the thousands of producers, and the hundreds of thousands of prices to be considered make such regulation exceedingly arduous. It will be interesting to watch the success of the attempted control.

Even though the 1937 law has not been adopted as a permanent means of regulation, its objectives will almost certainly continue to be a government function. These are to bring orderly marketing of coal at prices which will cover average mining cost, including a fair wage to labor. The objectives are similar to those employed in transport regulation. They differ somewhat from the aims of regulation of local public utilities in that these businesses are treated more individually and the law allows them to try for prices which will cover all costs of the particular producing plant. The objectives are similar to those noted in agriculture, except that in the latter, in place of an attempt to cover average costs of production, there is the desire to obtain a "fair share" of the national income for farmers.

The means of attaining objectives of coal regulation may also be compared to other kinds of regulation. The importance of supervised self-regulation is somewhat matched by the quota and marketing agreement programs of agricultural control. But the reliance upon price regulation rather than production control is in rather sharp contrast with agriculture, and compares more favorably with transport and other public-utility regulation. The methods of control in the coal industry may well undergo radical change. Price regulation may be found inadequate to stabilize the industry and the government may be obliged to restrict production. The part played in regulation by miners and producers, through the district boards, may also be modified, with resultant increased powers in the hands of the federal administrative agency. The trend in this direction has been notable in the changes included in the Act of 1937 as compared with that of 1935.

From an economic point of view, much that was said of agricultural regulation may be applied to regulation of coal. Stable conditions in an industry may be advantageous and necessary to the efficient functioning of the economic system. But the control of prices designed to cover the costs of production of even the average producer may tend to shield inefficient production. Moreover, if the prices fixed are not high enough to cover costs of most producers, there will be strong pressure to have them raised. From a purely economic point of view, the rise in prices means a higher cost of coal to the consumer and a possibility that this cost will not be as low as would be possible under the incentive to efficiency furnished by competition.

Another economic aspect of the coal regulation plan has to do with the effectiveness of the means in accomplishing the objectives. Price control may increase the profitable volume of production and place individual operators in a position of attempting to find a market. If the total production cannot be marketed at the prices fixed by the government, the strain may be too great for the regulatory program to stand, and violations of the price provisions may become so numerous as to endanger the enforcement of the law. In such an event, the law will probably be forced to adopt means for control of production.

The economic effectiveness of the regulation may also be questioned in terms of thoroughness. The price of coal at the mine is only a part of the price at the consuming points, and often transportation and distribution costs are far more than the mine cost. The law does not attempt to regulate retail prices, nor can it do much to control transportation costs. Moreover, regulation of prices must bend to the elasticity of demand, especially as this is affected by the prices of substitute fuel and power resources.

From the point of view of the public, the regulation of coal raises questions similar to those discussed in the previous chapter on agriculture. As for the conservation aspects of the legislation, rather little can be said in favor of it. In the first place, the bituminous coal industry is not one in which conservation is a very pressing problem, since the known resources are adequate for centuries. Furthermore, the law does not seem to have any effects which will lead producers to modify their mining methods. It will still be most profitable to mine the best veins first, and the slightly higher price following will hardly make profitable a more thorough cleaning up of a given mining area. Even if regulation should retard the rate of consumption, it might result in increased consumption of such fuels as oil, of which the known reserves are far less plentiful.

If the stabilization of prices at higher levels enables the miners to have more steady employment at better wages, the law has some merit from a public point of view. Mine labor has long been subject to a standard of living among the lowest in the nation. The public has an obvious interest in seeing this standard improved. Nevertheless, if prices are raised, the elastic demand will probably cause a large fall in consumption, with consequent effect upon mine employment. If mine wages are raised, as they have been, and if they maintain their

trend upward, the result may be to encourage further mechanization of mining with loss of employment to miners. Consumption must be increased and productive efficiency heightened if miners are to receive increased employment at higher wages.

The placing of bituminous coal under government regulation means the removal of one more industry from the field of price competition. There is adequate precedent for this event, both in governmental action and in private business policy. But, wherever and whenever it occurs, the consuming public is deprived of one of its most important safeguards against high prices and reduced consumption. Perhaps government regulatory agencies can encourage efficient production at reasonable prices; perhaps competition of coal with other fuels will serve to protect the consumer. Nevertheless, the problem must still recognize the necessity for efficient production and low prices, and their effects on the material welfare of society.

C. REGULATION OF THE OIL INDUSTRY

The earlier discussion of the economic problems of the oil industry and the social interest in it has indicated the need for some kind of government control. This has been developing over a period of many years, although it has only begun to take definite shape in the last two or three decades. Practically all the regulation has been aimed at the production and marketing of crude oil. On occasion, states have attempted to regulate the retail price of oil products, notably gasoline,[1] and the federal government placed regulation of oil pipe lines under the Interstate Commerce Commission in 1906. Since pipe-line regulation has been discussed in an earlier chapter [2] and is only indirectly related to the problem of regulation of the extraction of oil, the present discussion will be limited to control over the production and marketing of crude oil.

1. GOVERNMENT CONTROL BEFORE 1933.[3] The earliest statutes with any effect upon the production of oil were the state "anti-waste" laws. For approximately three decades following 1880 most of the states with any significant production of oil and gas made it unlawful to waste oil and gas in production. These laws did not attempt to restrict the production for marketing purposes, but merely forbade allowing gas and oil to escape into the air for more than a few days, leaving wells unplugged upon abandonment so that surface water would filter in, or permitting other types of obvious waste. These early laws were often poorly enforced, had various loopholes, such as not applying to waste of one product when the well was drilled for the other, and had virtually no effect upon stabilizing production of oil or gas. The laws were upheld by the courts, however, as being within the police powers of the states.[4]

[1] See *Williams v. Standard Oil Co.*, 278 U.S. 235 (1929). [2] See Chapter 11.

[3] This section is drawn in large part from Lyon, L. S., Abramson, V., and others, *op. cit.*, pp. 988–1008.

[4] See *Ohio Oil Co. v. Indiana*, 177 U.S. 190 (1900).

a. State production control. The earliest state control over production, as distinguished from mere waste, was undertaken by Oklahoma. Under laws passed in 1915, that state provided that oil and gas should not be produced so as to result in "economic waste." Economic waste was defined as production in excess of reasonable market demands, or the pumping of oil when the price at the well was below actual value. The law authorized the Corporation Commission to administer it, and to determine the actual value of crude oil by taking the average retail price of oil products in the United States and subtracting therefrom the cost of marketing, transporting, and refining the crude oil. When the Commission found that oil was being produced in the state so that such economic waste would be caused, it was empowered to prorate production among operators in proportion to the potential production of their individual wells.

Although the Oklahoma Corporation Commission issued some curtailment orders soon after the passage of this legislation, they were applied to limited fields and were generally promulgated in accordance with recommendations of producers. Because these producers were in competition with production from other states, especially Texas, the proration law of Oklahoma can hardly be regarded as effective until after 1930, when Texas production control was accomplished. The early Oklahoma law is interesting, however, in that it represented the first real attempt to regulate oil production in relation to price and the first application of proration of well capacity as the basis for production control. Such type of control has continued to be the accepted method since that time.

Texas was the next important oil-producing state to adopt a broader type of oil production law by enacting comprehensive legislation in 1919. But while the Texas law provided for restriction of output whenever waste would result, it did not list low market price as one of the causes of physical waste. The Texas Railroad Commission was given administration of the statute and issued many regulations concerning drilling methods, gathering of well data, well-spacing, and other matters related to conservation. Not until 1929, however, did the Commission put into effect proration of production, and it was not made state-wide until 1930. Adoption of this expedient followed discovery of new fields in Texas with resultant glut of the crude oil market. So ineffective were the devices of proration, and so much opposition to proration came from local interests fearing discrimination and curtailment of individual profits, that the restriction of production had little influence in stopping the rapid and large production of Texas oil.

In 1932 the Texas legislature finally enacted regulation of oil production based upon market demand and market prices, similar to the earlier Oklahoma legislation. The proration measures of the Texas Railroad Commission following 1932 have varied from a flat per-well basis to a percentage of potential capacity to an absolute shutdown, on an emergency basis, of certain wells.

The Commission has also endeavored to meet the problem of excessive drilling in certain areas by modifying its proration allowances by the number of wells drilled in given acreages.

Other states have passed laws affecting oil and gas production. Except for a Louisiana law which was not particularly well enforced, these other state laws, at least prior to 1933, did not go very far in actual limitation of production. Oil proration was provided for in Kansas in 1931 and in Mississippi in 1932. California passed a proration law in 1931, but repealed it in 1932. Other legislation has come since 1933.

The state laws passed before 1933 represent a rather halting development of control over oil production. Only Oklahoma can be said to have introduced anything like real restriction, beyond cases of obvious waste, before 1932, when the Texas regulation providing for co-ordination of production with market demand was passed. The formal adoption of production restriction by Louisiana in 1920, 1924, and 1926 apparently had little effect upon the actual production practices. This lack of uniform regulation made it difficult for the state authorities in Oklahoma and Texas to secure compliance with the law, and in Texas, especially, the opposition of oil producers virtually negatived production control before 1933.

The restriction of production according to the Oklahoma pattern has been justified in the interests of conservation. The principal objective has actually appeared to be the stabilization of the industry. Proration was adopted as a means of reducing market supply until price should make for profitable production. The principal proponents of the control legislation in Oklahoma were the independent producers who often found themselves at the mercy of oligopolistic buyers of oil. Moreover, in working out the plans for quotas and the determination of fair demand, state production-control officials have shown a tendency to follow suggestions of the producing group. Conservative methods of drilling and pumping have generally given way to the desire to stabilize market prices. While the curtailment of production to obtain profitable prices has implications of conservation, the primary motive seems to be economic stabilization of the industry.[1]

The validity of proration under the Oklahoma law was upheld by the United States Supreme Court in 1932. In a case arising from the proration orders of the Corporation Commission, the Court declared that the police power of the state included the power to conserve natural resources for the general welfare.[2] It contended that none of the Commission's orders were made for the purposes of price-fixing or had had that effect, and curiously stated that all the Commission had done was to limit production to the market demand. In view of the decision in the recent coal-regulation case, mentioned above,[3] the

[1] For an excellent discussion of these points, see Watkins, M. W., *Oil: Stabilization or Conservation?* (New York: Harper and Brothers, 1937), chaps. IV, IX, and XIV.

[2] *Champlin Ref. Co. v. Corp. Com. of Oklahoma*, 286 U.S. 210 (1932).

[3] See *supra*, p. 650.

attempt to distinguish the objectives of proration between fixing of prices and meeting the market demand appears no longer to be significant.

b. The federal government and oil production before 1933. Under the United States Fuel Administration and other agencies, the federal government exercised some control over the production of oil as early as the first World War. Federal legislation has also been enacted since 1920 to supervise production in the interest of conservation on public lands. Although output on public lands has been a very small part of total output, the practices employed by the government on them have served to set an example for private producers. Moreover, an important aspect of the advisory work of the federal government has been the publication of suggested production quotas from time to time by the Bureau of Mines. Owing to the fear that oil reserves were declining and oil prices were too low, the government in 1924 created the Federal Oil Conservation Board, consisting of the Secretaries of Interior, War, and Navy, to examine means for obtaining stabilization of the industry and conservation of this valuable resource. As prices sank to low levels and the leaders of the industry became convinced of the need for legislation to conserve petroleum, the American Petroleum Institute, a trade association of oil producers and refiners, asked the Oil Conservation Board in 1929 to help limit production to the 1928 level. The Board recommended a program of federal and state legislation to restrict production, including voluntary co-operation by producers and exemption of restriction agreements from the anti-trust laws. It also recommended a system of state proration regulation, made effective by an interstate compact between interested state governments.

2. Industry Self-Regulation Before 1933. Government control of petroleum production before 1933 was both preceded and supplemented by occasional attempts of operators to control production through co-operation. In the period following the World War, when oil production increased rapidly and prices fell, there were many local agreements by producers to cut production until prices became more satisfactory. Producers have often met in important oil-producing states and agreed to reduce output voluntarily. The American Petroleum Institute has impressed upon its members the advisability of production restriction, and has received statistical aid as to the wise amount of production from the advisory quotas published by the Bureau of Mines.

In one state, California, a voluntary restriction program has been employed since 1929. Under state encouragement, a private organization, the Central Committee of California Oil Producers, has become a sort of code authority for production control. The Committee has selected an Oil Umpire who distributes production quotas to the various fields and oversees allotment of the quotas to individual operators. This control is not enforceable by law, but the pressure which can be placed upon recalcitrant producers by the major oil companies through their control over refineries and transportation companies, as well as the well-understood desirability of production control, has served to keep the voluntary restriction program in operation.

Production control by the industry itself has often broken down and has no led to restriction adequate to stabilize prices. But the existence of relatively few large producers and even fewer purchasers of oil has made this private regulation more effective than is generally realized. One of the greatest drawbacks to the co-operation of producers has been the danger of prosecution under the anti-trust laws.[1] Some states exempted private control agreements from their anti-trust laws before 1933, but co-operating producers had to be careful not to extend their restrictions far enough to affect interstate commerce materially.

3. CONTROL UNDER THE NATIONAL RECOVERY ACT, 1933–1935. The first positive program of federal regulation of oil production and prices came under the National Recovery Act of 1933. In addition to the general authority given industries to set up codes of fair competition with the effect of law when approved by the President, the Recovery Act specifically granted to the President the power to prohibit transportation in interstate and foreign commerce of petroleum produced or withdrawn from storage in opposition to any state law. Thus, the act set up two kinds of controls. One set could arise from a code of fair competition; the other was the authority of the federal government to enforce state production restrictions in interstate commerce. This latter type of control in practice, however, necessitated some uniformity in production laws by the states concerned, if the federal government was to have its desired power over interstate commerce in petroleum.

a. Production control under the code. The petroleum code provided for production control to balance the consumer demand for oil products. Estimates of this demand were made periodically and the allowable total output for the country was divided among the states, arrangements being made for allocation of quotas to each pool, lease, or well within the state. Withdrawal of oil from storage was also controlled, as was the production of gasoline in excess of certain quotas. Any departure from the allocated quota by a producer or refiner became an unfair trade practice, punishable by law.

The production controls were rather difficult to enforce and were of questionable value as conservation measures. Although prices rose after 1933, the increase followed abnormally low levels before the code regulation. The basis of allocating quotas on the productive capacity of each well tended to cause additional wells to be drilled so that producers could obtain larger quotas. This resulted in further increases in excess capacity and aggravated the production problem. The enlargement of capacity and the improvement of prices in 1933 encouraged evasion of the quota restrictions and impaired the effectiveness of the controls.

b. Price control under the code. The petroleum code included extensive provisions for control of prices. A definite relationship between gasoline prices and crude oil prices was provided for, with the requirement that minimum

[1] See *supra*, Chapter 19.

crude oil prices per barrel be equal to 18.5 times the price per gallon of gasoline of a particular grade. The President was also authorized to fix in detail minimum prices for oil and oil products during the first ninety days of the code. Thereafter, crude oil could not be sold below the cost of production, as determined by the code authority, and oil products could not be sold below average cost of production. The actual administration of the price provisions was largely delegated to an association of refiners who, in addition, were authorized to buy excess supplies of gasoline threatening stabilized prices and dispose of them in an orderly way.[1]

All departures from the price provisions of the law were held to be an unfair trade practice. However, owing to the intricacies of administering price regulation and the competitive situation in the industry, most of the effective price controls resulted from regulation of production and sales.[2]

c. Interstate commerce and state oil laws. The power of the President to prohibit interstate shipment of oil in excess of state proration quotas did not appear to have much effect. Most of the attention of the Secretary of the Interior, to whom authority to administer this provision was delegated, appears to have been taken up in attempts to keep output in the large East Texas field within state proration requirements. As will be noted presently, this attempt met with failure because of adverse opinion in the courts.

The Secretary of the Interior also encouraged uniform state oil production laws by calling a conference of state governors in 1934. The states concerned disagreed as to the extent of control deemed desirable and did not arrive at any agreement. The conference did serve to lay some groundwork for the more successful meeting the following year after the collapse of the federal oil control law.

d. Invalidation of the Recovery Act program. The provision of the National Recovery Act, by which the President was granted power to limit interstate commerce in oil produced above state quotas, was one of the first New Deal measures to be invalidated. In a case involving an East Texas refiner and a producer, the Supreme Court held in January, 1935, that the provision delegated unwarranted legislative power to the President.[3] It is interesting that in this case the Court did not take issue with the power of Congress to regulate interstate commerce in oil.

The remaining part of the oil-production program of the Recovery Act, of course, fell a few months later when the Supreme Court found that the code regulations invaded the powers of the states.[4]

4. Oil Regulation Since 1935. The regulation of petroleum production

[1] It is interesting that the combination of refiners to purchase "distress" oil continued after the end of the Recovery Act and caused the members to run afoul of the anti-trust laws. See *supra*, pp. 447–48.

[2] Burns, A. R., *op. cit.*, pp. 475–76.

[3] *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935).

[4] *Schechter Poultry Corp. v. U.S.*, 295 U.S. 495 (1935).

by the government did not cease with the decisions regarding the Recovery Act. If anything, the disorganization of the industry following the collapse of the Recovery Act program stimulated more effective regulation. This has proceeded in three ways: an increasing number of states have passed more potent production-control laws; a promising interstate compact has been worked out by most of the interested states; and the federal government has again entered the field by passing a law assisting the states in their control programs.

a. New state legislation. By 1933, restriction of oil production was written into the laws of Oklahoma, Texas, Louisiana, Kansas, and Mississippi. New Mexico enacted a proration law in 1935, and Arkansas and Michigan passed similar laws in 1939. Amendments setting up more adequate laws were also enacted in Oklahoma and Texas in 1935. This increase in administrative control leaves only a few states without such laws. Those states with laws accounted for more than 72 per cent of the 1938 total crude oil production in the United States and a much larger percentage of the mid-continent crude oil.[1] California, another important producing state, though producing a special grade of crude, had a law which left production control to the voluntary co-operation of producers. If California is included within the list of those states with proration laws of some kind or another, the result is that more than nine tenths of the country's oil production is under state control. Among the more important producing states without laws in 1940 were Wyoming, Illinois, and Pennsylvania.

The state laws in recent years show a tendency to emphasize the conservation aspects of regulation. The restriction of production for purposes of price stabilization and profitable operation is still very much in the fore, but other measures for efficient utilization of oil reserves have been required. In curtailing the flow of wells, some state authorities have attempted to work out a rate which will conserve reservoir energy and lead to higher total recoveries of oil from the pools. The laws and their administration have also met with better success in recent years in allocating withdrawals to producers out of the same pool, thereby reducing the competitive urge for one producer to pump as much oil as possible to get his share of a large underground pool. State laws still have not made as much progress as might be desired in reducing the incentive to drilling too many wells. Acreage limitations have been applied in some cases, but all too often reliance is upon restriction of output per well and the number of wells in each field is not generally effectively limited.

b. The Interstate Oil Compact. After several disappointing attempts, an agreement was reached between leading producing states in 1935 for co-operation in the regulation of oil production. This agreement took the form of an interstate compact which was ratified by Texas, Oklahoma, New Mexico, Kansas, Colorado, and Illinois. Congress enacted a resolution in 1935, approving the

[1] *Investigation of Concentration of Economic Power*, pt. 14, p. 7465 (1940).

compact for two years, and renewed the ratification for two-year periods in 1937 and 1939.

The purpose of this compact was ostensibly the conservation of gas and oil. Each state signing it promised to enact and administer laws controlling production in the interests of conservation and market stability. The members of the compact also agreed not to let "hot oil" — oil produced in excess of quotas — enter the commerce of their states. No joint action was taken to insure that each state would have the same kind of law or would co-ordinate its production requirements with the others, although this unity of control was understood informally to be an objective. To aid in the carrying out of the pact by investigating conservation devices and by making recommendations to the signatories for putting them into effect, the interstate compact set up the Interstate Oil Compact Commission.

One of the main tasks of the Oil Compact Commission has been to work out suggested quotas for each state in the compact. It has shown a tendency to take the United States Bureau of Mines data on forecast of demand for petroleum and use these as the basis of its quotas. The allocation of these quotas is a difficult task, for each state fears loss of revenue by being forced to forego a disproportionate share of its potential production.

The effectiveness of control by the interstate compact has been threatened by the fact that several important states are outside it, and also by the lack of co-operation by Illinois. This state had not, by 1940, passed an oil production control law. With the discovery of profitable oil fields in the state, increasing its production to about 10 per cent of the country's total in 1940, the lack of restriction has been endangering the entire control plan. Other important states outside the compact, like California, have been restricting output, although not necessarily to levels suggested by the Compact Commission.

The interstate compact has made some progress, however, in production control. Evidence to 1940 indicates that most states within it, as well as some outside, have co-operated to reduce the production of oil and to administer state laws more adequately. At certain times of excessive production and low prices, the compact states have even co-operated and led the way for non-co-operating states in temporarily closing wells to force down supplies. For example, in August, 1939, the governors of Texas, Oklahoma, New Mexico, Kansas, Arkansas, and Louisiana ordered wells to be shut down for two weeks.[1] These shutdowns were recommended to the state authorities by the Interstate Oil Compact Commission.

c. Federal assistance — the Connally Act of 1935. To assist the states in their proration control after the fall of the National Recovery Act, Congress enacted in 1935 the Connally "Hot Oil" Act. This law prohibits interstate and foreign commerce in oil produced in excess of state production quotas. To supervise interstate commerce in oil so that "hot oil" may not be shipped, the law

[1] *New York Times*, August 16, 1939, p. 33, and August 17, 1939, p. 29.

created a Federal Petroleum Agency and a Federal Tender Board. All shipments of oil in interstate commerce are registered with these agencies, thereby making it possible for the government to know whether the oil was produced in conformity with state production quotas. In view of the constitutionality of state proration measures and the undoubted power of Congress to police the channels of interstate commerce, the constitutionality of the Connally Act is hardly open to question.

5. Results of Regulation Since 1935. The success of production control under interstate compacts, state laws, and the Connally Act has not been as great as proponents of control had hoped. The average price of crude oil declined from $1.22 per barrel in 1937 to $1.02 in 1939 and 1940.[1] Except for 1938, average daily oil production has exceeded consumption estimates of the United States Bureau of Mines, and in 1940 the excess increased rapidly and crude oil prices showed evidence of breaking sharply. Texas is said to be the only state which maintained effective control over oil production in 1940, and even in that state there is some evidence of production and shipment of hot oil.[2] One of the most disturbing factors in production control has been the rapid increase of production in the Illinois field and the outright refusal of that state to co-operate in production control.

The reasons for the breakdown of production control have been the lack of co-operation by state governments and the apparent inability of the federal government to enforce the Connally Act. After all, federal regulation depends upon the establishment of legal allowable production by the states. Several states have not enforced such proration laws as they possess, and others, such as Illinois, have not even enacted legislation. The interstate compact device depends in the final analysis upon the voluntary action of the states. The federal government cannot act without such state legislation. Furthermore, up to 1941 the federal government has not made a very strenuous effort to police interstate shipments of oil, except in the East Texas field. Obviously, such inadequacies in control make it difficult for the present system to succeed.

6. Oil Regulation: Conclusions. A much better case can be made for regulation of oil production than can be made for the control either of coal or agricultural production. The necessity for conservation of natural resources is much greater in the case of oil than in the case of the other extractive industries in which the government has attempted to establish regulation. Oil reserves are admittedly fairly large, and new discoveries and new techniques have continually improved the outlook for the future. However, as compared to the replaceability of soil fertility and the existence of large coal reserves, oil re-

[1] These and following data are drawn from Gordon, J., "Why Oil Profits are Lagging," 20 *Barron's*, no. 13, p. 3 (March 25, 1940).

[2] One witness testified before the Temporary National Economic Committee in 1939 that over 104,000,000 barrels of hot oil were shipped out of the East Texas field, and that only 5,000,000 barrels of this were confiscated. See *Investigation of Concentration of Economic Power*, pt. 14, p. 7365 (1940).

serves are dangerously small. With oil so important to national defense and to peacetime operation of the economic system, no one can doubt the desirability of conservation of petroleum.

From an economic point of view, the effect of control of oil production upon the industry and upon the consumer is practically the same as in agriculture and coal. Effective reduction of supply must tend to increase prices. Increased prices are likely to make it possible for inefficient producers to stay in the field along with the efficient; moreover, they tend to make the problem of production control more difficult, simply because production becomes more profitable and the individual producer has a strong motive to pump all the oil he can.

Granting that conservation is desirable, and assuming that the present system of oil-production control can be made effective, is the system designed primarily for conservation or for price stabilization? Conservation is a justifiable ground, but price stabilization without real conservation tends to increase the profits of one segment of society's producers and is open to question from the point of view of the public. It has been said that the dominant motive for present production control is price stabilization, one expert claiming that the conservation element is exceedingly small.[1] Restriction of production has continued to be related to estimated market demand, which is based upon the amount which can be sold at prices regarded as satisfactory. Hence, any production restriction for conservation purposes is an incidental result and follows from the mere curtailment of output.

Conservation would involve either one or both of the following points of departure in production control. In the first place, production might be limited to the optimum rate of output for any individual well in any pool. This rate would depend upon the gas pressure and size of the pool and the number of wells. The number and spacing of wells in such a plan would be important considerations in obtaining the most efficient withdrawal of oil. A second type of conservation involves the restriction of oil production below the optimum rate, if necessary to save oil resources for future years. This limitation could apparently be accomplished by placing well production at a predetermined level, possibly below optimum, by restricting the number of wells drilled, and by not allowing the opening of new fields until such time as they might be needed.

At the present time, conservation practice does not go much beyond reduction of obvious waste and the desire by many authorities to restrict wells to optimum output and to stop the drilling of too many wells in a single field. Some state laws encourage these practices, but little evidence exists that they are actually put into effect. It may be that proration according to market demand accidentally results in reduction of output to most efficient long-run operation. In these cases, the result is largely incidental to the more important motive of price stabilization.

[1] See *Investigation of Concentration of Economic Power*, pt. 14, p. 7356–57 (1940).

Neither the problem of conservation nor that of price stabilization has been solved under the present system of production control. As has been pointed out, conservation has played a small part in present plans; furthermore, even these plans have not worked very well and have been in danger of a complete breakdown. In consequence of these developments, the question of additional governmental control has recently been becoming more pressing; for this new action, two general alternatives have been suggested.

Many individuals believe that the entire oil industry, including production, transportation, refining, and marketing, should be given a public-utility status. Oil products are highly necessary to our present economic system. The pipe lines are already common carriers subject to government regulation. The business of marketing oil products has probably developed excessively, with far too many outlets for profitableness. Competition in the production of crude oil, aggravated by the legal rule of capture, is undesirable in the interests of conservation and makes production control difficult. The inclusive regulation of output, price, and service of all branches of the industry, implied in calling oil a public utility, can find some strong justification in the conditions under which petroleum is produced and sold for ultimate consumption.

Another plan of regulation of the oil industry which has been recommended is to adopt a system of modified self-regulation under a code supervised by the federal government. The kind of control used for bituminous coal, with the probable addition of production restriction, has been suggested. Such a plan would undoubtedly be constitutional and, if adequately enforced and supervised by the government, would surely be far more satisfactory than past regulation has been. The government could accept advice from co-operating groups of operators, but it should be given the power to insist upon control measures properly adapted to conservation.

Enlarged federal control seems to be inevitable in the oil industry. The public interest in conservation, the desire of operators for more stable conditions, and the inability of individual states in handling the problem, even through the compact device, are of such character as to indicate this conclusion. If and when more effective control comes, however, it is to be hoped that the dominant emphasis will be upon conservation of oil resources and efficient production, rather than upon mere price stabilization designed to protect the profits of a group of producers. Control should allow the efficient to cover all their costs, including a fair return on capital, but it should not attempt to guarantee a fair share of the national income to the efficient and inefficient alike.

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Part Seven

REGULATION FOR LABOR

CHAPTER

26

REGULATION OF WAGES AND HOURS

LEGISLATION for the protection of laborers has been one of the earliest forms of government interference with business. Massachusetts and Connecticut enacted laws in 1842 limiting labor of children under twelve years to 10 hours per day in manufacturing establishments. Pennsylvania led with prohibition of child labor in manufacturing plants by a law in 1848 forbidding such labor to children under twelve. A 10-hour day for women was prescribed by legislation in New Hampshire in 1847. But the real development of labor legislation has belonged to the twentieth century.

While government has long had a part in the relations of workers and management, the acceleration in labor laws in recent years has made this rôle exceedingly important. Labor legislation is no longer based upon mere protection of workers' physical health and safety, but has become a means for protecting labor against economic risks and for supplementing its weakness in making a contract for work. Regulation for labor, then, is no longer social control with an incidental effect upon business, but a type of intervention which has become widespread control of business itself. Just as control over public utilities and business combinations is designed to protect the consumer from abuses of unbridled economic power, so regulation affecting workers has become a kind of regulation of business for the purpose of protecting labor or enhancing its economic and social position.

Every business man must reckon with the government in making a labor contract. He must take note of the hours for which he employs workers, the conditions under which they work, and the wages which they are paid. He must provide for their insurance against accidental injury, occupational disease, old age, and unemployment. And when he hires or discharges workers, or enters into a contract of any kind for the use of labor, he may have to take into account the existence and bargaining rights of an organization of workers.

Just as other incursions of government into business affairs have signalized a departure from *laissez-faire*, so government regulation for labor has involved a

deviation from the tenets of a system based upon free private enterprise. However, the United States lagged behind other economically advanced countries, at least until 1933, and has not had nearly as long experience with its labor regulation. The growth of this control has met with more resistance than most other forms of regulation. For one thing, the existence of a frontier in unexploited natural resources until about 1900 served to make the spirit of *laissez-faire* last longer in this country than in most others. Another factor is the existence of forty-eight states and the difficulty of getting uniform action in labor matters. Without such uniformity, individual states have often hesitated to pass labor laws which, by increasing costs, might place businesses within their boundaries at a disadvantage. A third factor has been the judicial interpretation of the Constitution by which interference in labor matters has been peculiarly regarded as deprivation of property rights, notably the freedom to contract, without due process of law.

A. PUBLIC INTEREST IN WAGES AND HOURS

In order for wage and hours regulations to have developed, the general public must have been aroused to the need for such control. Without such broad public interest, limitations would hardly have come, especially in the face of the tradition of freedom of contract.

1. PUBLIC INTEREST IN HOURS REGULATION. The earliest regulation of hours had to do with women and children. The most compelling basis of public interest is found in the health and moral aspects of the problem. It has been easy to convince the public that long hours worked by women and children are deleterious to their health. The effect of long hours and of night work upon moral tone has also been easily understood. As for men, the ill effects of long hours upon health and morals have not been so well established. However, in certain trades, such as mining, transportation, and a few other hazardous occupations, the limitation of hours has often been based upon safety, as well as health.

Public interest in shorter hours for men and women alike has been due to an increasing extent to considerations of good citizenship and economy. Long hours mean little time for leisure activities, for attention to home life, or for mental and physical betterment, and are consequently looked upon as a threat to a stable and intelligent citizenry. They have also been of doubtful economic justification. Since human beings are subject to fatigue, there is a limit to efficient working periods. The lesson that long hours do not pay has been brought home to many industrialists, notably since the World War. Numerous investigations have indicated that reduction of hours to 8 per day not only tends to increase hourly output but often increases daily output.[1]

[1] Commons, J. R., and Andrews, J. B., *Principles of Labor Legislation* (New York: Harper and Brothers, 4th rev. ed., 1936), pp. 87 ff. It might be noted that some studies of the increased

2. PUBLIC INTEREST IN WAGE REGULATION. The close relationship between health and safety and long hours is not so evident in wage regulation. As a result, laws requiring employers to pay a minimum wage have been slow to develop, the first such law being one applicable to women and passed by Massachusetts in 1912. But the motives which have prompted the public to demand minimum-wage laws have been similar to those which have resulted in other labor regulation more closely related to considerations of safety and health.

The evils of low wage payment are to be found in the need for a certain minimum of material means for subsistence on a level of health and decency. Low income may mean inability to have proper food, shelter, clothing, and medical attention. It may lead to immorality. It often means social instability, unhappiness, irritability, and the willingness to listen to and support any kind of social nostrum purporting to solve economic ills. The payment of wages below some accepted standard of social subsistence may well be fraught with such social evils that the community is justified in setting a minimum below which wages may not fall.

The fixing of minimum wages has sometimes rested upon other grounds. The lower-paid groups are likely to be the more unskilled and ignorant workers whose lack of bargaining power makes them easily exploited by an unscrupulous [1] employer. This situation, it is said, leads to inefficiency in production and slackness in adopting improved methods of production. Moreover, the lack of bargaining power of certain workers and their low wages tend to depress wages in general and thereby to extend the evils of economic insufficiency.

3. THE DEVELOPMENT OF HOURS AND WAGE REGULATION. Early regulation of hours for women and children has already been noted. Following the lead of Massachusetts and Connecticut in 1842, other states passed such laws, until by the time of the Civil War seven states had legislation fixing hours of labor for children.[2] These laws represented little more than a gesture, however, since they were loosely drawn and were not well enforced. They often provided punishment only for "knowingly" violating the law, or allowed longer hours with the consent of parent or guardian, or merely required that children could not be "compelled" to work longer than the stated maximum.

More effective regulation of hours for children did not come until after 1900. Beginning with an Illinois law in 1903, practically all states had some sort of regulation of child labor by 1938. As can be expected, these laws vary widely, both in regard to the kinds of work covered and the age limits and hour maxima fixed.

efficiency due to shorter hours fail to take into account other factors, such as improved equipment, which may increase productivity.

[1] From an economic point of view, it would seem that such an employer is not only unscrupulous, but foolish. If he can get labor at a price below its productivity, his most profitable course would seem to lie in hiring more of it until the marginal product of labor just equals its wage. See discussion of these economic aspects, *infra*, pp. 705–10.

[2] Commons and Andrews, *op. cit.*, p. 95.

Other states followed the lead of New Hampshire in regulating hours for women, and five states had limited them to 10 a day before the Civil War.[1] But these laws were largely made ineffective by the usual clause that 10 hours was the limit in the absence of a contract requiring greater time. Massachusetts passed an hours law for women in 1874 which, after amendment in 1879, became the first effective regulation in this direction. From time to time other states have passed enforceable hours laws, so that by 1940 only four states had no such law.[2]

Laws fixing maximum hours for men have not been as general as those for women and children. A campaign for the 8-hour day was pressed after the Civil War and some states passed such laws, but they proved to be unenforceable and nothing came of them.[3] After the turn of the century, hours limitation laws for men were again placed on the statute books, and by 1936 there were forty-three states having maximum-hour laws affecting men in some occupations.[4] Most of these laws applied to workers in transportation, mining, and industries in which the employee works under air pressure. Scattered examples of hours limitation in certain manufacturing industries are found, and three states, Ohio, Mississippi, and Oregon, had general regulation of hours in all mills, factories, and manufacturing establishments.[5]

Hours regulation by the federal government dates from the law of 1907 limiting hours of work of railroad employees engaged in or connected with the movement of trains. Other laws fixing transportation employees' hours have been passed by the government since then.[6] Further federal hours limitation did not come until 1933, when codes established under the National Recovery Act of 1933 were required to provide for the 8-hour day. Other hours regulation was included in the Bituminous Coal Conservation Act of 1935, by which hours of work in the soft-coal industry were to be fixed. Since both the Recovery Act and the Coal Act were found unconstitutional by the Supreme Court, these regulations were not effective long. The most recent attempt of the federal government to regulate hours is the Fair Labor Standards Act of 1938. This law attempts a comprehensive scheme of hours and wages regulation in many industries adjudged to be in interstate commerce.

Other regulation by state and federal governments might be mentioned. Through fixing hours for government employees and through requiring those

[1] Commons and Andrews, *op. cit.*, p. 101.

[2] These were Alabama, Florida, Iowa, and West Virginia. See "Hours-of-Labor Legislation in the United States," 51 *Monthly Labor Review*, pp. 545–50 (September, 1940).

[3] Commons and Andrews, *op. cit.*, p. 122.

[4] U.S. Dept. of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics*, 1936 ed. (Bull. No. 616), pp. 1075–79.

[5] *Ibid.* Although some states had included a few additional employments under hours limitation, the situation had not materially changed by the latter part of 1940. See "Hours-of-Labor Legislation in the United States," 51 *Monthly Labor Review*, pp. 545–50 (September, 1940).

[6] See *supra*, pp. 133–34, 139–40.

who do business with the government to abide by certain standards of hours and wages, these governments have an indirect, but real, effect upon the length of the working day and week. The federal government ordered a 10-hour day in navy yards as early as 1840 and an 8-hour day for all government employees in 1868.[1] By acts passed in 1892 and 1912, it forced most government contractors and subcontractors to limit hours of their laborers to 8 per day.[2] In 1936 this regulation was extended to require a 40-hour week and to include contractors of any agency or instrumentality of the federal government. Most of the states have followed these policies.

Regulation of minimum wages has had a much shorter history than regulation of hours. Massachusetts' first minimum-wage law for women and children was followed by similar legislation in fourteen other states, Puerto Rico, and the District of Columbia between 1912 and 1923. But owing to the action of the United States Supreme Court in finding the District of Columbia law unconstitutional in 1923,[3] the laws as applied to women were either repealed or were no longer enforced throughout the 1920's.

Following the depression after 1929, new demands for minimum-wage legislation led to enactment of such laws in a number of states. The depression also brought the federal government into direct wage regulation through the requirement that all codes set up under the National Recovery Act have minimum-wage provisions. After this act was held unconstitutional in 1935, the government strengthened some of its indirect controls over wages and then, in 1938, through the Fair Labor Standards Act, passed a broad minimum-wage law applicable to interstate industries.

As in the case of hours, both federal and state governments have brought pressure to bear on private industry by the example set in minimum wages of government employees and by requiring government contractors to live up to the standards set by law. As with hours, the control through government purchases was materially strengthened by amendment in 1935.

In the development of minimum-wage legislation, the states and the national government have been particularly hampered by adverse court decisions. The finding of minimum-wage fixing, even for women, to be an unlawful deprivation of property in 1923 served to hinder any effective attempt at enforcing these laws until the Supreme Court reversed its finding of 1923 in a decision handed down in 1937.[4]

B. STATE REGULATION OF WORK DAY AND WEEK

Regulation of hours of work by the states represents a typical situation in which the nature and scope of laws of individual states vary so much that de-

[1] Commons and Andrews, *op. cit.*, pp. 117–18.
[2] *Ibid.*, p. 118.
[3] *Adkins v. Children's Hospital*, 261 U.S. 525 (1923).
[4] *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

tailed analysis is virtually impossible without a far more extended treatment than can be undertaken here. What will be attempted is to indicate the general extent and nature of these laws and to discuss their administrative aspects and constitutionality. An economic analysis will be reserved for discussion in the latter part of this chapter, along with an examination of economic aspects of minimum-wage laws. This analysis involves the same economic principles whether the regulation is undertaken by one state or another or by the federal government.

1. HOURS LIMITATION FOR CHILDREN. Regulations of hours of work for children may be divided between outright prohibition and limitation. The problem of prohibition will be treated in the chapter on safety and health regulation; consequently, the discussion of hours regulation at this point must subsequently be modified by the existence of any outright prohibition.

Where child labor under sixteen is permitted, most states have limited the work day to 8 hours and the work week to 44 or 48 hours. This usually means that such regulations apply to minors between fourteen and sixteen, since every state except Wyoming does not permit those below fourteen to work in factories, and all but two states have prohibited work by such children in mercantile establishments.[1]

Practically all states exempt children employed in agriculture and domestic service from child labor laws. The purpose of this exemption is to allow part-time work by children outside of school hours, particularly in helping their parents with work. Most states are also far less strict in the regulation of street trades, many exempting them, and others not attempting to regulate therein hours but merely to limit such employment to minors aged fourteen or more.

Administration of hours restrictions for children has been very difficult. With the large area of exemption and with different requirements in different fields, checking up on violations has called for a higher order of enforcement machinery than most states have possessed. But with improvement in administrative methods and personnel and the increased appropriations for enforcement of the multitude of labor laws, the supervision by states has become much better in the last few years. There are still those, however, who think that the best way to regulate the hours of child labor is entirely to forbid it until the age of sixteen or eighteen.

Some indirect regulation of the hours of child work has resulted from the school-attendance laws of the various states. Practically all states require full-time school attendance of minors below sixteen, and in a few states this age minimum is placed at seventeen or eighteen. For example, Wyoming, with no age limitation for child labor, forbids the employment of children

[1] U.S. Dept. of Labor, Children's Bureau, *State Child Labor Standards — A Summary of State Laws Affecting the Employment and Compulsory School Attendance of Minors*, July 1, 1938. For a more recent discussion see Carter, I. G., "Legislators Define Childhood," 212 *Ann. Am. Acad.*, pp. 38–41 (November, 1940), and Fuller, R. G., "Child Labor — Continued," *ibid.*, pp. 146–52.

during school hours, and requires school attendance to the age of eighteen. If such attendance laws and the general prohibition against night work by minors are enforced, working hours are likely to be limited. As a matter of fact, the record of enforcing compulsory school attendance is probably better on the whole than that of enforcing child labor laws. In consequence, the administration of these laws has been quite instrumental in regulating hours and working conditions in employment of minors.

2. HOURS LIMITATION FOR WOMEN. Regulation of hours for women varies from Indiana's mere prohibition of night work in manufacturing establishments to the extensive law of Oregon by which hours are limited to eight per day and 44 per week in practically all industries. By 1940, of the forty-three [1] states regulating hours for women, nineteen set limits as low as 8 hours per day, one had an 8½-hour day, fourteen had a 9-hour day, and the others had either a longer day or a weekly instead of daily limitation.[2] The weekly hours allowed showed variations from the 42½-hour week in Utah, and the 44-hour week in Oregon and Pennsylvania to the 60-hour week allowed in Georgia, Kentucky, Maryland, and Mississippi. In a few states, such as Colorado, Montana, Idaho, and Virginia, no weekly maxima have been fixed, although certain Sunday prohibitions have the effect of weekly limitations.

The above restrictions on hours do not mean that all trades are so covered or that the maxima mentioned are the same for all those trades which are covered. All the states having laws limit the hours in manufacturing establishments, and nearly all states with such laws make them apply to mercantile businesses. Forty of the states limit hours in laundries, thirty-nine in restaurants, and thirty-two in hotels.[3] Other occupations covered include telephone and telegraph operations and clerical work, although many states exempt such employment from the maximum-hour laws.

Agricultural and domestic employments are usually exempt from application of hour maxima. Nursing is also customarily exempt. Other exemptions are made in many states where the employment is not looked upon as dangerous or conducive to ill health. Exemptions are sometimes provided for trades in small communities. Thus, some states exempt telephone employment where a small number of women are employed in a single office.

In some of the more advanced types of laws, the statute does not place a maximum for all employments, but allows a special state commission to fix the maximum in each trade in accordance with the danger to health, safety, and welfare. In a few states, no maximum is placed, the law merely laying down the general principle that women are not to be employed for periods detrimental to their health and safety. In other cases, a commission is allowed to

[1] The forty-fourth state, Indiana, merely prohibited night work.

[2] "Hours-of-Labor Legislation in the United States," 51 *Monthly Labor Review*, pp. 545–50 (September, 1940).

[3] *Ibid.*, p. 549, and Millis, H. A., and Montgomery, R. E., *Labor's Progress and Problems* (New York: McGraw-Hill Book Company, Inc., 1938), p. 530.

fix lower hours than the general legal maximum where the nature of a trade seems to demand it.

3. HOURS LIMITATION FOR MEN. Few states have attempted to limit the hours of employment of men in many industries. Most of the hours laws have applied to particular industries, and to governmental work or work under government contracts. In the case of laws applicable to individual industries, the basis for regulation has been either the protection of the safety and health of the general public or the protection of labor employed in particularly hazardous or unhealthful occupations.

a. Hours in public employments. The majority of states have fixed an 8-hour day for employment in state work. A good many of these states have also provided for a 40-hour week for their employees. Nearly as many states have insisted that those persons furnishing the state with materials, supplies, or services also abide by similar requirements for their employees. The requirement for those doing business with the states naturally applies only to work or purchases done under special contract. Purchases in the open market do not require that the goods so bought be produced under the stipulated hour condition.

b. Hours in particular industries. State laws generally place restrictions on the hours of work of employees actively engaged in public transportation. Designed primarily to protect the public, these laws set maximum hours for continuous service, for non-continuous service in each 24 hour period, and for minimum rest periods for those directly concerned with the operation of public transportation facilities. These statutes place limits from 8 to 14 hours for continuous service, from 8 to 16 hours in any 24-hour period, and require minimum rest periods varying from 3 to 10 hours between continuous maximum periods on duty.[1]

In those industries regarded as particularly hazardous or unhealthful, the limitation on hours tends to run far below those allowed in public transportation. States usually place a maximum of 8 hours per day in mining and smelting businesses. Many states also limit hours in industries in which work under air pressure is required. The maximum set is ordinarily 8 hours, the number of hours allowable being less as the air pressure becomes higher. Other scattered examples of special hours limitation may be found. For example, Arizona limits to 8 hours work in stamp mills, concentrating mills, chlorinating processes, cyanide processes, cement works, rolling mills, rod mills, coke ovens, and blast furnaces, in addition to mines and smelters.[2] Similar regulation is also found in Colorado, Idaho, Nevada, and Wyoming.[3] California restricts work in laundries to 9 hours per day, and South Carolina places a maximum of 10 hours per day in cotton and woollen mills. In all these special employments, relatively few states had, by 1940, placed any weekly maximum on hours of work.

[1] U.S. Dept. of Labor, *Handbook of Labor Statistics*, 1936 ed., pp. 1078–79.

[2] *Ibid.*, p. 1075. [3] *Ibid.*, pp. 1075–77.

c. Hours laws of general application. A few states have passed hours laws applying fairly generally to industry. Mississippi has had a law since 1912 under which 10 hours was fixed as the daily maximum in manufacturing businesses, and since 1924 the legal weekly maximum has been 55 hours. Oregon has had a rather general 10-hour day law since 1913, applicable to mills and factories, as well as special hours limitation for mining, transportation, lumbering, and compressed air industries. Ohio passed a law in 1932 setting 8 hours as the maximum work day in mechanical, manufacturing, or mining businesses. Montana has also had a fairly broad law, which was made to provide in recent years for an 8-hour day in retail establishments, in addition to hours limitation for mines, quarries, cement plants, hydroelectric dams, telephone switchboards, and common carriers.[1] In 1937, Pennsylvania enacted a maximum 8-hour day and 44-hour week for all employments except those in agriculture and personal service. In the same year, North Carolina approved legislation for a maximum 10-hour day and 55-hour week in manufacturing and mechanical businesses. At approximately the same time, South Carolina provided by law for a 56-hour week in manufacturing and retailing.

In spite of the fact that many of the state laws have been held to be unconstitutional, as will be noted presently, and that many states still do not restrict hours in businesses generally, there is a tendency to increase the scope of hours laws. For years, states have only undertaken to regulate hours where a definite danger to the public or to labor tended to result. Inclusion of all manufacturing businesses and retail establishments within hours-limitation legislation seems to denote a tendency toward restricting hours in business where the length of the working day does not present a particular hazard. These broader laws are consequently justified on the ground that too long hours for any worker may be deleterious to physical or mental health, or may result in a citizenry with too little time for recreation and community upbuilding. With the fairly broad coverage of the federal government's hours regulation, to be discussed presently, the scope of state regulations will probably increase.

4. State Regulation of Rest Periods. One aspect of hours regulation includes those laws which require certain minimum rest periods between periods of continuous work. These laws are of several types. One type is ordinarily applicable to men in the transportation industry and requires that those connected with actual operation of common carriers be given a certain number of hours of rest, generally 8 to 12, between each working period. Nearly all states have such a law.[2] Another type of law applicable to men requires the granting of one day's rest in seven. Relatively few states have this type of law, and even where found there are usually exemptions for many industries and occupations, as well as exceptions in case of emergency.[3]

[1] U.S. Dept. of Labor, *Handbook of Labor Statistics*, 1936 ed., pp.1075–77. [2] *Ibid.*

[3] These laws usually apply to factories and mercantile establishments only, and exclude in these industries occupations such as those of janitors, watchmen, superintendents, foremen, and maintenance crews. See Commons and Andrews, *op. cit.*, p. 151.

A further type of rest law applies to women and minors. Many states provide for a minimum of ½ to 1 hour to be allowed for noon meals. A few states even require short rest periods to be given to women and minors in the course of the morning or afternoon employment. In addition, many states, by limiting weekly work to a certain number of hours, or by limiting work to six days in seven, or by forbidding certain classes of work on Sunday, add to the scope of rest-period laws for women and children.

An hours-limitation law which may be looked upon as a kind of rest law is the prohibition of night work by women and minors. Night work by children is quite generally outlawed. Over one third of the states prohibit night work by women in specified industries. The usual restriction applies to work between 10 P.M. and 6 A.M. in manufacturing enterprises. In some states, the regulation of night work extends to one or more of the following: mercantile businesses, hotels, laundries, elevators, offices, and street railways.

5. Constitutionality of State Hours Regulation. Regulation of hours of labor presents an interesting conflict between the use of state police powers and the restrictions of the due-process clause of the Fourteenth Amendment to the federal Constitution. Since due-process clauses are often found in state constitutions, they also serve to restrict use of state police power when the case is brought to the state courts. As was pointed out in a preceding chapter,[1] the proper use of the state police power is largely dependent upon whether or not a piece of legislation seems to the court (ordinarily a federal court) to be so necessary for the protection of health, safety, morals, or welfare of the general public that any resultant interference with contract and property rights appears reasonable.

The power of the government to fix the hours of work of its own employees and employees of government contractors doing work for it has not been questioned since 1903. In that year, the United States Supreme Court held that the state has the power to control its affairs and make contracts for public work on whatever terms it pleases.[2] A private contractor doing work for the government, the Court declared, had no right to do it as he wished but was subject to the conditions the state wished to impose.

State regulation of hours of work for minors has not been subject to serious question on the score of constitutionality. The law regards minors somewhat as wards of the state, which has power to act in any way for their protection. Moreover, since a minor has no legal right to enter into a free contract, the due-process clause can hardly act as a deterrent to state regulation. Regulation of hours of child labor cannot be said to take away any rights to sell labor, because children have no such right in law.[3]

The constitutionality of hours regulation for women was not so easily settled. Early cases differed somewhat. Some courts held such hour regulation to be

[1] *Supra*, pp. 47, 48–49. [2] *Atkin v. Kansas*, 191 U.S. 207 (1903).

[3] The leading case on these points is *People v. Ewer*, 141 N.Y. 129, 36 N.E. 4 (1894).

valid exercise of the police power,[1] and others found that the regulation caused deprivation of property without due process of law.[2] In 1908, however, the Supreme Court found no difficulty in holding constitutional the 10-hour law for women in Oregon.[3] The Court, faced with able briefs showing the effect of long hours upon the health of women, agreed that the limitations placed on contractual powers of women were far outweighed by the public's interest in healthy motherhood. A few years later, the Supreme Court upheld a California law which limited the hours of work for women to 8 each day.[4]

Hence, at the present time, it is safe to say that no question of constitutionality exists in hours laws for women, at least to the extent that these limits have been placed by the states. This statement is true for laws which limit daily and weekly work, which exclude night work, and which require definite rest periods.

Where hours of men are limited, or where rest periods are provided, in the transportation industry the constitutionality is not open to doubt. If the laws are reasonable, and none in this field have been found to be so restrictive as to be unreasonable, the courts have taken the position that protection of the safety of employees, travelers, and property through such means is eminently within the police power of the states.[5] In the field of transportation, conflict between state and federal laws is most likely to occur; but the United States Supreme Court has made it clear that state laws must give way where federal laws exist.[6]

Regulation of hours of work in distinctly hazardous undertakings has also long been regarded as within the reasonable exercise of state police power. As early as 1898, the United States Supreme Court upheld an Oregon law which limited work to 8 hours daily in underground mines, smelters, and ore-reduction works.[7] Admitting that the law interfered with freedom to contract, the Supreme Court none the less held that a state might limit the hours of workmen in employments reasonably adjudged by the legislature to be detrimental to health when pursued for too long a working day.

In spite of a decision against a New York 8-hour day for bakers in 1905,[8]

[1] Note especially *Commonwealth v. Hamilton Mfg. Co.*, 120 Mass. 383 (1876).

[2] See *Ritchie v. People*, 155 Ill. 98 (1895).

[3] *Muller v. Oregon*, 208 U.S. 412 (1908). The briefs in this case were prepared by Mr. L. D. Brandeis (later of the Supreme Court) and Miss Josephine Goldmark, and were noteworthy as emphasizing the consequences of excessive hours rather than mere legal precedents.

[4] *Miller v. Wilson*, 236 U.S. 373 (1915). In allowing the 8-hour law to stand, the Court recognized that hours limitation could be pressed to "indefensible" extremes, but agreed that 8 hours was a reasonable limitation.

[5] See *B. and O. R.R. Co. v. I.C.C.*, 221 U.S. 612 (1911). Although this decision by the Supreme Court upheld the right of Congress to legislate hours limits of employees on interstate trains, it has furnished an adequate precedent for state regulation, since it involved an interpretation of due process.

[6] *Erie Ruy. Co. v. N.Y.*, 233 U.S. 671 (1914).

[7] *Holden v. Hardy*, 169 U.S. 366 (1898).

[8] *Lochner v. New York*, 198 U.S. 45 (1905).

the United States Supreme Court in 1917 upheld an Oregon law which established a 10-hour day for both men and women in any mill, factory, or manufacturing establishment.[1] The Court emphasized that the record of the case did not include any facts to support the view that the law was not necessary to preserve health.

In 1937 Pennsylvania enacted a law limiting hours of work for men to 44 per week and 8 per day. The statute exempted from its application agricultural labor, domestic servants, and persons over twenty-one earning $25 per week or more in executive positions and professions. In addition, the statute provided that the state industrial board might grant further exemptions where working conditions warrant and the board should conform to any schedule of hours fixed by later federal regulation. The Pennsylvania Supreme Court found this law unconstitutional,[2] but upon grounds of unlawful delegation of power rather than unreasonable use of the police power. The Court held that the legislature had abdicated its power by granting authority to a board to follow whatever regulation the federal government might later set up. Unfortunately, this very broad hours law did not furnish a test of the proper extent of the police power in the field of hours regulation.

In 1939, the South Carolina Supreme Court held that limitation of hours for both men and women to 56 per week in the manufacturing and mercantile fields was unconstitutional.[3] The Court found that this limitation violated due-process and equal protection and contract clauses of both state and federal constitutions in that it was not a proper exercise of the police power.

In a decision in 1941, the United States Supreme Court upheld the federal Fair Labor Standards Act which provides for a 40-hour week.[4] In view of the interpretation given to due process in this case and previous support of the 10-hour day, an 8-hour day or 40-hour week in general employment would seem clearly to be within the federal Constitution.

The requirement of rest periods and a day of rest in seven have been generally upheld as reasonable police power regulation.[5] Where such laws have been found unconstitutional, the ground has been unreasonable classification of industries, rather than the principle that the state police power does not extend to such matters.[6]

6. Administration of State Hours Laws. Any regulation of labor matters on a broad scale involves difficult problems of administration. The number of workers and establishments hiring labor is large. The possibilities for infractions are consequently numerous. Even where the coverage of state

[1] *Bunting v. Oregon*, 243 U.S. 426 (1917).

[2] *Holgate Bros. v. Bashore*, 200 Atl. 672 (1938).

[3] *Gasque, Inc. v. Nates*, 2 S.E. (2d) 36 (1939).

[4] See *infra*, pp. 704–05.

[5] See *Hennington v. Georgia*, 163 U.S. 299 (1896) (Sunday labor prohibition), and *People v. Klinck Packing Co.*, 214 N.Y. 121 (1915) (one day's rest in seven).

[6] *State v. Pocock*, 161 Minn. 376, 201 N.W. 610 (1925).

laws is not very broad, the problem of administration is still complicated. This complication arises especially with the smaller firms, since larger firms can be more easily policed and are subject to wider public scrutiny. The smaller firms are, of course, the larger in number. This situation calls for administrative personnel and devices of an exceptionally high sort. In administering hours regulation, as in other labor regulation, many states have devoted inadequate funds for enforcement and have paid too little attention to personnel.

One of the most generally used administrative methods is publicity. State laws usually require posting of notices as to hours and rely to a large extent upon complaints to aid in enforcement. Where workers are ignorant of the law, or notices are not conspicuous, or if workers are afraid to make complaints, this type of enforcement procedure often breaks down. Even when states make periodic inspections, the enforcement is not always adequate. Infractions of hours laws are difficult to discover through inspection. To aid in this inspection, a few states require the use of record books of hours and place strong penalties against falsifying these records. This is perhaps one of the best means of enforcing hours limitation, but unfortunately altogether too few states require the keeping of such records.

Effective enforcement of hours limitations is often thwarted by loopholes left in the statutes. Thus, statutes may allow extra hours at overtime pay rates. This places a burden upon the state enforcement agencies to determine whether overtime pay was actually made. Most statutes also allow extra hours to be worked when due to an emergency. But unless the state takes pains to define what an emergency is and to make the employer defend extra work in specific cases, the emergency clause may become the means of evasion of the intent of the hours laws. In a few states, too, only "willful" violations of the law or instances of "compelling" an employee to work longer than maximum stated hours are penalized.

If state regulation of hours is extended to practically all industries, instead of the special coverage now general, the administrative problem may in some respects be simplified. While the number of establishments to which the law applies would be increased, the general character of such a law plus the more widespread publicity which would necessarily follow might ease the task of administration. As it is now, state welfare boards or labor commissioners are faced with laws which set up different standards for different industries and for men and women. Even where the maximum day or week is set by action of the state board, the task of investigating each industry and establishing maxima, and then policing these standards, is of great magnitude.

7. State Hours Regulation: Conclusions. Regulation of hours by the states has been of utmost importance in reducing the time which men, women, and children are required to work. From the "radical" law of the early nineteenth century, by which children under twelve were not allowed to work more

than 10 hours a day, labor and management alike now accept with calmness present limitation of hours for men to as little as 8 per day. This development is of real significance in the struggle of human beings for more time in which to re-create themselves physically, mentally, and socially. While hours might have been reduced without resort to legislation through the pressure of labor unions and enlightenment of management, it is hardly to be doubted that legislation hastened this reduction. The fear of one employer to reduce his hours lest he place himself at a competitive disadvantage tends to slow down the adoption of fewer hours, even though shorter hours do not mean lower output. Nor could such uniformity in hours reduction come without legislation, for certain unscrupulous or ignorant employers would still force a long working day and week despite social pressure to the contrary.

With all its advantages and contribution to progress, state hours regulation is not without faults. State laws still do not cover all employments in which hours limitation might be justified. Those specifying applicable coverage leave too much to the accuracy and the progressiveness of legislative judgments. Even if the legislature should include at one time all occupations the hours of which should be limited, future events might change this need and the legislature might not change the laws. The tendency to make laws apply only to certain occupations leaves altogether too many workers exempt in certain states. All states exempt agricultural and domestic employment. A very few states have hours laws for men covering manufacturing, mining, transportation, and other industries, while a few other states may have no such hours regulation except as applied to transport workers. In the case of regulation of hours for women, the difference is almost as great.

To meet the deficiencies of legislative selection of occupations to which hours laws should apply, a few states have established commissions with power to determine for women the length of the working day and week and to select the occupations to which such limitation should be applicable. These states usually provide by law that women are not to be employed for periods dangerous to their safety, health, or welfare. A commission is authorized to investigate conditions in different industries and to establish such limitations as the facts indicate to be necessary for protection from the dangers of long hours. In some states, notably California and Oregon, the commission may set limitations only if they are below the maximum hours allowed in the law. In other states, like Ohio and Wisconsin, these standards may be set at hours either more or less than the law.

The use of commissions to establish such standards seems to be a logical development in control of hours. In public-utility and railroad regulation, the legislature generally states only that rates shall be "reasonable" and the determination of reasonableness itself is left to a commission. The reason for making such provision is that the question of reasonableness is eminently one for commission determination after an analysis of all pertinent facts.

This same reason should justify the use of a commission in the establishing of labor standards. At least if the limitation of hours is to be based upon the protection of health, safety, and welfare, the differing conditions in various occupations would seem to make such a system advisable.

The whole problem of hours limitation may be placed in a different light as the result of recent developments. In many new laws and in the drive for new legislation there has been a tendency to justify limitation by economic rather than health and safety considerations. Hours limitation has been looked upon as a solution of the problem of unemployment. Recent proponents of regulation have assumed that there is only so much work to do, and that the only means of reducing unemployment is to restrict labor to an 8- or 6-hour day, thereby bringing work to the millions of unemployed. The economic basis of this argument is open to some question and will be analyzed later in this chapter. At this point, however, this argument is of importance as it affects the hours-restriction movement. For if hours are to be reduced to spread employment, the health and safety aspects will tend to sink into the background. Hours limitation would tend to be far more general and to go further in lowering the working day and week than would be strictly necessary if the worker's health, safety, and welfare are the only matters to be considered. Moreover, if the economic argument gains momentum, any difference in treatment of men and women would probably disappear.

C. STATE WAGE REGULATION

Regulation of wages by the states may be classified as: (1) regulation under government contracts; (2) regulation of the minimum wage at which labor might be hired in private industry; and (3) control over methods of wage payment. While this latter type of regulation is not a restriction of the wage itself, it does amount to a limitation upon certain features of the wage contract. Little attention need be paid to regulation of wages under government contracts. States have long had laws requiring that government contractors pay a certain minimum, usually the "prevailing wage" in a locality. This provision has generally meant that they must pay the union scale where a union exists; but if a community is not unionized, the contractors are sometimes given complete freedom from government influence in fixing wages.

Regulation of minimum wages has been undertaken to protect certain classes of labor from exploitation and to protect society from the evils of too low pay. Perhaps in no other field of government control has the development of regulation been so colored by the problem of constitutionality. The first state minimum-wage law was passed by Massachusetts in 1912. Yet not until twenty-five years later could it be said that any state had an enforceable wage-regulation law. The United States Supreme Court failed until 1937 to find that the state police power included the right to forbid employment at wages

below certain minima. The problem of constitutionality has also affected the coverage of minimum-wage regulation. Until 1937, when Oklahoma applied minimum-wage regulation to men, women, and minors, it had dealt only with women and minors. Without doubt the fact that women seemed to be in a less powerful bargaining position than men, and the fact that courts have looked more favorably on laws protecting women than upon those protecting men, have influenced the course of regulation.

1. COVERAGE OF STATE MINIMUM-WAGE LAWS. By late 1940, twenty-six states plus the District of Columbia, Puerto Rico, and Alaska had minimum-wage laws upon the statute books.[1] In two states, Connecticut and Oklahoma, the laws applied to men as well as to women and minors. In all other states, however, they applied only to women and minors.[2]

Since state minimum-wage laws usually apply only to women and minors, few exemptions from them have been granted. Many states specifically exclude household labor and farm labor. Others do so in effect by making the law cover any occupation but defining occupation as a business, industry, branch of trade, or trade. Some states direct the law against any sweatshop occupation and define such occupation as any business, trade, industry, or occupation paying unfair and oppressive wages. State laws generally make an exception of workers physically defective by age or otherwise, and apprentices in trades, but require that licenses be obtained for work below the minimum in these cases.[3]

2. MINIMUM-WAGE STANDARDS. Only three states — Arkansas, Nevada, and South Dakota — and Alaska and Puerto Rico establish specific minimum wages by statute. In the other states, the fixing is left to a commission, committee, or industrial or labor commissioner. The legislatures in the latter states have prescribed either a "cost-of-living" standard or one calling for a "fair wage." The cost-of-living standard, which is by far the most popular, requires that the minimum wage selected must be sufficient to meet the minimum cost of living necessary for health. The fair-wage standard is one which takes into account the work performed with the wage representing a fair and reasonable return for such work.

Many states combine the two standards. Thus, Wisconsin provides that the minimum wage established by its industrial commission must be both a living wage, i.e., one which is sufficient to maintain an employee under con-

[1] 28th *Ann. Rep. U.S. Secretary of Labor* (1940), p. 7, and "Minimum-Wage Legislation as of January, 1940," 50 *Monthly Labor Review*, pp. 891–909 (April, 1940).

[2] These states were Arizona, Arkansas, California, Colorado, Illinois, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Nevada, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Utah, Washington, and Wisconsin.

[3] For summaries of state laws, see U.S. Dept. of Labor, *Handbook of Labor Statistics*, pp. 481–87; *idem.*, *Digest of State and Federal Labor Legislation* (Div. of Labor Standards, Bull. No. 32, 1939); Johnson, E. M., "The Administration of Minimum Wage Laws in the United States," 39 *International Labor Review*, pp. 149–83 (February, 1939); and "Minimum-Wage Legislation as of January 1, 1940," *loc. cit.*

ditions consistent with his welfare, and a wage which is not oppressive, i.e., a wage which is not lower than a reasonable and adequate compensation for services rendered. This dual standard has been adopted by states in the interest of constitutionality, since the United States Supreme Court found the living-wage standard unconstitutional in 1923 and intimated that one of its weaknesses was that it did not take into account the value of the labor to the employer.[1]

3. Administration of State Minimum-Wage Laws. Administration of state minimum-wage laws is generally placed either under an industrial commission of three to six members, or the state commissioner of labor. These agencies have authority to issue wage orders directing compliance with wage findings, to follow up with suits for their enforcement, and to supervise the wage regulation generally. In selecting occupations for imposition of the minimum wage and in establishing the minimum wage itself, the customary procedure is to use wage boards. These boards, ordinarily made up of representatives of labor, management, and the public, act in an advisory capacity.

The state authority administering the wage laws generally makes a preliminary investigation of conditions in certain industries, either upon its own initiative or upon request of a certain number of persons. Upon its preparation of pertinent data, a wage board is appointed. This board studies the information compiled by the state, along with any other information it wishes to get. If it finds that the conditions of an industry demand special standards to be set to raise the wages to the level required by law, it makes a finding as to the minimum wage advisable and presents it to the state administrative agency.

The state authority may accept or reject the findings of the wage board, or may appoint a new one to study the problem. If the findings are acceptable, the state commission or commissioner, after public hearing, issues a wage order for the occupation under consideration. This order may be "mandatory" or "directory." Under the former, the order becomes enforceable upon its effective date; under the latter, it merely serves to warn employers to conform to its terms. After a specified period of thirty or sixty days, the order becomes mandatory upon the employers. Where the wages are fixed upon a cost of living basis, less flexibility in the minimum-wage terms is usually granted than in the case of orders based upon both cost of living and ability of the employer to pay. Determinations made upon the latter standard customarily cover such matters as employers' costs, compensation for apprentices, the relation of time rates and piece rates, the number of hours constituting full-time work, and any special rates for part-time or overtime work.

Any interested party is given the right to appeal the wage orders of the state to the courts. In some states, review by state courts is limited to ques-

[1] *Adkins v. Children's Hospital*, 261 U.S. 525 (1923). In a later case, the dual standard was held not to make any difference. See *Morehead v. People ex rel. Tipaldo*, 298 U.S. 587 (1936).

tions of law as separate from questions of fact, but in others it is extended to matters of fact as well as of law.

Compliance with the wage orders is obtained by means of inspection by the state labor department or through complaints from workers. The penalty for infraction may include fine or imprisonment of the employer, and almost always includes the right to collect back wages for employees who have been paid less than the minimum rate.

4. PROBLEMS OF ADMINISTRATION.[1] There are many rather difficult problems which are encountered in the administration of state minimum-wage laws. Many of these are not found in other kinds of labor legislation. For example, the whole organization of the wage board makes it essential to obtain persons who are familiar with the wage problem, who are fair and reasonable, and who can ably represent the groups for which they are selected. These qualities are especially important in the case of public representatives.

Effective administration of minimum-wage laws depends to a great extent upon public support. Not only must the public know what the wage regulation is in the various industries, but it must be convinced that it is fair. If the wages fixed are too low, the public may feel that such regulation deprives deserving individuals of the right to make a living. Support of employers and employer's associations is particularly desirable. Minimum-wage laws cannot be very successful if they must be enforced against a group which does not believe in them. The cost in money and irritation of forcing employers to provide a minimum wage to which they are greatly opposed may be too great to insure success of the law. If employers can be made to appreciate the social value of a reasonably administered law, their co-operation will not only diminish the job of enforcement but tend to make for a code of business ethics opposed to departures from the letter and spirit of the law.

When the complicated character of wage regulation is appreciated, the importance of adequate and expert personnel in the state administration is apparent. Altogether too many states appropriate too little money for the enforcement of minimum-wage laws. One writer has pointed to appropriations for this purpose varying from $2500 to $175,000 per year.[2] While these appropriations tend to vary with the number of workers covered by the law, they show variation and inadequacy in certain instances quite beyond that which could be attributed to the workers covered. Moreover, less than half the states having minimum-wage laws have employees of the state administration under civil-service regulation. The danger of political considerations influencing selection of personnel is consequently great. Owing to the expertness and personal qualifications necessary for administrative work in minimum-wage regulation, any means to improve this personnel should not be overlooked.

[1] Much of this section is drawn from Johnson, E. M., *op. cit.*

[2] *Ibid.*, pp. 170–72.

5. CONSTITUTIONALITY OF STATE MINIMUM-WAGE LAWS. The history of state minimum-wage regulation in the courts until 1937 has been exceedingly interesting, even though disappointing, to its proponents. We have already seen how it has affected the course of regulation, how it has accounted for the general limitation to women and minors, how it has led to adoption of a value-of-service standard, and how it has caused effective enforcement to be withheld for more than two decades.

The first case involving a state minimum-wage law came before the United States Supreme Court in 1917, when a decision of the Oregon Supreme Court favorable to the Oregon minimum-wage law was appealed. By an evenly divided court, the decision of the Oregon court was allowed to stand.[1] Since an evenly divided court sets no precedent for future court action, this case cannot be regarded as controlling in later decisions. It is curious that if Mr. Justice Brandeis had been able to vote, he would almost surely have voted in favor of the law, and its constitutionality might then have been decided once and for all.

The second case of this type was decided in 1923, when the United States Supreme Court found the District of Columbia's minimum-wage law to be unconstitutional.[2] By a vote of five to three (Justice Brandeis not voting), made by a court the personnel of which had changed after 1917,[3] the Supreme Court held that the regulation of minimum wages of women deprived them of their liberty to contract for the sale of their labor without due process of law. The majority held that the law was a simple price-fixing one for which there had been no precedent outside of businesses affected with a public interest. Mr. Justice Sutherland, reading the majority opinion, was not impressed with the argument that minimum-wage protection was necessary to protect women from exploitation, and pointed out that women were legally quite as capable of contracting for themselves as men. He also pointed out that the cost-of-living standard might force an employer to pay more for labor than it was worth, thereby representing a "naked arbitrary exercise of power."

The minority of the Supreme Court vigorously defended the constitutionality of minimum-wage regulation. Mr. Chief Justice Taft held that the evils

[1] *Stettler v. O'Hara*, 243 U.S. 629 (1917). Mr. Justice Brandeis, having been counsel for the state of Oregon in the case, before he was appointed to the Supreme Court, did not vote in the case. As is customary with an evenly divided court, no written opinion was handed down and the names of the opposing and favoring justices can only be surmised.

[2] *Adkins v. Children's Hospital*, 261 U.S. 525 (1923).

[3] It is interesting that the following new justices were appointed to the Supreme Court between 1917 and 1923: Taft, Sutherland, Butler, and Sanford. While the record indicates that two of these justices favored constitutionality and two opposed it, the two opposing replaced two who had favored the law in 1917. But only one justice against the law in 1917 was replaced by a justice favoring the law. An interesting study of the accidental nature of this decision has been made by Powell, T. R., "The Judiciality of Minimum Wage Legislation," 37 *Harvard Law Review*, pp. 545–73 (March, 1924). Powell finds that if the case had come before the Court in 1921, constitutionality would have been upheld by a vote of 6–3. And the case would have reached the Supreme Court at that time if one of the judges of the District of Columbia Court of Appeals had not been sick.

of the sweating system were well known and that the police power should be broad enough to include control over the evil of sub-standard wages, as well as too long hours, the regulation of which was no longer open to any constitutional question. He insisted that there was no substantial difference between regulation of wages and regulation of hours. Mr. Justice Holmes claimed that the objectives of minimum-wage regulation — the removal of conditions leading to ill health, immorality, and deterioration of the race — were clearly within the scope of the police power; and that the approach through wage control was certainly one which a reasonable man might find to be designed for such objective in view of the many laws in foreign countries and in the United States.

Following the Adkins case, the United States Supreme Court consistently held unconstitutional state laws requiring minimum wages based upon a cost-of-living standard to be paid to women.[1] With the new wave of minimum-wage legislation following 1933, several states attempted to insure constitutionality by outlawing only wages which were both below a minimum standard of living and below the fair value of the labor. A New York law drawn along such lines was brought to the Supreme Court in 1936, and by a closely divided vote of 5 to 4 was found to be unconstitutional.[2] The state of New York attempted to differentiate its law from the previous one by insisting that the inclusion of a value-of-service principle placed the regulation outside of the doctrine of the Adkins case. The validity of this position was denied by the majority of the Court. Moreover, Mr. Justice Butler, reading the opinion for the majority, declared that the Adkins case "and the reasoning upon which it rests clearly show that the state is without power by any form of legislation to prohibit, change or nullify contracts between employers and adult women workers as to the amount of wages paid."

Mr. Chief Justice Hughes strongly asserted for the minority that there is nothing in the federal Constitution which denies to a state the power to fix minimum wages for women being exploited by employers, and that the New York law was decidedly different from the law invalidated in the Adkins case. Mr. Justice Stone, with Mr. Justice Cardozo and Mr. Justice Brandeis, declared that, in the face of the evils of low wages, any minimum-wage regulation was within the police power of a state. Mr. Justice Stone remarked that "there is grim irony in speaking of freedom of contract of those, who, because of their economic necessities, give their services for less than is needful to keep body and soul together."

One year after the New York law was found unconstitutional, the United States Supreme Court overruled its line of decisions resting upon the Adkins

[1] See *Murphy v. Sardell*, 269 U.S. 530 (1923) (Arizona law), and *Donham v. West Nelson Mfg. Co.*, 273 U.S. 657 (1927) (Arkansas law). It should be noted that these decisions merely invalidated minimum-wage legislation for adult women. No question was raised as to the validity of wage regulation for children.

[2] *Morehead v. People ex. rel. Tipaldo*, 298 U.S. 587 (1936).

case when it upheld the Washington minimum-wage law.[1] Although the Washington law was practically identical with the New York one, the change of opinion of Mr. Justice Roberts, who voted with the majority in the New York case, turned the tide in favor of constitutionality. As an excuse for the change in attitude, Mr. Chief Justice Hughes, presenting the majority opinion, claimed that the Court had not been asked to reverse the Adkins ruling in the New York case. But the reasoning by which the majority sustained the Washington law was essentially that which the minority had used in all the cases from the Adkins case of 1923. The majority pointed out that the evils of sweating were so generally recognized that it could no longer be denied that minimum-wage regulation was within the competency of the state police power. Upon this reasoning the majority frankly stated that the decision in the Adkins case "should be, and it is, overruled."

Thus after years of unconstitutionality, the fixing of minimum wages of adult women has been held to be a valid use of the state police power. Whether this means that the state has the constitutional authority to fix the minimum wages of adult men has not been specifically decided. However, in 1941 the United States Supreme Court upheld minimum-wage regulations by the federal government under the Fair Labor Standards Act as being within due process of law.[2] Since this law applied to men and women alike, and since the Court maintained that no constitutional question longer exists as to the validity of such regulation, the due-process clause of the Fourteenth Amendment would appear not to limit the states in this respect any more than the Fifth Amendment restricts the federal government.

6. State Regulation of Minimum Wages: Conclusions. The economic aspects of wage regulation are reserved for a later place in this chapter. Suffice it to say at the present that if the minimum wage were set above the value of the worker to an employer, the employer would no longer find it advisable to hire the worker, and some unemployment would seem to follow. As a matter of fact this very point has been advanced against the imposition of a minimum wage by law. Moreover, labor unions have opposed the regulation of such minima on the grounds that the minimum will tend to become the maximum wage, and that when the employer is forced to raise wages on his low-paid workers, he will lower wages on the higher-paid group. Another objection which has been raised against minimum-wage regulation by the states is that it may place such a hardship on employers, especially those competing against producers from states which either have no minimum-wage law or a less strict law, that they will be forced out of business. State wage regulation has also been questioned upon grounds of the administrative problems involved. Some fear the bureaucracy and inflexibility which may come from

[1] *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

[2] See *infra*, pp.704–05. In 1939, however, an Oklahoma law applying to men and women was invalidated by the state supreme court, largely upon a technicality, in *Associated Industries v. Welfare Commission*, 90 Pac. (2d) 899 (1939).

administration to enforce the law. Others fear that if the law is not uniformly administered, the honest or ethical employer will be placed at the mercy of those producers who evade it.

In view of the above apprehensive attitudes toward state minimum-wage regulation, it may be well to look at the available record. To be sure, the status of unenforceability of minimum-wage laws prior to 1937 and the fact that very few states have even had effective laws on the statute books until recently make the record one upon which full credence cannot be placed. One should also note that, even if the record is not encouraging on all points mentioned above, the humanitarian considerations which have so dominated the minimum-wage movement may still far outweigh the disadvantages.

On most of the points raised above, the conclusions of two authorities in the labor legislation field are extremely favorable.[1] The experience of minimum-wage regulation in California, New York, and Wisconsin, as well as in foreign countries with a rather long minimum-wage experience, indicates that there is no perceptible tendency for wages above the minimum to be lowered, and that employees who received more than the minimum before the passage of a law tend to get the same after it. Nor is there evidence to support the fear that minimum-wage laws will drive workers out of their jobs. Commons and Andrews admit that these laws have caused some "marginal" workers to lose their jobs, but point out that this loss has not been very important. As for the effect upon employers and their costs, the evidence indicates that most of the sweatshops were driven from the state, but that the effect upon other industry was not serious.

Too much emphasis should not be placed upon these conclusions as representing results which can be expected to follow from recent and future wage regulations. The wages established before 1937 were generally very low, so that little economic dislocation need be expected; furthermore, many occupations have not been covered, and in those covered doubtless many employers were able to evade the law. Now, with the constitutional aspects cleared up and with wider wage regulation, as well as somewhat higher wage minima, more unfavorable results, especially in connection with unemployment, may follow. Such possible economic results will be discussed in the latter part of this chapter. The difficulty of discovering these results is that so many other factors influence unemployment, costs, and wage rates that the influence of minimum-wage legislation will be hard to perceive.

D. FEDERAL WAGE AND HOURS LAWS ENACTED BEFORE 1938

Until 1938 the lead in wage and hours regulation had been taken by the states. This is not surprising in view of the fact that the federal government

[1] Commons and Andrews, *op. cit.*, pp. 70–74.

has not had the general police power which belongs to the states. Being a government of delegated powers, the federal government has felt itself constitutionally incompetent to deal with such local matters as are involved in most wage and hours regulation. Also, since the problem is a local one, the treatment by state governments has seemed to be the logical course of action. However, in recent years the problems of minimum wages and maximum hours have taken on a national aspect owing to the country-wide economic considerations involved and to the variations in state problems of regulation. At about the same time, the more liberal construction of the meaning of interstate commerce by the Supreme Court has made legislators believe that the federal government has the power to regulate hours and wages. The result of this changed conception of the rôle of the national government was the Fair Labor Standards Act of 1938.

Even before the wage and hours law of 1938, however, the federal government had some part in the regulation of hours and wages. Except possibly for the regulation under the National Recovery Act of 1933, its control was rather haphazard and opportunistic. In some cases, the control had included both wages and hours, while in others it was limited to hours. The wage and hours regulation of the federal government before 1938 included control in connection with government employees and government contractors, limitation in the transport industry, regulation under the short-lived Recovery Act, and control under such specialized pieces of legislation as the Bituminous Coal Act and the Sugar Act.

1. Government Employees and Contractors. As the largest employer of labor, the federal government has naturally influenced private industry by the wages and hours fixed for government employees. In matters of hours, it has taken the lead, the 8-hour day having been established for government employees as early as 1869. Likewise, by setting attractive wage rates for certain classes of its employees, especially the lesser skilled, the government has probably affected the level of wages in private employment.

Much more direct regulation of wages and hours has resulted from the establishment of conditions upon which private business men may undertake government contracts. Although regulation of this sort dates from 1869, the first really effective law was one passed in 1912. At that time Congress provided that an 8-hour provision be inserted in all public contracts made by the federal government, any territories, or the District of Columbia. This provision applied to work done by laborers or mechanics. Exception was provided for work done on contracts for transportation, transmission of information, and purchase of most supplies in the open market. Work caused by emergencies was exempted, and later during the first World War the President was allowed to excuse contractors from the law if pay at the rate of time and one half for the overtime was made. Under the emergency public works acts passed in 1932 and later, the government placed further restrictions upon

work done under these laws, in some cases setting a 30-hour week and requiring hourly wages to be at the prevailing rate.

The most complete regulation of work done under government contracts to date has been the Walsh-Healey Act of 1936. This law provides that all contracts made by the government, its territories, the District of Columbia, and government-owned corporations, for the furnishing of any materials in excess of $10,000, must include the stipulation that the contractor not hire any person for more than 40 hours a week and 8 hours per day. The contractor must also agree to pay prevailing wage rates in the industry, and not to hire in the making of government goods males under sixteen years of age and females under eighteen years of age. The Secretary of Labor was placed in charge of enforcement of the act and was authorized to grant exceptions to the hours requirements where necessary in the public interest and where overtime rates of time and a half are paid. The act exempted from its provisions supplies which might usually be purchased in the open market and agricultural products processed by the original producers.[1]

The influence of the federal government upon wages and hours through the Walsh-Healey Act has been felt in a number of industries. The Secretary of Labor reported in 1940 that approximately 30,000 contracts involving $3,000,000,000 have been handled under the act.[2] In June, 1940, the Secretary noted that minimum-wage determinations had been made in thirty-one industries covering approximately 2,000,000 workers, and that shortly thereafter these determinations would extend to more than 3,000,000 workers, or over 25 per cent of the employees in manufacturing industries.[3] In making these wage determinations, the Secretary of Labor has made use of advisory panels of labor and management, and has established minima ranging from 30 cents an hour in the Southern furniture industries to 67½ cents an hour in the men's hat and cap businesses. As for the scope of the hour limitation, it has been estimated that factories hiring over 5,000,000 workers may become subject to the act, although not all these workers may be employed directly on government work.

2. TRANSPORTATION EMPLOYEES. Since 1907 the federal government has regulated the hours of service of persons engaged in or connected with the actual movement of interstate trains. These hour limitations, which have been discussed above,[4] are designed to protect the traveling or shipping public from loss of property or life due to the fatigue of too long employment. Except for the Adamson Act of 1917, by which a basic 8-hour day was fixed, the regulation of hours of labor of railroad trainmen has not gone much beyond the safety law of 1907. The establishment of an 8-hour day, it should be remem-

[1] The act was amended in 1940 to authorize the President to suspend the substantive provisions of the law when the public interest so requires.

[2] 28th *Ann. Rep. Secretary of Labor* (1940), p. 13.

[3] *Ibid.*, pp. 36–37.

[4] *Supra*, pp. 133–34.

bered, did not limit hours to 8, but merely provided for time and a half for any hours in excess of that number.

Hours of work of employees in water transportation have also been subject to regulation by the federal government. By a series of acts in 1913, 1915, and 1936, the 8-hour day is now provided for all officers and seamen in the merchant marine, whether service is at sea or in port. The law of 1936 has also given the United States Maritime Commission authority to fix minimum rates of pay for crews and officers of ships the owners of which receive a subsidy from the United States. Since these subsidies are granted to almost all American ship operators on the high seas, this coverage is rather broad.

The Motor Carrier Act of 1935 authorized the Interstate Commerce Commission to fix maximum hours of work for operators of motor trucks and buses in interstate commerce. The law established no definite maxima, but left the problem to the Commission to be solved as it saw necessary for protection of public safety.

The Civil Aeronautics Act of 1938 empowered the Aeronautics Authority to fix maximum hours for airmen and enacted into law a base rate for annual wages and hourly rates for air-line pilots.

The power of the government to regulate in the interest of safe transportation in interstate commerce has not been subject to question. For this reason, the hours limitations provided in the transport field have been of clear constitutionality. However, the lack of wage regulation in the transport industry is interesting. Several factors may account for it. For one thing, with the attitude of the Supreme Court what it was on wage regulation prior to 1937, the federal government may well have thought that its power to police interstate commerce did not extend to fixing wages. Even when minimum wages were fixed by the Merchant Marine Act of 1936, the law applied only to those operators who were obligated to the government by subsidies. Another factor which may account for the lack of wage regulation is probably that there has not been much demand for it. The railroad unions have been well able to handle their own wage requests and have not been very much interested in the few unskilled workers who may be receiving low wages. The motor-carrier and water-carrier employees have not been well enough organized to present a very strong demand for wage regulation; and even if they had been, perhaps they would have felt about wages much as the railroad unions apparently have.

3. National Recovery Act, 1933–1935. Although it was a short-lived experiment, the National Industrial Recovery Act of 1935 has furnished us with the most extensive federal government regulation of wages and hours ever attempted before 1938. Even the wage and hours regulation of 1938 did not, as we shall see, try to cover as many employees as did the Recovery Act. As will be recalled, the Recovery Act had as its purpose the stabilization of business and employment through the elimination of elements of instability

in the economic system. These elements included cut-throat competition and substandard working conditions. In the codes of fair competition through which the law was to be enforced, certain minimum wages and maximum hours were to be included. While these codes were to be made up by industry itself, they had to be approved by the federal administration. If an industry did not make up a code, or if it was in the process of formulating one, it was virtually required to operate under a "re-employment agreement." This agreement embodied arbitrary limitation of hours to 35 to 40 per week and minimum wages of 30 to 40 cents per hour.

Under the Recovery Act, some five hundred and fifty-seven codes and two hundred supplementary codes were put in force, providing for a coverage of an estimated 22,500,000 workers.[1] The code wage provisions were rather complex, with minimum rates varying among codes, and with differentials made in the same codes for such factors as geographical region, sex, and population of cities in which a plant might be located. A majority of the codes also made a difference in groups in the working force, generally as between factory workers and office employees.[2] Although the minimum wages fixed ranged from 12½ cents per hour (needlework in Puerto Rico) to 75 cents an hour (printing roller and print-block industry), the majority of codes fixed minimum wages between 35 and 40 cents per hour and $14 and $15 per week.[3]

In contrast to the wage provisions which affected only the more unskilled workers, the hour limitations of the Recovery Act codes affected all but a few administrative employees and executives. By far most of the codes fixed 40 hours as the maximum week for factory and clerical employees, although slightly more were usually allowed for maintenance or service employees. For factory workers many of the codes provided for an average week of 40 hours, thus allowing a longer week, ordinarily 48 hours, in times of peak demand. Daily limits were ordinarily set at 8 hours. For work in excess of maximum time, nearly all codes provided for pay at some kind of overtime rate.

Even though the Recovery Act was too short-lived to stabilize wage and hours provisions throughout industry, and even though the codes involved tremendous administrative problems, there is evidence that they contributed to a general rise in real wages and a reduction of the work period which were not lost when the United States Supreme Court invalidated the law. An index of weekly earnings in manufacturing industries (with 1932 = 100) increased from 91 in January, 1933, to 113 in January, 1935, despite a drop in average weekly hours.[4] There is evidence, too, that real earnings increased

[1] Millis, H. A., and Montgomery, R. E., *Labor's Progress and Problems*, pp. 356–57.

[2] For an analysis of these and other features of the Recovery Act, see the summary in *Handbook of Labor Statistics, op. cit.*, pp. 491–536.

[3] *Ibid.*, pp. 513–17.

[4] *Ibid.*, p. 543.

in the face of rising costs.[1] An index of real earnings showed a rise from (1923–1925 = 100) 91 in 1932 to 105 in 1935.[2]

4. Coal Conservation Act of 1935. Under the Bituminous Coal Conservation Act of 1935, popularly known as the Guffey Coal Act, the federal government set up a comprehensive system of code control of the soft-coal industry. Among other things,[3] the law provided that the working agreement to be established between coal producers, known as the Bituminous Coal Code, should include standards of minimum wages and maximum hours for miners. Technically, wage and hours regulation was not to be effective unless approved by producers of two thirds of the annual tonnage production in a district and a majority of the miners in each producing district. But because a majority of the producers and workers were in favor of wage and hours restrictions, and desired to force other operators to their standards, the required majority was not difficult to obtain.

The Coal Conservation Act was found unconstitutional by the United States Supreme Court shortly after it went into effect.[4] The main basis upon which the Court found the law to be invalid was the fixing of wages and hours. It held that the law allowed a majority to use the power of the federal government to enforce wage and hours standards on a dissenting minority. In substance the law was declared to be a regulation of wages and hours by the federal government. The court held also that mining was a local matter outside the authority of the federal government and that such work did not constitute employment in interstate commerce.

5. Sugar Act of 1937. An interesting approach to wage regulation was made by the Sugar Act of 1937. This law is primarily an agricultural control act providing for the payment of benefits to producers who enter into a plan for controlling sugar production through the marketing agreement device.[5] But in order to obtain benefits, the producers must agree to pay a fair and reasonable wage for workers engaged in the cultivation or harvesting of sugar beets or sugar cane. The Secretary of Agriculture is empowered to fix the wages he finds to be fair and reasonable.

This regulation, while not applying to a very large group of workers, is an interesting example of how regulation can be extended to receivers of government favors. For while the agricultural control program is on its face a system of co-operative regulation between government and agriculture, the terms of the co-operation are such that the producer can hardly refuse them. Nevertheless, in accepting his advantageous bargain with the government, he is bound to government regulation of the wages he pays his laborers.

[1] Bowden, Witt, "Wages, Hours, and Productivity of Industrial Labor, 1909 to 1939," 51 *Monthly Labor Review*, pp. 517–44 (September, 1940), and Wolman, Leo, "The Recovery in Wages and Employment," National Bureau of Economic Research, *Bulletin No. 63*, p. 12 (1936).

[2] Bowden, Witt, *op. cit.*, p. 534. [3] See *supra*, pp. 647–49.

[4] *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936). A minority of three felt that consideration of the wage provisions was premature and should not have been ruled upon.

[5] See the discussion of this device, *supra*, pp. 620–22.

E. THE WAGE AND HOURS ACT OF 1938

Agitation for federal regulation of minimum wages and maximum hours really dates from the institution of the New Deal under the Roosevelt administration following 1933. While the roots for such legislation can be found in state regulation, and federal control was suggested before 1933, no effective movement for such a program developed until President F. D. Roosevelt placed his support behind it. When the Recovery Act code provisions were invalidated by the Supreme Court in 1935, the administration and Congress began a new drive for the removal of substandard labor conditions as well as the elimination of child labor. However, when the Supreme Court found the New York minimum-wage law to be unconstitutional in 1936, this drive resulted in suggestions to amend the Constitution. And when it was realized that amendment involved uncertainty and delay, the desire for an accepted constitutional basis for labor regulation and other reform measures led the President to suggest change of the Supreme Court itself by appointment of six additional members to supplement those over retirement age who did not retire.

Although the program to enlarge the Supreme Court did not meet with popular approval, the Court changed its position on the constitutionality of several reform measures so that the constitutional barrier of wage and hours regulation seemed to be removed. In 1937, the Court found the Wagner Labor Relations Act to be constitutional, even though it placed employers in mining, manufacturing, and other local industries under the possible scope of the interstate commerce power, on the ground that Congress may remove obstructions to the free flow of commerce.[1] In 1937, also, the Supreme Court reversed itself on the constitutional basis of state minimum-wage regulation and found the Washington minimum-wage law to be within the reasonable use of the police power.[2]

With the constitutional basis apparently aided by the less restrictive decisions of the Supreme Court, practically identical bills to regulate wages, hours, and child labor were introduced in the House and Senate in 1937. After some difficulties in Congress, largely occasioned by organized labor's fear of having legal standards fixed which the public would interpret as reasonable and which would hinder the attainment of better conditions through collective bargaining, the bill was finally passed and became law by signature of the President in June, 1938.

Before proceeding with a study of the Fair Labor Standards Act of 1938, popularly known as the Wage and Hours Law, a few general objectives of the law might be noted. Its principal purpose is to place a floor under wages and a ceiling over hours as uniformly as possible throughout the country so that

[1] For discussion of this case, see *supra*, p. 43, and *infra*, pp. 785–86.

[2] *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

low labor standards cannot exist in certain parts of the nation where state legislatures are reluctant to act. The law seems to be motivated by a desire not only to fix standards of decency and health, but to increase purchasing power and reduce unemployment. Its main constitutional basis is the interstate commerce power, and the removal of low living standards as unfair methods of competition leading to labor disputes and interference with orderly marketing of goods. For this reason, the law aims merely to apply to those workers which may be held to be in the "stream" of commerce, and leaves much regulation of labor standards to the states.

Administration of the Fair Labor Standards Act has been placed under an Administrator, and a Wage and Hour Division has been set up in the Department of Labor. Administration of the child labor provisions of the act is placed in the Children's Bureau of the Department of Labor. The use of a single administrator rather than a commission of several members is in line with customary state labor standards regulation. On matters such as the setting of wages and hours, the law provides for advisory committees to aid the Administrator in defining several of the general terms of the act.

1. COVERAGE OF THE ACT. The act applies only to employees of private industries the products of which enter into interstate commerce. These include workers engaged in interstate commerce itself and those engaged in production, or in a process necessary for production, of goods destined for interstate commerce. Employees engaged in final intrastate distribution and in personal services are apparently exempted. While these provisions are broad and involve much administrative definition, there are numerous provisions which exempt certain workers entirely, exempt others from wage provisions, and exempt still others from hours provisions. Further exemptions apply to child labor provisions only.

Agricultural workers are exempted so far as wage and hours regulations are concerned. Processing on the farm of commodities produced there exclusively is likewise exempted, as is that of commodities in the immediate locality of their production and where the number of employees does not exceed seven; thus, many small canneries, small dairies, cotton gins, and grain elevators are exempt. Fishermen and seamen and persons engaged in the fish-packing industry are excepted from the law, as are postal employees, employees working on weekly or semi-weekly newspapers with a circulation of less than three thousand, switchboard operators employed in a public telephone exchange which has fewer than five hundred stations, and employees of street and interurban railways and local bus companies. In addition, employees of air carriers subject to certain federal government laws are exempted, as well as employees of most pipe-line companies.

Although all classes of exemptions are to some extent subject to administrative definition, certain exemptions were made with the specific proviso that the Administrator may limit and define the exempted classification. Exemp-

tions in the latter group are those including executive and administrative employees, professional employees, outside salesmen, and employees engaged in a local retailing capacity.

Exempt from the wage provisions only are learners, apprentices, handicapped workers, and messengers. These exemptions are not absolute, but merely permit the Administrator to make them when and to the extent he finds necessary for the prevention of reducing opportunities for employment.

All employees whose maximum hours of labor are set by the Interstate Commerce Commission are excluded from the hours portions of the law. This exemption applies to railroads and interstate motor carriers.

Where employers, pursuant to contract made by *bona-fide* collective bargaining, hire employees for a year or half-year period, but agree to provide work for not more than 2000 hours in 52 weeks, or 1000 hours in 26 weeks, an employee may be made to work for as much as 12 hours a day and 56 hours in a week, without the payment of overtime rates. Partial hours exemption is also enacted for seasonal industries, as defined by the Administrator. In such industries employees may be worked a total of 14 weeks in a calendar year at hours as high as 12 per day or 56 per week.

Child labor in retailing, personal service, street trades, motion pictures, and theaters is not covered by the law. Children employed in agriculture at a time when they are not required to attend school are also exempt. Moreover, except in manufacturing and mining, children working for their parents are excluded.

2. Administrative Aspects of Coverage. As can easily be noted, the law leaves much to the discretion of the Administrator in applying the coverage provisions. As a matter of fact, from an administrative point of view this feature is probably the most difficult aspect of the law's enforcement. There are questions as to when an employee is working in interstate commerce and when he is working on goods for commerce. There are problems of definition which naturally arise in applying the exemptions of the law. Obviously, all these interpretations cannot be discussed here,[1] but a few of the more important administrative definitions may be noted briefly.

In defining the scope of employment in commerce, the Administrator has pointed out that it covers all employees working in the interstate transportation and communication industries, unless specifically exempted, as well as those working in businesses which are instrumentalities in the stream of commerce, such as warehouses, stockyards, and some grain elevators.[2] As for employees engaged in or necessary to the production of goods destined for inter-

[1] For an excellent article on this point, see Cooper, F. E., "The Coverage of the Fair Labor Standards Act," 6 *Law and Contemporary Problems*, pp. 333–52 (June, 1939). See also Douglas, P. H., and Hackman, J., "The Fair Labor Standards Act of 1938, II," 54 *Pol. Sci. Quar.*, pp. 29–55 (March, 1939). On the child labor aspects, see Lumpkin, K. DuP., "The Child Labor Provisions of the Fair Labor Standards Act," 6 *Law and Contemporary Problems*, pp. 391–405 (June, 1939).

[2] Wage and Hour Div., *Interpretative Bulletin*, No. 1 (October 12, 1938).

state commerce, the Administrator has held that virtually all such employees are included if the enterprise could not operate without them.[1] This definition places within the law maintenance and general office employees, as well as those who actually work on the goods through definite physical contact.

The question of when goods are intended for interstate commerce has caused some difficulty. It is often hard to tell whether a given good will enter interstate commerce. Apparently, if an employer makes any goods so destined he is within the coverage of the act. Recognizing that this is a difficult point, the Administrator has held simply that an employer falls under the act when he has reason to believe that the goods he produces will move in interstate commerce.[2]

Even if a producer within a state sells the goods to a vendor within the state and the vendor distributes them in the channels of interstate commerce, the producer may be liable under the law. The question, as interpreted by the Administrator, is not whether the goods stop after being produced before they enter interstate commerce, but whether they enter interstate commerce at some later time. While this interpretation may seem to enlarge the scope of federal power unduly, especially when the use of goods as ingredients for further manufacture is considered, any other interpretation would seem to leave open an easy means of evading the law.

In defining executive and administrative work for exemption, the Administrator at first held that such employment must include all the following characteristics: (1) management of the business concern or a customarily recognized department thereof; (2) direction of the work of other employees; (3) authority to hire and fire or to make recommendations of this sort carrying considerable weight; (4) exercise of discretionary powers; (5) compensation of at least $30 weekly; (6) performance of no substantial amount of work of the nature done by non-exempt employees.[3]

Late in 1940, the definitions of executive and administrative employments were changed.[4] Instead of being linked, the two types of employments are defined separately. Under the new definition, an executive is held to be a person whose primary duty covers management, who directs other employees, who has authority to hire and fire, who exercises discretionary power, who receives not less than $30 per week, and whose work hours do not exceed by 20 per cent those of non-exempt subordinate employees. The last requirement would thus exempt an executive, such as a foreman, who does not spend more than 20 per cent of his time at tasks of his non-exempt employees. Administrative workers are now broadly defined to be persons whose duties, although important and connected with management, are functional rather than super-

[1] See Cooper, F. E., *op. cit.*, p. 338.
[2] *Ibid.*, p. 341.
[3] 1 *Wage and Hour Reference Manual*, p. 78 (1939).
[4] *New York Times*, October 14, 1940, p. 1.

visory, and who receive at least $200 per month. The result of these new classifications, especially in the administrative group, was to extend exemptions to approximately 100,000 additional employees.

Professional employees were at first defined as those engaged in work predominantly intellectual and varied in character, work requiring consistent exercise of judgment and discretion as to manner and time of performance, work the output of which cannot be standardized in relation to a given period of time, and work based upon education in a specially organized body of knowledge.[1] In 1940, this exempt classification was expanded to include the artistic professions, such as musicians, sculptors, painters, actors, and newspaper reporters, and was narrowed to include only those earning $200 a month or more; however, licensed members of the legal and medical professions were excluded from this wage requirement.[2]

Another interesting definition has arisen out of the exemption of seasonal industries. As defined by the Administrator, such an industry is one which engages in operations during seasons regularly recurring and which ceases production, apart from maintenance, clerical, and sales work, during the remainder of the year. Such cessation must, moreover, be due to conditions, natural or otherwise, which make the materials for production not available during the recurring portion of the year.[3] This definition has the advantage of excluding from its scope the typical business which always closes down for a few weeks of the year for repairs or changes.

3. Wage Provisions. The Fair Labor Standards Act became law on June 25, 1938, and went into effect on October 24, 1938. For the first year minimum-wage rates for all employees subject to the act were placed at 25 cents an hour. Beginning with the second year such wages were set at not less than 30 cents an hour and were allowed to range between 30 and 40 cents for the next six years. At the end of seven years from the effective date of the act, 40 cents an hour was to become the lawful minimum wage, except where a lower rate is prescribed by the Administrator. But in no case after 1939 was the minimum wage to be less than 30 cents an hour.[4]

Except as minima lie between 30 and 40 cents, the minimum wage is not necessarily to be the same as between industries or within the same industries. Between 1939 and 1945 minimum wages may be fixed at rates above 30 cents per hour but in no event above 40 cents. In setting wages above 30 cents during this period, the Administrator must find that the higher rate is justified in view of the economic situation of the industry and will not cause hardship or unemployment. After 1945, the burden of proof is shifted. At that time,

[1] 1 *Wage and Hour Reference Manual*, p. 78 (1939).

[2] *New York Times*, October 14, 1940, p. 1.

[3] 1 *Wage and Hour Reference Manual*, p. 55 (1939).

[4] An exception was allowed by amendment of the law in 1940. Because the 30-cent rate proved prohibitive in Puerto Rico and the Virgin Islands, Congress granted exemption from this rate to these territories.

any minimum wage fixed below 40 cents an hour will have to be established after special recommendation of the Administrator.

The wage provisions of the law are intimately related to the administrative procedure of establishing the wage minima. Although it is the announced purpose of the law to make the minimum wage, for all industries covered, the rate of 40 cents per hour, the makers of the law realized that a general and abrupt requirement of this kind might lead to economic dislocation and unemployment. In order to lend flexibility to the regulation, the act empowers the Administrator to appoint industrial committees for each industry to which the law applies. While these are to serve in a research or advisory capacity, the assumption is that the Administrator will ordinarily see fit to follow their recommendations.

The industrial committees provided by the act are similar to state wage boards. Their personnel is made up of an equal number of persons representing the public, the employees, and the employers. The definition of industries and the determination of the size of committees are left to the Administrator, but in the appointment of personnel the act requires him to give "due regard" to geographical regions in which the industry may operate. The committees are to be paid a reasonable compensation upon a *per diem* basis.

The question of proper minimum wages, within the limits set by law, is to be referred by the Administrator to these industrial committees. They are to collect evidence of the economic conditions in an industry, and select the minimum wage they believe to be feasible. The wage decided upon must be approved by a majority of the members. In voting this rate, the committees are advised by the law to note economic and competitive conditions in the industry and to avoid setting a wage which will substantially curtail employment. They may not base any classification of minimum wages upon age, sex, or geographical regions. Moreover, they are ordered to consider, among other factors, (1) the competitive conditions as determined by transportation, living, and production costs; (2) the wages established for work of like character by genuine collective bargaining agreements; and (3) the wages paid for comparable work by employers (the "fair" employer) who voluntarily maintain minimum-wage standards in an industry.

One might note in passing that even though regional differentials are not allowed, consideration of several of the above factors may lead to the fixing of virtual regional differentials. In taking into account transportation costs in an industry as affecting its ability to compete, committees for industries in certain inland regions, especially the Middle South, may well fix a lower wage rate to make up for this disadvantage. Moreover, since cost of living varies between the South and the North, and between urban areas and rural areas, accounting for differences in cost of living may lead to differentials practically drawn on regional lines.

When a committee has reached a conclusion upon minimum wages for an

industry, it reports to the Administrator, who must hold hearings upon the report. If he then finds that it complies in letter and spirit with the law, he approves it and the wage so fixed becomes the lawful minimum wage. If he disapproves of the report he may not change it, but must remand it to the committee for further consideration, or dissolve the committee and appoint a new one.

4. HOURS PROVISIONS. The hours provisions of the Fair Labor Standards Act are relatively simple. For the first year, the law establishes the 44-hour week as standard. During the second year a maximum of 42 hours becomes standard, and beginning with the third year this maximum is reduced to 40 hours per week, the ultimate maximum intended. More than the maximum hours may be worked by a covered employee, but he must be paid at overtime rates of time and a half.

The hours provisions are for the most part absolute. Some elasticity is introduced as the result of special exemptions, and of longer hours permissible in seasonal industries and businesses operating under guaranteed employment contracts. These have been referred to in discussing the coverage of the act. To meet the temptation for employers to reduce hourly rates so that more than standard weekly hours might be worked without increasing weekly pay,[1] the act states that none of its provisions shall "justify" employers in reducing wages previously above the minimum fixed by the law. This provision, drawn as it is, seems to be little more than a wishful gesture.

5. CHILD LABOR PROVISIONS. The regulation of child labor under the law was assigned to the Children's Bureau of the Department of Labor rather than to the Wage and Hour Division, largely because of the long experience of that Bureau in such matters. Subject to the exemptions already noted, the law which the Bureau is called upon to enforce sets a general minimum age for employment in industry at sixteen years. Outside of manufacturing and mining, where such employment does not interfere with schooling, health, or welfare, the Bureau may lower the age limit to fourteen. In any occupation found to be particularly hazardous or detrimental to the health or well-being of minors, it may raise the age limit as high as eighteen.

As an aid in enforcement, the Fair Labor Standards Act provides that the Children's Bureau may make use of the state child labor administrative machinery. Instead of having a corps of federal government officials throughout the country, the Bureau accepts as evidence of age the age certificates which states require of employers. If a state certification system is not available or does not meet the standards of the federal government, special federal certification agencies are created. However, the state systems have been so ade-

[1] Thus, assume that an employer was paying a worker $24 for a 48-hour week before the law, or at the rate of 50 cents an hour; if after the law is in effect at a 40-hour standard the employer lowers the hourly rate to 46 cents, the employee could still be worked 48 hours for $24 (40 hrs. @ 46 cents plus 8 hours @ 69 cents = $23.92).

quate that the Children's Bureau has found only four states needing special federal measures.[1]

6. ADMINISTRATION: RESULTS AND PROBLEMS. Accurate appraisal of results under the Fair Labor Standards Act will have to wait until some time in the future. In the first few years of operation of the act many problems have been faced and some results can be noted. But the administrative process is still in a state of development. The law itself is not settled and many suggestions for its amendment have been made.

a. Coverage of the act. The extent of application of the act is indicated by estimates of people affected by its provisions. In September, 1938, it was estimated that 10,850,000 persons were subject to the wage and hours sections.[2] At that time, the number receiving less than 25 cents an hour was estimated at 300,000 and the number working more than 44 hours a week at 1,384,000. In April, 1939, the total number of workers subject to the act was placed at 12,300,000, with 650,000 receiving less than 30 cents an hour and 2,400,000 working more than 42 hours a week. The number estimated to be receiving less than 40 cents an hour was 1,418,000, and the total working more than 40 hours a week was calculated to be around 3,000,000.

The coverage of the wage and hours portions of the act is approximately one fourth of all persons gainfully employed in the United States.[3] This may seem a rather small proportion in view of the comprehensive character of the Fair Labor Standards Act, but when it is remembered that purely intrastate industry and agricultural employment are among the other many exemptions, the limited coverage is understandable.

The actual coverage of the child labor provisions is even more limited. It has been estimated that in 1938 some 650,000 children under sixteen were gainfully employed in the United States and that the act touches at best only 50,000 of them, or about 8 per cent.[4] The reason for this is of course the exemption of so many children in agriculture and in local personal-service trades. While the act does not meet the problem of eliminating child labor, it does allow for regulation and prohibition in some of the trades, especially in manufacturing and mining, where the social hazards of child labor are greatest.

b. Wage and hours provisions. The task of administration of the wage and hours provisions may be divided into three parts. One involves the determination of the minimum wages for each industry; this is primarily the function of industrial committees. Another has to do with interpretation of the act by the Administrator. A third is the enforcement of the regulations which have been determined.

[1] 28th *Ann. Rep. Secretary of Labor* (1940), p. 186.

[2] These and following data are from 27th *Ann. Rep. Secretary of Labor* (1939), p. 198.

[3] Doctor Isador Lubin, Commissioner of Labor Statistics, estimated total employment as of October, 1938, to be 43,580,000, of which 10,894,000 were in agriculture and 32,686,000 were in non-agricultural employment. See *Investigation of Concentration of Economic Power*, pt. 1, p. 162 (1939).

[4] Lumpkin, K. DuP., *op. cit.*, p. 401.

The establishment of industrial committees and the determination of minimum wages have necessarily been subject to delay, owing to the importance of thorough investigation of economic conditions. As of July 31, 1940, committees had recommended minimum wages for the following industries: textiles, wool, apparel, knitted wear, paper, railroads, hosiery, carpets and rugs, leather and leather products, millinery, and shoes.[1] The rates fixed by the industries reporting by that time ranged from 30 cents for the apparel industry in Puerto Rico to 40 cents in certain divisions of the same industry and in such industries as millinery, paper, and leather. These rates are probably fairly representative of what may be expected. And the Apparel Industry Committee recommendation of twenty-nine divisions of the industry with five different minimum-wage standards may be typical of results to be expected elsewhere.

During the first month that the law was in effect, the Wage and Hour Division received 2473 complaints alleging violation.[2] Within the first eight months 18,200 complaints were received, and by July, 1940, over 42,400 complaints had been received.[3] Obviously, to answer these complaints and to make inspections for determining their validity, and then to proceed against the employer in some of the cases, involve a very heavy administrative task. With only one hundred and ten inspectors by June, 1939, and less than three hundred by January, 1940, and with inspections requiring from four to eight days each, the first year's enforcement of the act was not spectacular. Relatively few valid complaints could be investigated owing to shortage of personnel and funds, and the Administrator was forced to rely upon a measure of co-operation in enforcing the law.

The federal government budget for the year ending June 30, 1941, provides for more than one thousand inspectors in the field. This force would seem to be large enough for the complaints, and the future of enforcement promises much better compliance with the law. In addition to the answering of complaints, the periodic payroll inspection contemplated by the Wage and Hour Division will aid in enforcement. Compliance would also seem likely to follow as the employing group and the employee become educated as to the meaning of the law. On this score, the Administrator has done an excellent job. Bulletins and press releases were sent out to employers, and during the first month of the law nearly five million pamphlets explaining the general purpose of the law were distributed.

c. Child labor provisions. Besides working out co-operative arrangements with state child labor agencies for enforcement purposes, one of the principal administrative tasks of the Children's Bureau in enforcing the child labor pro-

[1] "Two Years of the Fair Labor Standards Act," 51 *Monthly Labor Review*, pp. 551–63 (September, 1940).

[2] 27th *Ann. Rep. Secretary of Labor* (1939), p. 203.

[3] 28th *Ann. Rep. Secretary of Labor* (1940), p. 226.

visions is to investigate and define those occupations at which children may work. This task is divided between the determination of permissible employment for children of fourteen to sixteen, and of hazardous employments for minors between sixteen and eighteen. In the first age group, the exclusion of child labor is to be determined on the basis of interference with health and schooling, and no permission can be granted for work in manufacturing or mining enterprises. For minors from sixteen to eighteen, the only exclusion which can follow is that which the Children's Bureau finds necessary, in view of special hazards, for the protection of health and well-being.

Children from fourteen to sixteen are excluded from the following occupations, according to interpretation by the Children's Bureau: mining, manufacturing, and processing occupations and work which takes them into rooms where such employment is going on; work on power-driven machinery and hoisting apparatus; operation of motor vehicles or service as helpers on such vehicles; and public messenger service. These exclusions are, of course, in addition to those for minors over sixteen. For those industries fraught with special hazard, investigation has not yet resulted in many exclusions of work for minors from sixteen to eighteen. This exclusion has been ordered only in the explosive and munitions industry, for most occupations in coal mining, and in the operation of motor vehicles.[1]

d. Enforcement procedure. The law specifically makes a number of actions punishable offenses. Violation of the wage and hours provisions is prohibited. Discharge of any employee for making a complaint is made an offense, and the keeping of false records is prohibited. Transportation, movement, or sale in interstate commerce of goods produced in violation of the law is a punishable offense. These offenses are punishable upon complaint made to the federal courts, where, if an employer is found guilty, he may be fined as much as $10,000 or imprisoned up to six months.

Another means of securing compliance is through giving employees or their agents the right to sue for unpaid minimum-wage rates or overtime bonuses. If the suit for these back wages is upheld, the award must be double the damages allowed plus all costs of bringing the suit. This provision is so strong that usually when the Administrator finds back wages to be due an employee, the employer has readily agreed to pay them.

e. Constitutionality of the act. In a unanimous decision handed down in 1941 the United States Supreme Court upheld the constitutionality of the Fair Labor Standards Act.[2] The Court held that the power of Congress over interstate commerce is complete and extends to the exclusion of articles whose use is conceived to be injurious to the public health, morals, or welfare. The Court claimed that, even though manufacture is not itself interstate commerce, the power to exclude goods extended to shipments made by employers

[1] 28th *Ann. Rep. Secretary of Labor* (1940), pp. 196–99.

[2] *U.S. v. Darby Lumber Co.*, 85 Law. Ed. (Adv. Sheets), 395 (1941).

whose wage and hours practices do not measure up to the federal law. The Court found no objection to the law in that it was accompanied by the same incidents which attend the exercise of the police power of the states. Moreover, so far as restrictions of due process are concerned, the Supreme Court held that legislative fixing of minimum wages and maximum hours is "no longer open to question."

In view of the changed interpretations with respect to the interstate commerce power and the due process clause, advanced by the Supreme Court since 1937, the Wage and Hour Law decision is not surprising. At the same time, the broad power granted by this decision to Congress opens wide the legal basis for federal regulation of businesses once regarded as local.

F. SOME ECONOMIC ASPECTS OF WAGE AND HOURS REGULATION

However much wage and hours regulation of the kind which government has enacted may be desired, its economic consequences should not be overlooked, and should play a part in determining legislative policy. This is especially important if the arbitrary increase of wages or decrease of hours is based upon economic considerations rather than considerations of health, morals, welfare, or the desirability of leisure.

1. Economic Basis of Wage Payments. Although many imperfections and many monopolistic elements exist in the labor market, there is fundamental truth in the economic principle that the demand for labor is determined by its value to the employer. An employer hires labor because he expects that the value of the product created by it will equal or more than equal the price of the labor. The value of this product of labor follows a law of diminishing marginal productivity. That is to say, the value of the additional product of a unit of labor (work by a certain general type of employee for a period, say, eight hours) tends to diminish with the employment of additional units of labor, other things remaining equal. This is due to the fact that, after a certain point, the physical product of labor tends to increase at a rate which is not consistent with the increase in units employed (assuming that quantity of capital and land remain constant so that the change in production can be traceable to labor), and also to the fact that generally the price at which the product of labor is sold tends to fall with increasing output. Regardless of the rapidity of the rate of decrease of this marginal value product, at any given time there will be a tendency for it to diminish.

If the employer feels himself free to take advantage of the possibilities of profit from hiring labor, he will tend to pay workers an amount equal to their marginal value product. If the additional value product which an additional unit of labor could add were greater than the wage which the employer would have to pay to get that labor, it would clearly increase his profits to hire the

labor. On the other hand, if the marginal value product were less than the wage, it would pay him to reduce his employment until the marginal value product was no less than the wage. This process of equalization would tend to result from the rise in marginal value product with fewer units of labor employed, or from a fall in wages, or from both. Therefore, wages and employment would tend to be in equilibrium under circumstances in which the wage per unit of labor equals the marginal value product of the units of labor employed.

To be sure, the marginal analysis assumes the existence of a homogeneous mass of labor, freedom on the part of employers to follow the possibilities of greatest profit, knowledge on the part of both employers and employees as to their best interests, and effective competition between them. While labor is not homogeneous, certain types of labor are surprisingly alike, and differences in productivity of laborers within each group are not always great. Although employers may not wish freely to change labor rates for fear of disrupting friendly industrial relations, or may be unable to make changes in employment organization or productive processes readily, the desire for profit is strong enough so that, given time, it is likely to exert real influence. Knowledge and competition are ordinarily far from perfect, but the shrewdness of successful enterprisers and labor union executives make these factors felt in the labor market, more often than is sometimes realized.

An employer's demand for a particular kind of labor will, then, reflect diminishing marginal value product, so that ordinarily, over large enough quantities, the quantity of labor which will be purchased varies inversely with the price at which it is offered. In some cases this demand is very elastic, in that a change in the price of labor will affect the quantity purchased to an extent much more than proportionate to its price. Thus, if a drop of 10 per cent in wage rates would elicit an increase in quantity of labor employed of 20 per cent, the demand would be relatively elastic. On the other hand, the demand for labor may be fairly inelastic. In this case changes in the price of labor would not materially change the quantity of labor which would be purchased. If a drop in wages of 10 per cent is accompanied by an increase in employment of only 1 per cent, the labor in question has a relatively inelastic demand.

In the economic analysis of matters concerned with labor, the concept of elasticity of demand has been extremely useful. If the demand for a kind of labor is relatively elastic, the total amount that would be spent for that labor will be greater, the lower the wage rate. Or, looking at the same thing a little differently, the purchasers of labor will be very sensitive to price changes. But if the demand for labor is relatively inelastic, the total amount that will be spent for it will be greater, the higher the wage. The employers of labor will not condition the quantity of their employment to a very great extent upon the wages received.

The differing elasticity of demand between different kinds of labor is due to several factors. In the first place, the elasticity of demand for the commodity which labor produces will influence the elasticity of demand for labor, since labor is a derived demand. A second factor is the ease with which labor can be replaced by machinery. If labor is fairly necessary in given quantities for a productive process, this will tend to make the demand for it relatively inelastic. But if it is fairly easy to replace labor by investing additional capital in a labor-saving machine or other instrument, the demand will tend to be rather elastic, particularly in response to a rise in wages. The rapidity of the rate of diminution in marginal productivity, owing to the very character of the productive process, aside from the two factors mentioned, will also influence elasticity of demand.

The supply of labor is not nearly as complicated a phenomenon as the demand for it, although there may be difficulty in knowing the character of supply in given circumstances. While the total supply of all labor at one particular time may be quite inelastic,[1] the supply in certain trades entry into which or departure from which is easy may be quite elastic. In those trades where a high degree of skill is required or where union policy is effective in keeping newcomers out, the supply of labor may be quite inelastic, particularly in the short run. But in the longer run, this supply is likely to be much more elastic as additional workers are able to qualify for the trade, or some of the workers in the trade retire or leave it.

The labor market has traditionally been regarded as a fairly competitive one.[2] To the extent that this is true, and even where the competition is not as keen, the price of labor tends to be fixed by interaction of supply and demand factors. While many refinements can be made in the analysis of supply and demand, as well as in the determination of prices by them,[3] the following analysis of wage and hours regulation will proceed upon the simplified basis of these forces. This approach may well be criticized as oversimplifying a complex problem, but the conclusions thus obtainable are not far different in main outlines from those derived from elaborate analysis.

2. Economic Effects of Wage Regulation upon Employment. If the law requires payment of a minimum wage which is not higher than the value of the marginal product of workers in any industry covered, it will have no ef-

[1] Some students hold that the short-run *total* supply of labor has a negative inclination. In other words, within certain limits the higher the wage, the lower the quantity of labor offered. See Douglas, P. H., *The Theory of Wages*, pp. 494–500.

[2] See Nathan, Otto, "Favorable Economic Implications of the Fair Labor Standards Act," 6 *Law and Contemporary Problems*, pp. 416, 417 (June, 1939).

[3] The literature on wage theory is abundant. For a simple analysis of labor economics, almost any elementary economics textbook may be consulted. Some of the better more thorough treatments may be found in Hicks, J. R., *The Theory of Wages* (London: Macmillan and Company, 1935); Douglas, P. H., *The Theory of Wages* (New York: The Macmillan Company, 1934); Daugherty, C. R., *Labor Problems in American Industry* (Boston: Houghton Mifflin Company, rev. ed., 1938), chaps. VI and VII; and Millis, H. A., and Montgomery, R. G., *Labor's Progress and Problems* (New York: McGraw-Hill Book Company, Inc., 1938), chap. IV.

fect upon employment. If the minimum wage is below the marginal value product, either the wages in the industry are above the minimum legal wage, or imperfections in the competitive system have led employers to pay workers less than such marginal value product. In either case, the number of units of labor employed would not be affected, and since there is nothing in the establishment of minimum wages by law immediately to affect supply, there could be no effect of the law upon employment.

If the lawful minimum wage were set at a point above the marginal value product of any workers employed before the act took effect, the resultant tendency would be a reduction of employment. For unless some methods were devised for increasing worker productivity, the employers would tend to reduce their employment until the marginal value product of remaining workers rose to the minimum wage. The extent of this unemployment would, of course, depend upon the amount by which the minimum wage exceeded the value of the labor's marginal product and upon the elasticity of demand for this labor. If the demand for the affected labor were highly elastic, the reduction in employment would be considerable.

Another way of looking at the effects of minimum-wage regulation upon employment is to trace its influence upon costs. If an industry is more or less in a state of equilibrium before the imposition of a minimum wage, and the minimum wage is higher than the former competitive wage rate prevalent in the industry, the result is to increase labor costs. Some employers just able to stay in business with the old wage rate may now be forced out by the higher costs. Other more fortunate ones may either seek ways of saving labor by introducing machinery or attempt to pass the costs on to consumers in the form of higher prices. The success with which they can replace labor for capital will depend largely upon the character of the productive process and the availability and cost of capital. The success with which the higher costs can be passed on to the consumer will depend upon the elasticity of demand for the product of the employer or of the industry. If this demand is relatively elastic, the high prices will tend to reduce sales and output to a very great degree. In any event, the result is likely to be a reduction in employment, unless, of course, something should occur to increase the demand for labor. The severity of this reduction will depend upon the disparity between the minimum wage and the previous competitive wage and upon the elasticity of demand for labor.

3. Economic Effects of Hours Limitation. The limitation of hours of work has been justified in the interest of health, safety, and morals, and also on grounds of economic expediency. As for the latter basis, it is said that shorter hours will cause the given amount of work to be shared, will make labor scarce and increase its price, will give workers leisure and increase their demand for goods, and will solve the problem of overproduction by the higher price for labor and the greater demand for goods by workers.

The analysis of effects of hours limitation in accordance with "orthodox" economic theory does not support the reduction of hours as the economic panacea that many claim it to be.[1] The results indicated by economic analysis are different with varying conditions. Thus, it is important to distinguish between cases of hours reduction which increase hourly or daily production, those at the same hourly wage, and those with an increasing hourly wage. One should also be careful to distinguish between changes in productivity which occur from changes in hours and those which follow from improved methods of production.

In some cases reduction of the working day or working week may actually increase the productivity of labor. Labor is a factor of production which is peculiarly subject to fatigue, and which may actually be able to produce more in a shorter day or week than in a longer time. Some industrialists have been surprised to find that with the lowering of daily working hours from 12 to 10 or 8, the total product which results has been greater. This has been due to the fact that beyond a certain time, labor may become so tired that efficiency is impaired and costs are increased through a poorer quality of work and a higher accident rate. But the increase in productivity traceable to lower hours is not without limit. Ordinarily this increase does not follow if the work day is reduced below 10 or 8 hours. In some industries and in some occupations the point at which total productivity is not increased may be with a longer work day than in others.

If hours are reduced with no change in the hourly rate of pay, the economic consequences to be expected are not particularly complex. Labor costs per unit of output are not directly affected. But unless more shifts of labor are employed, the cost of capital per unit of output will tend to be higher, since capital will not be used for so long a time. If capital costs increase, the ultimate result will tend to be an increase in cost of production and an increase in supply price of goods produced (or a decrease in supply). With such increase in supply price, the quantity of goods which would be sold would tend to fall, the extent of the fall depending upon the elasticity of demand for the goods, and some unemployment might ensue.[2] Unless the demand for goods were very elastic, however, the drop in employment occasioned by higher prices would be overcome by the increase of employment caused by the shorter hours. Even so, such increase would be accompanied by lower daily or weekly earnings per worker, and the result would be merely to spread work and wages over more workers.

[1] In support of this economic justification for reducing hours, see Black, H. L., "The Shorter Work Week and Work Day," 184 *Annals of Am. Acad.*, pp. 62–67 (March, 1936), and "The 30-Hour Week," 42 *American Federationist*, pp. 272–74 (March, 1935).

[2] This would seem to be the result in competitive industry. But even in monopolistic industry similar conditions would appear to follow. The immediate effect would be the reduction in profits, with lowered returns going to the capitalist or enterpriser group. This in return would affect the demand of this group for the goods of other industries. Moreover, even in monopolistic industry increasing capital cost would probably mean an ultimate adjustment of price and production for maximum net profits, at a point of lower output than before.

The extent to which these results might be expected depends upon the amount by which capital costs per unit are decreased. And this in turn depends upon the organizational problem of putting on more shifts and the economic problem of marketing a larger output if the addition of more shifts increases output over that which existed prior thereto.

When workers have pushed efforts for shorter hours they have generally tried to force maintenance of the same daily or weekly wage. In other words, they have attempted to bring about an increase in hourly rates of pay. If the reduction in hours does not bring about an increase in hourly productivity to compensate for the increase in hourly rate of pay, one has virtually the same situation as was found in the fixing of a legal minimum wage above the marginal value product of labor. The practical difference between the two situations is that with reduction of hours and maintenance of daily or weekly pay, a much larger group of workers is likely to be affected. The legal minimum wage has usually been low enough so that few workers have been concerned. But a reduction of hours with an increase in hourly rates tends to affect far more laborers.

Higher hourly rates of pay for labor, in addition to possible higher capital costs, would tend to have a material effect upon total costs. Higher costs will cause a rather large drop in employment if the demand for the commodity is relatively elastic, and will also tend to cause displacement of labor by capital. If the demand for labor were inelastic enough in a particular trade, it is quite conceivable that its increased cost could be absorbed without decreasing the total quantity of labor much, and that the total workers employed on the shorter day or week might actually be larger than before. However, the demand for labor generally is quite elastic, and in most industries is usually relatively elastic.[1]

G. WAGE AND HOURS REGULATION: CONCLUSIONS

The past century has brought about tremendous changes in public attitude toward the sanctity of the labor contract. From a belief that interference with hours of work for children under twelve years was dangerous meddling with private rights and inexorable economic laws, public opinion has come to condone, if not to support, prohibition of most child labor below the age of sixteen, limitation of hours for both men and women to as little as 8 per day and 40 per week, and restriction of wages to a minimum of 30 or 40 cents an hour. Limitation of hours in more progressive states led the way to legislation fixing minimum wages. Regulation of hours for women and minors and for men working in unhealthful or hazardous occupations has been extended in some states to control over hours of practically all industrial workers. The

[1] Douglas found that the elasticity of demand for labor in manufacturing is between -3 and -4. In other words, a rise in wages of 1 per cent would bring about a decline in units employed of 3 to 4 per cent. See Douglas, P. H., *op. cit.*, p. 501.

progressive attitude of many states has even been outdone in the last few years by more rigorous control by the federal government.

This growth of wage and hours regulation raises many questions. Some arise from the validity of the motives involved and the effect of the control upon a material standard of living. Others have to do with the administrative task entailed and the legal bases of the regulations. The most important question of all requires the weighing of such controls in the light of the general welfare of society.

Although the desire to protect the working members of society from the hazards of long hours and too low wages is still probably the most dominant motive for wage and hours regulation, in recent years the wish to solve basic economic problems of unemployment and underconsumption has furnished a strong incentive for such controls. Even if in the long run the material standard of living should be impaired, improvement of individual physical and economic health and welfare may more than justify such governmental interference with the labor contract. Even if the motive for some regulation is the assurance of adequate income and leisure for workers to enjoy a fuller life and become better citizens, the possible loss in material welfare may be a minor consideration. And, it should be remembered, much wage and hours regulation may not adversely affect the material standard of living, but may merely force a few unenlightened employers to adopt measures which improve labor's productivity.

From an economic point of view, lowering hours and increasing minimum wages in order to solve unemployment and overproduction or underconsumption, or similar economic ills, do not seem to be sound. An increasing material standard of living for a people as a whole can come only through increasing production. Curtailing output may be advantageous for a small monopolistic producing group faced with an inelastic demand, but generally speaking it can hardly enrich society. In the ardor to lift oneself by one's bootstraps, this simple truth is often overlooked. It may be that mechanical and social inventions and efficient management of the factors of production may bring forth a higher material production in the face of measures designed to increase labor cost per unit of output. Nevertheless, if such cost-increasing measures were not adopted, the total economic production would be greater than otherwise and the material standard of living would tend to be higher.

The administrative task in enforcing wage and hours regulations is large. Even with the restricted coverage of state and federal laws, it is still too early to say whether administrative techniques and legislative appropriations are adequate to meet the problem. Many state laws have been little more than ineffective declarations of legislative policies, because of inadequate enforcement machinery. The federal government has made an impressive start with its administration of the 1938 Wage and Hours Law. But in the first months of the law little more than solicitation of co-operation could be attempted. If the

coverage of both state and federal laws should be broadened, as would seem ultimately to be the case, the administrative problems will be greatly complicated. It is important that they be solved and that enforcement be effective, for a partially enforced labor law is not only unfair to the employer who abides by the law, but is likely to leave untreated some of the more serious abuses which the regulation was designed to solve.

Happily for the development of labor legislation to protect health, morals, and safety — the kind of regulation which the socially minded citizen can hardly help but support — the constitutional basis for wage and hours regulation seems to be sound. With the changed position of the United States Supreme Court and many state courts, the power of both the federal and state governments to deal with substandard labor conditions through such regulation does not seem longer to be open to doubt. However, if the regulation should be pushed beyond the standards necessary for health and public welfare, the courts might well curtail the legislative power.

Wise social policy would appear to demand a balancing of the desirability of fewer hours and higher minimum wages against that of material production. Many social reforms, of which wage and hours laws are no exceptions, cost society something in terms of the total production of goods and services. Yet this loss may be far outweighed by humanitarian considerations. These facts should be realized and well understood so that the legal fixing of hours and wages may proceed along lines indicated by an intelligent balancing of material and humanitarian factors.

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CHAPTER

27

HEALTH, SAFETY, AND SOCIAL INSURANCE

In a sense, all government interference with business on behalf of workers deals with labor's risks. Regulation of wages and hours lessens the risks of workers in connection with health, safety, and well-being. Government control in behalf of the bargaining position of labor, to be discussed in the next chapter, tends to reduce risks in the process of making a labor contract. But in certain fields of government regulation the relation of control and risks is far more direct. For perhaps the greatest of labor's risks is found in the hazards of disease, accident, old age, and unemployment. Whether these are caused by industrial conditions, by natural causes, or by dislocation of the economic system is of no great moment. They all lead to suffering to an extent great enough to cause public concern. Some risks are more directly attributable to industry, and the conditions under which people work, than others. Most, however, can be traced to social or economic maladjustment.

The seriousness of these risks is not difficult to show. The losses of time to wage-earners on account of sickness or non-industrial accident average more than seven days per year for each worker; the loss in wages alone is about $900,000,000 per year; the cost of medical care is much more than the loss in wages; and more than 2 per cent of the working population are disabled at any one time.[1] The proportion of this loss attributable to occupational disease or to physical conditions traceable to employment is probably large; the exact proportion, however, is not known, owing to inadequate investigation and reporting of sickness and non-industrial accident disability, and it should be recognized that much of this ill health is caused by personal habits, general environment, and natural causes.

Industrial accident also presents a serious risk. It has been estimated that during 1938 industrial accidents led to 16,400 deaths, 98,900 cases of perma-

[1] Millis, H. A., and Montgomery, R. E., *Labor's Risks and Social Insurance* (New York: McGraw-Hill Book Company, Inc., 1938), pp. 242–43.

nent disability, and 1,260,300 cases of temporary disability; [1] the average time lost per worker employed was estimated to be 2.9 days.[2] If the number of employed persons is taken into account, the loss due to industrial accidents during 1938 alone was equal to approximately 126,000,000 work days. The total cost of industrial accidents has been estimated at $2,000,000,000 per year, the loss in wages, medical cost, and insurance being about one third of this total.[3]

Although accident and disease generally strike at individuals with greater severity than does loss of a job by persons able and willing to work, unemployment is probably the greatest of all labor's risks and one of the most important problems which society has to face. While unemployment data vary somewhat and estimates are sometimes disputed,[4] the official estimates indicate that over 14,300,000 persons were unemployed in March, 1933; that 7,400,000 were unemployed in July, 1937; and that in October, 1938, the number was around 10,500,000.[5] With expenditures of the government for national defense and with the general rise in business by the end of 1940, the number of unemployed had probably dropped to approximately 5,000,000. Hence, in recent years from one fourth to one eighth of the labor force in the United States has been unemployed. Even more striking are the losses involved. It has been conservatively estimated that wage losses due to unemployment in nonagricultural employment alone amounted to $119,000,000,000 in the nine years from 1930 through 1938.[6] This tremendous total is the equivalent of the total wages and salaries actually paid out in the three years of 1936 through 1938.[7]

The losses to labor in health and in economic status are indicative not only of the great risks which labor faces, but of the compelling public interest in these risks. Individuals are seldom able to absorb them. Even the thrifty worker who makes a fair rate of pay may be unable to stand the financial cost of layoff due to accident, sickness, or unemployment. If a worker has been earning even an average wage, he is seldom able to save enough to pay doctor's bills and maintain the expense of a household, if he happens to be one upon whom the misfortune of sickness or unemployment falls. The risks of

[1] Kossoris, M. D., and Kjaer, Swen, "Industrial Injuries in the United States During 1938," 49 *Monthly Labor Review*, pp. 869–83 (March, 1939).

[2] *Ibid.*, p. 869. In 1937 the average time lost was four days.

[3] U.S. Dept. of Labor, Bureau of Labor Statistics, *Manual on Industrial-Injury Statistics* (Bull. No. 667, 1940), p. 1.

[4] Arthur Krock, in his "In the Nation" column in the *New York Times* for March 12, 1940, at p. 22, stated that private investigation indicated that the amount of unemployment was exaggerated and that, instead of more than 10,000,000 persons unemployed, the number of employables who were unemployed was between 2,000,000 and 3,000,000. In the *Times* for March 4, 1941, at p. 22, Mr. Krock offered further proof that his earlier estimate was correct.

[5] See *Investigation of Concentration of Economic Power*, pt. 1, p. 160 (1939). These estimates include, as unemployed, individuals working on work relief projects, but not on public works.

[6] *Ibid.*, p. 13.

[7] *Ibid.*, p. 196.

laborers are not only great, but they tend to fall rather unevenly and to bear particularly heavily upon some individuals. The result, without some sort of co-operative risk-bearing scheme, is that the worker and his family are reduced to pauperism, and to a standard of existence which may make them disgruntled and useless members of society.

The solution of these risks and their bearing upon a group unable individually to cope with them appears to lie in prevention and in pooling of the expense involved by them. The sound social policy designed to accomplish these things should be one which will, as far as possible, levy the costs of prevention and insurance in accordance with the causes of the risks. Some articles of consumption are necessarily produced under hazardous conditions. Some business enterprisers follow policies which make work more hazardous in their plants than in the plants of others. The costs of these hazards should be levied accordingly. Some risks are inherent in industry generally; others are produced by imperfections of the social organization. Where risks are traceable to industry, this cost should be allocated there. Where they are attributable to social dislocation, the costs should be borne by taxation as is any governmental cost.

The development of legislation to place the cost of accident, disease, and unemployment has not in the United States presented a record which can be looked upon with great pride. Accident reporting did not become very important until 1915,[1] and reports upon sickness and disease are still not very adequate. Safety and health legislation designed to enforce better conditions of work are largely a development of the last two decades. Compensation to workmen injured in industrial accidents was not adopted until the decade after 1910. Compensation for occupational disease has come only within the last two decades, and many states did not adopt legislation for this purpose until recent years. Compulsory health insurance is still only a much discussed plan which in time apparently will be adopted. Systematic compensation for unemployment through the insurance device was not adopted by any state until the Wisconsin law of 1932, and the federal government took no part in such a move until the Social Security Act of 1935. Furthermore, compensation for old age and invalidity, except through the medium of the "poorhouse" or private charity, was not provided for until the Alaskan pension law of 1915, and was not generally adopted in the United States until after the Social Security Act.

In contrast to the tardy development of social-compensation legislation in the United States, most European nations adopted such measures of government control decades earlier. In the latter part of the nineteenth century, many leading European governments passed legislation providing for safety prevention, accident compensation, compulsory health insurance, old-age

[1] Commons, J. R., and Andrews, J. B., *Principles of Labor Legislation* (New York: Harper and Brothers, 4th rev. ed., 1936), p. 162.

pensions, and old-age and invalidity insurance. Shortly after the turn of the century European nations passed laws providing for occupational disease compensation and compulsory unemployment compensation.[1]

Despite the recentness of most American social legislation, the development has been greatly accelerated since 1929. With the depression turning public attention to social problems to a much greater degree than before, both federal and state governments have passed extensive social measures. The protection of American labor from physical and economic hazards of employment has received such excellent legislative treatment in recent years that America may become a leader in this type of regulation. Nevertheless, some states have lagged far behind others and many laws have defects which amendments should eliminate.

A. STATE REGULATION IN BEHALF OF HEALTH AND SAFETY

The physical risks which labor faces are those which arise from accident and disease. Legislation to deal with these risks has applied largely to accidents and disease resulting directly from workers' occupations. The preventive aspects of regulation have been devoted to reporting and publicity, to limitations placed on persons, to prohibition and regulation of use of harmful materials, and to requirement of safety standards in the working environment. The alleviative aspects of regulation have been evidenced by enforced insurance measures, usually financed by the employing group.

1. Reporting and Publicity. The first step in the prevention or alleviation of industrial accident or disease is the compilation of accurate data as to their nature and extent. Under the leadership of the Bureau of Labor Statistics in the United States Department of Labor and such organizations as the American Association for Labor Legislation, reporting of industrial accidents has improved immensely in recent years. While all states report industrial accidents, the thoroughness and accuracy of these reports vary. States differ as to the kind of injuries reported, some states reporting only the more serious accidents and others insisting upon reports of all accidents. Moreover, states differ somewhat in the degree of enforcement of their reporting laws. In some cases, the requirements are rigidly enforced and administered by aid of a corps of inspectors, while in other states administration is likely to be somewhat lax.

One of the most serious defects of accident reporting is the fact that in some of the states many groups do not have to report accidents. Agricultural acci-

[1] For an excellent discussion of foreign experience, see Commons, J. R., and Andrews, J. B., *op. cit.*, chaps. IV and V, and Millis, H. A., and Montgomery, R. E., *op. cit.*, chaps. III, IV, VI, and VIII. Perhaps the most striking of all examples of American slowness in adopting social legislation is the outlawing of use of phosphorus in making matches. Commons and Andrews (pp. 194–95) note that this substance, work with which generally led to contraction of a fatal disease, was forbidden for match production in Finland in 1872 but was not prohibited in the United States until 1912.

dent statistics are seldom gathered by government. Many occupations where hazards exist are not reported upon by some state governments, although each year sees the list of occupations for which reporting is compulsory grow.

In passing, one should note the work of employers themselves in reporting accidents. As a part of the "safety first" movement in American industry, the National Safety Council was established in 1912. This organization, with a membership of several thousand employers, has done excellent work in accident investigation and prevention, and has saved very large sums to industry through aiding in the reduction of accident rates.

Reporting of occupational disease is still in its infancy. Altogether too few states have taken considered measures to obtain accurate information about its extent and nature. The United States Department of Labor has published such information as it could get, and has attempted to keep industry and labor informed of medical research on the subject. Strangely enough, the hope for more accurate data appears to lie in the administration of compensation legislation covering occupational illnesses. In recent years more and more states have included occupational disease as a basis for claiming workmen's compensation, and an increasing number of states have enlarged the list of diseases to which this compensation coverage must apply. As a natural result of granting compensation for diseases, there will be built up a mass of information about them.

2. Limitations on Persons. State safety and health regulation has approached the problem in some instances by excluding persons from dangerous occupations. Most common of such limitations is the exclusion of children from many occupations. Other regulation prohibits working by women in selected occupations regarded as particularly dangerous to their health and safety. Still other state laws provide that men who are not qualified by physical or technical fitness may not work in certain occupations.

The most general method of protecting the health and safety of minors in employment is through limitations placed upon the age at which children may enter certain employments. Practically all states forbid general factory and store work and underground employment to children under fourteen, although a few exempt children employed outside of school hours and children specially excused because of poverty. In an increasing number of states these limitations have been extended to children under sixteen years of age.[1] In recent years, this prohibition has been extended to child labor in mercantile establishments and, in some cases, to street trades and messenger work. In a few states where occupations are exceptionally hazardous, such as work with explosives, operation of dangerous machines, and work with poisonous compositions, the age limit has been raised to eighteen. Generally exempt from child labor laws

[1] By 1939 all states except Wyoming forbade factory, store, and mine work to children under fourteen. In the case of twelve states the minimum age for work in factories and stores was sixteen. See "Trend of Child Labor, 1937 to 1939," 50 *Monthly Labor Review*, p. 29 (January, 1940).

of states is employment in agriculture, in the home, in the street trades, and in canneries outside of school hours.

Other limitations applicable to children are found in laws providing for physical examination or completion of a minimum of education for the granting of an employment certificate. A majority of the states require some sort of physical examination before children below sixteen or eighteen can enter industry. Because these examinations are not standardized and are seldom repeated at intervals after employment starts, their effectiveness in protecting the health of minors is open to question. Most states require that a child applicant for work during school hours have completed a certain minimum of schooling, ordinarily through the eighth grade. Many states, by requiring that schooling be pursued until a child is sixteen or eighteen years of age, also effectively place a bar to entry into employment at an earlier age.

Most regulation for the health and safety of women has been devoted to limiting the hours of work. But in addition to limitations of this kind, already described in the previous chapter, miscellaneous special health and safety laws are found. Most mining states prohibit work of women in mines. Other states prohibit women from quarries, steel mills, smelters, pool rooms, freight or baggage services, and delivery services. In addition occasional states prohibit women from working in businesses requiring constant standing and from employment on moving or otherwise dangerous machinery. Some states also forbid employing women for stated periods before and after childbirth.[1] These state laws vary so much that generalizations are practically impossible. It can be said, however, that altogether too few limitations have been placed on the work of women. In the interest of public health and safety, these should be extended and made far more uniform as between states.

Exclusion of men from employment in the interest of safety and health has been conditioned upon physical and technical qualifications.[2] As compared to European countries, American states do rather little to limit the entry of workers into occupations which may be of special danger. A few states require physical examination to determine fitness of workers in work done under air pressure and on lead and lead products. Many more states, but far from all, require examination of workers in food-preparation industries for the existence of any diseases which might be communicated to consumers. Some states require other physical qualifications for entry into an occupation. These requirements are usually designed to protect the general public, such as the eyesight tests often required for employees in transportation.

3. Harmful Working Conditions. Regulation of the conditions under which labor works has been the principal means whereby government has attempted to prevent the occurrence of industrial disease and accident. The safety and health measures enforced by the states may be classified into those applicable to manufacturing, to mining, and to transportation.

[1] Commons, J. R., and Andrews, J. B., *op. cit.*, pp. 186–89. [2] *Ibid.*, pp. 189–96.

At first, state laws specified safety and health measures to be taken, among which were generally included machine guards, proper ventilation and lighting, fire safeguards, boiler inspection, and requirements of sanitation in washrooms and toilets. While state laws still establish definite minimum safety and health standards, the recent tendency is for the specific rules and regulations to be formulated and enforced by administrative agencies provided by the laws. Under this plan an enabling act is passed by the state legislature and the labor administration proceeds within the confines of this act to make up the safety and health code. In this way, as new conditions arise requiring regulation, the labor authority can draw up appropriate rules and not have to wait for the tedious process of state legislatures.

The accident rate in the mining industry is notoriously high and the conditions of work are naturally not conducive to good health. Numerous safety measures are provided by state laws. They include provision for adequate ventilation, tests for poisonous and explosive gases, precautions against falling rock and coal, and safeguards in the use of machinery, lamps, electrical equipment, and explosives. But one of the most serious of all coal-mining hazards is the existence of highly inflammable coal dust, and state regulation has yet to deal adequately with this problem. A few states require that mines be sprinkled with water to lay this dangerous dust, yet the most effective preventive, dusting with pulverized rock, has not been required. Owing to the expense of rock dusting and to the claims of many individuals that it is not worth the expense, this method has not been forced by legislation, in spite of the existing legislation of that kind in Europe, the recommendations of the federal government's Bureau of Mines, and the fact that many mine operators voluntarily use it.

The adoption of safety legislation in transportation has already been noted and need not be discussed here.[1] This legislation has been quite generally adopted and has required of transportation companies a wide array of safety measures. These devices have been designed in many instances to protect the traveling and shipping public, and in other instances to protect the health and safety of transportation workers.

State regulation of harmful working conditions calls for administration of a high order to be effective. Many states place fairly adequate laws on the statute books but fail to provide enough funds for effective enforcement. The question of enforcement depends largely upon the ability and adequacy of the inspection personnel. Most state laws require a minimum of one annual inspection in each establishment per year, but even this altogether inadequate minimum cannot be realized in some states. Several states, like Arkansas and Alabama, hire only one inspector for the entire state. In other states the number may be much greater but still be insufficient. Moreover, safety and health inspection requires a high degree of competency, and even the most

[1] *Supra*, pp. 130–34, 216–17, 230–31, 252–53.

expert inspector may not be able to pass accurately upon the many technical matters which safety and health laws provide. Much work is being done in some jurisdictions to train inspection personnel, and some states, of which New York is an example, have approximately one hundred inspectors divided into groups with special duties.[1]

Fortunately for the cause of safety and health, many employers have come to find out that measures to reduce disease and accident pay in savings far more than their costs. Since compensation laws often levy costs in accordance with the accident and disease records of businesses, and insurance payments often vary with the existence of hazards, accident and disease prevention has been found to be economical. Examples may be given where an expenditure of $1,000,000 for accident prevention by the American Car and Foundry Company resulted in savings of $2,700,000, and an expenditure of $9,760,000 by the United States Steel Corporation brought forth savings of more than $14,600,000.[2] At the same time, it should be realized that many smaller employers have been either unable or unwilling voluntarily to embark upon safety and health programs, and, curiously enough, the very small employers are often exempt from the operation of state laws.

4. Workmen's Compensation Laws. Accidents and occupational disease can be reduced by safety regulation, but it is too much to expect that they can be eliminated. As was noted in the opening pages of this chapter, large losses still occur from industrial accident and disease. These risks are now compensated for in most states at the present time through some sort of insurance which employers are required to carry. But to appreciate the importance of compensation legislation based upon insurance principles, let us look briefly at the possibilities of labor's receiving compensation for industrial accident under the law of liability. The development of employer's liability for industrial accident is found first under the common law. It is now largely superseded by compensation legislation, but in many states statutes still allow payment for industrial accidents to be handled under legal rules of liability.

a. The law of employer's liability. Although court decisions have varied in the different states, and common-law rules for determining liability have been changed by statute in many of them, a few generalizations concerning the legal liability of an employer for industrial accident may be made. The law of employer's liability has been based upon the principle that someone is responsible for an industrial accident and should bear the burden of it.

Under the early common law, the employer was under the obligation to use reasonable care in protecting workers. He had the duty of providing a safe place to work, safe tools, and competent workers. Absence of such reasonable care subjected him to damages for injury. The employee, on the other hand,

[1] U.S. Dept. of Labor, Bureau of Labor Statistics, *Labor Laws and Their Administration, 1938*, (Bull. No. 666), pp. 196–97.

[2] Millis, H. A., and Montgomery, R. E., *Labor's Risks and Social Insurance*, p. 227.

was held to assume the ordinary risks incident to his work. Entry into an occupation was supposed to be evidence that he accepted the usual hazards of that trade. Moreover, if the accident was due to any negligence on his part, the employer might be absolved of blame under the legal doctrine of contributory negligence. If the employer had not taken reasonable care in protecting his workers, but if the latter knew of the special dangers arising from this oversight, working under such conditions might be taken to be contributory negligence. Furthermore, under the fellow-servant doctrine the employer might be freed from liability. This doctrine held that if an employer used reasonable care in selecting his employees, injury to a worker caused by negligence of a fellow worker was not the responsibility of the employer.

The common law of employer's liability has been modified from time to time by statute. Although most states and Congress had made certain changes in the law as early as 1908, these left the main principles of common-law liability much as they had been developed by the courts. The more advanced of these laws abrogated the fellow-servant doctrine, and made the employer liable for damages caused to an innocent employee by a fellow worker. The doctrine of contributory negligence was changed to make the damages allowable reflect the degree of contributory negligence. Thus, if the employee was entirely at fault, no damages might be allowed, but if his negligence was of minor importance, the damages allowed should take this into account. States and the national Congress also imposed liability on employers for accidents in specified employments found to be especially hazardous. Railroad operation and mining were often excepted from the common-law rule that an employee accepts the inherent risks of his employment.

Despite some statutory changes in the common law of employer's liability, this method of compensating for industrial accidents was vigorously attacked between 1900 and 1912. Compensating injuries by resort to legal suit was declared to be unjust, uncertain, inadequate, and uneconomical. The injured employee was held to be a victim of the system under which he worked, and the cost of accident and disease resulting from employment, it was maintained, should properly be levied against the employer and included in the cost of production. Reliance upon legal suit was uncertain and inadequate because liability laws often absolved the employer from blame, and damages, if awarded, usually bore little relationship to the real loss suffered by the employee. Moreover, available evidence indicates that few employees injured in accidents obtained damages. Few workers even pressed suits for damages, because of the expense involved and the fear of losing their jobs. Some employees received voluntary settlements from employers; a few obtained damages in court action, but by far the majority received little or no compensation.

The results of employer's liability were also shown to be uneconomical. A large part of the payments actually made by employers in suits was absorbed in various legal fees. Since most employers took out insurance to protect

them from the liability of suit by employees, a part of the cost of industrial accident to the employers went to the insurance companies. One investigation, conducted in 1910, showed that out of every $100 paid by employers for premiums for liability insurance, only $28 actually reached the injured workmen.[1]

Another weakness of the system of employer's liability was that it did not lend much encouragement to accident prevention. So long as industry did not have to meet the costs of the physical risks of employment, employers had little interest, or found little profit, in prevention.

b. Development of compensation laws. Europe led the world in the enactment of compulsory insurance for work injuries. Germany passed such a bill in 1884 and Great Britain in 1897. The first compensation laws passed in the United States were those of Maryland in 1902, Montana in 1910, and New York in 1910. While these laws were held unconstitutional by state courts and the issue in favor of constitutionality was not settled by the United States Supreme Court until 1917,[2] twenty states had enacted compensation laws by 1913, and ten more states had such laws by 1915. By January 1, 1940, every state except Arkansas and Mississippi, as well as the territories of Hawaii, Alaska, Puerto Rico, and the Philippine Islands, the District of Columbia, and the United States Government (for civil employees and harbor workers), had some kind of workmen's compensation legislation in effect.[3]

c. State compensation laws: general nature. As might be expected, state compensation laws vary in respect to many details, although there are many points of similarity between them. Nearly all place virtually the entire cost of compensation on the employer. All are based upon insurance principles whereby risks and costs are pooled, although many allow employers to assume their own insurance. None of the laws cover all employments, and some of them apply only to the more hazardous occupations. Half the states and most of the federal territories require insurance for disabilities due to some or all occupational diseases. All the states except Oregon require a waiting period following disability before benefits will be paid. Most states prescribe a schedule of benefits for specified disabilities. In all states medical aid is required to be given to employees for treatment of injuries.

d. State compensation laws: method of insurance. In twenty states and territories the employer of covered workers is compelled to carry some kind of in-

[1] Commons, J. R., and Andrews, J. B., *op. cit.*, p. 232.

[2] *New York Central Railroad Co. v. White*, 243 U.S. 188 (1917). The question of constitutionality of state safety and health regulation will be taken up below, at p. 728.

[3] These and other details of compensation legislation are drawn from the following: U.S. Dept. of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics*, 1936 edition (Bull. No. 616), pp. 1117–34; "Workmen's Compensation in the United States, as of July 1, 1938," 47 *Monthly Labor Review*, pp. 566–87 (September, 1938); U.S. Dept. of Labor, Division of Labor Standards, *Digest of Labor Legislation, 1939* (Bull. No. 32); and Sharkey, C. F., "Principal Features of Workmen's Compensation Legislation," 50 *Monthly Labor Review*, pp. 574–600 (March, 1940).

surance for compensation. Of these laws, all but five allow the insurance to be carried in state funds where they exist, in private companies, or by the employer, if he can convince state authorities that he has ability to pay possible benefits. The other five laws require insurance in state funds. It may be noted also that the federal government's compensation law for harbor employees is compulsory, but that insurance may be carried either in private companies or by the employer.

Thirty-one states and Alaska make the carrying of compensation insurance elective. In these states employers have the option of insuring under the state law or relying upon the old common or employer's liability law. However, if an employer elects to stay under employer's liability, the customary legal defenses are generally not permitted, so that elective laws tend in reality to be compulsory. Of the elective laws, only three have exclusive state funds, and the others allow insurance in state funds, private companies, or by the employer himself.

Although few states establish exclusive funds for handling workmen's compensation, and some state funds compete with private companies and self-insurance, the record of insurance through them has been good. Studies have indicated that the cost of administering insurance has been lowest in exclusive state funds, and lower in competitive state funds than in any private insurance company, whether stock or mutual.[1]

Regardless of the way the insurance has been handled, the effect has been to encourage accident and disease prevention. In practically all insurance schemes, rates have been based upon merit rating. The employer's insurance cost has been based upon his accident and disease record. Consequently, employers have found it to their pecuniary advantage to reduce the cases of compensation loss. Not only has this led to safety and health devices and campaigns, but the employer has taken a far greater interest in minor accidents and sickness, where at all attributable to employment, so that carelessness in immediate treatment may not lead to larger claims later.

e. State compensation laws: coverage. State laws vary considerably in the character of employment which they cover. In principle, if workmen's compensation is sound, all employments and all employees should be covered. Actually, exceptions are made for small establishments, exceptions result from laws applicable only to hazardous employments, and employees are removed from the protection of these laws by specific exclusion of certain employments.

Slightly more than half the compensation laws except employers who have less than a certain number of employees. These exemptions run from employers of less than two employees in Oklahoma to employers of less than sixteen in Alabama, with most states excepting employers of less than five. Employers so excepted may voluntarily come under most laws.

In nine states the compensation laws apply only to hazardous employments,

[1] Commons, J. R., and Andrews, J. B., *op. cit.*, p. 254.

as defined by the statute or by the labor commission. In most of these states, employers in other enterprises may elect to come under the law if they wish.

Employees in certain occupations are usually excluded from the operation of workmen's compensation laws. Such occupations are agricultural work, domestic employment, casual work, and often work in charitable institutions.

f. State compensation laws: occupational diseases. The primary object of state compensation legislation has been to insure workers against the risks of industrial accident. Obviously, there is equal justification for insuring workers against the hazard of disease contracted because of the nature of employment. Up to January 1, 1940, occupational disease had been included as a compensable risk in twenty-nine states and territories. The United States Government had also included occupational disease in its compensation legislation for civil and harbor employees. Although insurance for occupational disease is not as general as circumstances warrant, the rapid development in recent years of legislation covering such disease is remarkable. When originally enacted. compensation laws did not apply to disease. As late as 1934, only twelve states and four territories had such laws.

State laws covering occupational disease are of three types. Ten states and the District of Columbia had laws in 1939 providing compensation for any disability resulting from any occupational disease in a covered employment. A few states compensate such disability wherever the law uses the word "injury" rather than "accident," and the courts have construed this to mean injuries due to occupational disease. The majority of jurisdictions list the diseases which are compensable under workmen's compensation. Some of these laws are fairly broad, the law passed by Maryland in 1939, for example, enlarging the coverage to thirty-four diseases.

There appears to be no convincing reason why occupational disease compensation should not be as broad as accident compensation. One is as justifiable on grounds of social policy as the other. The cost of occupational disease compensation is generally held not to be great in comparison with its social advantages. Although difficult administrative tasks are involved, these do not appear to be a serious drawback. It is probably but a matter of time until occupational disease compensation will be as general as workmen's accident compensation. As this coverage is broadened, the specific disease laws should be replaced by laws insuring all occupational disease. There seems to be no substantial justification for listing certain diseases and not others, and a danger exists that the legislature may not be able to keep the law in line with the known hazards occasioned by occupational disease.

g. State compensation laws: benefits. Compensation benefits are usually of three kinds: death benefits, disability benefits, and payments for medical care. The amounts paid for death and disability benefits are usually determined by three factors: the benefit rate, ordinarily a percentage of wages; the term of payment; and the maximum total set by law.

Most states have not been very liberal in allowance for death benefits when the economic value of the loss of a wage-earner to his family is considered. The majority of states provide for a payment of benefits to the widow and dependent children. Some allow these to be paid until the widow remarries or the children become of age. Other states specify a certain maximum period of time (generally from two hundred to five hundred weeks) during which the benefits will be paid. Still others provide for benefits to be paid until the total has reached a certain maximum (usually $3000 to $15,000).

Payments for disability may be classified under the four kinds of disability: permanent total, permanent partial, temporary total, and temporary partial. In all states except Oregon a waiting period of one to fourteen days is required before benefits begin, the majority of laws specifying a seven-day period. In most states, if disability continues beyond a certain number of weeks, varying from one to seven, benefits will be paid for the entire period. The reason for the waiting period is, of course, to prevent malingering. This danger is probably not so great as is often supposed, for few workers would care to feign illness and lose regular wages in return for the small compensation benefits.

Benefits for permanent disability are often higher than death benefits. In view of the necessity of caring for the injured, this provision is perfectly reasonable. A few states allow benefits to continue for the life of the injured worker, but most states limit them to periods ranging from two hundred and forty to six hundred weeks. Weekly allowances are generally calculated as a percentage of wages, usually about 65 per cent, and are limited by minimum and maximum weekly limits. The minimum weekly payment is seldom higher than $10 and the maximum is seldom above $20.

For permanent partial disability, payment is usually a percentage of the wage loss for fixed periods varying with the type of disability. Thus, loss of a hand may be compensated for two hundred weeks, while loss of sight may bring only one hundred weeks' compensation, and loss of an index finger thirty-five weeks. Only three states make a permanent payment for partial disability. In the other states compensation is paid for periods ranging from seven weeks for loss of a little finger to five hundred weeks for loss of a leg or arm. Practically all states compensate on the basis of the kind of injury. This method is open to criticism as being unfair. The loss of a finger or a hand to one worker whose job requires digital skill may involve more economic loss than it would to another worker.

Temporary partial and total disability benefits follow pretty closely the provisions of permanent disability. The main difference is that the waiting period becomes of primary significance because temporary disability does not often last more than a week or two. Furthermore, nearly all cases of temporary disability are likely to be total, or to be treated as such. If the worker is forced to leave his job because of industrial accident or disease, the disability usually involves complete discontinuance of work for a time. Another difference be-

tween temporary and permanent disability benefits is that in the former time limits have little effect, although the weekly maximum pay allowed may be very important to the worker.

h. State compensation laws: medical benefits. In all the states and territories with any kind of compensation law, medical aid is required to be given to injured employees. In slightly more than one third of these states there is no limit as to the amount or time during which aid shall be given. In over one fifth, the time is not limited but the payment for medical service is; these states set limits varying from $100 to $800. In another fifth, the time of payment is limited to periods ranging from ninety days to one year, but no restriction is placed on the amount of expenditure. In still another group, about one fourth of the states having compensation laws, both the time and amount are limited. In many cases where the state places limits on the time or amount of benefits, additional service may be given in special cases or at the discretion of the labor commission.

i. State compensation laws: conclusions. Workmen's compensation has been in effect in the United States for a quarter of a century. Yet it is still in a stage of development. Mississippi and Arkansas have no effective compensation laws. Almost half the states are without legislation providing compensation for occupational disease, and still other states make only specific diseases compensable. Many workers in states with compensation laws are in employments or under employers exempt from them. Waiting periods are generally longer than necessary to protect against malingering employees. Compensation payments are perhaps too limited in amount and in period of payment in most states, and death benefits are generally not high enough to protect a worker's family from the economic loss caused by death. The placing of limits on medical attention by most states is also an instance of poor social policy.

Interference in business affairs by compensation legislation is no longer of doubtful wisdom. Not only is it recognized that the cost of accident and disease should be levied against the cost of production and included in the price paid by the consumer, but compensation laws have perhaps done more than anything else to interest private industry in accident and disease prevention. While one should not overlook the great strides made in meeting labor's risk through compensation insurance, efforts to remove some of the weaknesses in these laws should not be relaxed.

5. HEALTH INSURANCE. Even the best system of workmen's compensation absorbs only some of the risk of accident and disease, since these laws apply only to injury or sickness arising out of and caused by the employment. The laws do not cover the risks of disability arising from non-work accidents or disease, or any disability in occupations not covered. Some of these disabilities are in no way connected with employment. Others may be traced only indirectly to employment, and so are not compensable. For example, an

employee may contract pneumonia; this is not regarded as an occupational disease, yet conditions of work may have reduced his ability to withstand infection and have indirectly caused the illness.

Whether or not disabling illness arises indirectly from employment, the costs of medical care, the loss of wages, and the fact that these losses tend to fall heavily when they do occur, constitute a social problem which society can hardly overlook long. While the federal and state governments do much to aid in the prevention of illness, and private organizations, such as insurance companies and the National Safety Council, have made great progress in education for prevention, compulsory health insurance is still not provided by law in any jurisdiction of the United States.

When the federal Social Security Act was passed in 1935, there was some agitation for a program of compulsory health insurance. Such insurance had been provided in many European countries,[1] and was recommended by the Committee on the Costs of Medical Care [2] and the President's Committee on Economic Security.[3] But the belief that progress in social security must be made slowly and the outright opposition of many groups forestalled inclusion of health insurance in the Social Security Act of 1935, as they have in the years before and since.

Perhaps the most important reason why some kind of health insurance has not been adopted under governmental auspices is the opposition of certain strong groups. Private insurance companies, drug and patent medicine manufacturers, employers' organizations, and the medical profession have registered strong opposition to compulsory health insurance. Until 1935, the American Federation of Labor opposed it. Insurance companies and the drug industry fear loss of business and curtailment of profit margins. Private industry, although not entirely opposed, has generally fought the insurance because of the increased tax costs. The medical profession, with the exception of certain groups, has been against it on account of fear that doctors' fees and freedom might be restricted by government control. Labor's opposition was based upon the belief by leaders, not shared by the rank and file, that the attractiveness of union sickness benefits would be impaired. These real reasons were not always given in publicly opposing a health-insurance law. Instead, health insurance was branded as socialistic and un-American, as designed to

[1] For a good discussion of these developments, see Millis, H. A., and Montgomery, R. E., *Labor's Risks and Social Insurance*, chap. VI.

[2] Organized in 1927 and financed by several large foundations, this committee reported in 1932 in favor of placing health insurance on a compulsory basis. See *Medical Care for the American People* (Chicago: University of Chicago Press, 1932).

[3] *Report to the President of the Committee on Economic Security* (Washington: United States Government Printing Office, 1935), pp. 41–43. Other investigations and reports supporting compulsory health insurance have been made. See Technical Committee on Medical Care of the Interdepartmental Committee to Co-ordinate Health and Welfare Activities, *The Need for a National Health Program* (Washington: United States Government Printing Office, 1938). For a good summary of investigations, see Falk, I. S., *Security and Sickness* (Garden City: Doubleday-Doran and Company, 1936).

encourage malingering and hypochondria, to interfere in the personal relationship of doctor and patient, and to discourage medical research and the attractiveness of the medical career through government control over fees.

As the benefits of social-security programs are more widely experienced, and as fears regarding schemes once regarded as radical — such as compensation insurance, unemployment insurance, and old-age insurance — fail to materialize, it seems that the time will soon arrive when compulsory health insurance will be a part of the national and state social insurance program. The need for social action in the problem seems to be as great as the need in cases where social insurance has already been adopted. If measures are included to safeguard the personal relationship of doctor and patient and to prevent waste of time and money in treating imaginary ills, the real bases for fear of the law should disappear. The main difference between the present system and a compulsory health-insurance plan lies in the allocation and distribution of costs. Even if the portion of the national income going to prevention and treatment of illness should increase, the benefits might well be worth the costs.

6. Constitutionality of State Health and Safety Laws. Where the states have acted to require business to take measures to protect the health and safety of labor, little difficulty has been encountered on the score of constitutionality. Only in the matter of compulsory compensation insurance has any serious question ever been raised as to whether laws to protect health and safety are proper under the police power of the states.

Compulsory compensation legislation was declared unconstitutional by several state supreme courts around 1910. Typical of these decisions is the invalidation of the New York law in 1911.[1] The New York Court of Appeals in this case held that to require an employer to assume liability for accident without regard to the question of fault was to deprive him of his property without due process of law. The Court pointed out that the law did nothing to conserve safety or health, but merely took property from the employer and gave it to the employee. When state compensation legislation reached the United States Supreme Court, however, that Court held that the public interest in this type of legislation was great enough to warrant any taking of property from the employer.[2] It held that it was not unreasonable for the state to require the employer to contribute a reasonable amount for compensating the loss of earning power incurred in the common enterprise of employer and employee, irrespective of the question of negligence. In another decision, the Supreme Court upheld the right of the states to create an exclusive state fund for compensation insurance and to classify industries and payments according to the hazard involved.[3]

[1] *Ives v. South Buffalo Rwy. Co.*, 201 N.Y. 271 (1911).
[2] *New York Central R.R. v. White*, 243 U.S. 188 (1917).
[3] *Mountain Timber Co. v. Washington*, 243 U.S. 219 (1917).

B. FEDERAL REGULATION IN BEHALF OF HEALTH AND SAFETY

Because of the local nature of the problem, and because the constitutional power of state governments in matters of safety and health is broader than that of the federal government, most of such regulation has been under the states. The federal government has had some part in the program, however, mainly in terms of aid rather than regulation, although in certain fields, such as transportation, its activities have been predominant.

Safety regulation in transportation has been discussed in other chapters and need not be treated here. Safety and health regulation in regard to child labor and workmen's compensation has already been briefly covered in connection with the federal Fair Labor Standards Act of 1938 and state compensation legislation, and need only be mentioned here.

Of some interest in the regulation of child labor is the attempt to amend the national Constitution to give Congress the power to enact laws limiting the age for children entering employment. After attempts to regulate child labor, under the interstate commerce power in 1918 [1] and under the tax power in 1922,[2] had failed, owing to interpretations by the Supreme Court to the effect that these powers did not extend to such regulation, efforts were made to amend the Constitution. An amendment giving Congress the power "to limit, regulate, and prohibit labor of persons under 18 years of age" had been ratified by twenty-eight states by 1941. Because of objection to the amendment by many interested groups,[3] little hope is held that the additional eight states whose votes are necessary for adoption will ratify it. Moreover, in view of the new interpretation of the Constitution upholding the Fair Labor Standards Act, concern about the amendment has lagged.

Efforts by the federal government in the field of compensation legislation have been limited to civil employees and to harbor employees, although an employer's liability act applies to employees in interstate transportation. Compensation legislation for civil employees is of little regulatory concern, for it is simply the plan of a large employer for establishing definite accident and disease benefits for his employees. Congress has placed all employees in interstate transportation under an employer's liability law which makes the employer liable for all accident hazards involved in the employment. Because longshoremen were held not to be under this law, nor under state compensation laws when injured aboard vessels, Congress passed a special compensation law

[1] *Hammer v. Dagenhart*, 247 U.S. 251 (1918).

[2] *Bailey v. Drexel Furn. Co.*, 259 U.S. 20 (1922).

[3] Arguments advanced against the amendment may be summarized as follows: (1) the mistaken belief that the amendment would exclude children under eighteen from any work, including chores on the farm; (2) the belief that the amendment would interfere with parental authority and would make the national government dictator of the schools; (3) the claim that such control by the national government is not needed because of the existence of state laws.

for these workers. It does not differ in any material respect from typical state legislation.

1. PUBLICITY AND EDUCATION. One of the most significant contributions of the national government to the cause of occupational safety and health is its publicity and education work. The Bureau of Labor Statistics of the Department of Labor has compiled information needed to guide legislatures and interested parties in passing laws on behalf of safety and health. The Division of Labor Standards has initiated various conferences with organizations of state labor commissioners, with a view to developing legislation and administrative techniques. The Division also aids states in the effective training of factory inspectors by developing training courses and making studies of industrial hazards. The Division further co-operates with private state and national safety organizations. The research and advisory work of the Children's Bureau and the Women's Bureau of the Department of Labor is also an important source of aid in bettering working conditions dangerous to health and safety.

Nearly every regulatory agency of the national government carries on some kind of investigatory and advisory work related to safety and health. The activities of the Interstate Commerce Commission, the Civil Aeronautics Board, and the Maritime Commission are especially well known, and work of this kind is also performed occasionally in bureaus of government administrative departments other than the Department of Labor.

2. PUBLIC-HEALTH SERVICES. The activities of local, state, and federal government agencies to promote public health have been so varied and extensive that they cannot be more than mentioned. Some idea of these may be gained from the fact that expenditures from tax funds in 1935 for health and medical services amounted to $520,000,000.[1] The United States Public Health Service has made a great number of surveys and has engaged in numerous researches of methods of disease control. Under the Social Security Act of 1935, $10,000,000 was granted to the Public Health Service for such research and for allotment to states for public-health work. The Children's Bureau of the Department of Labor has also been granted funds, since 1935, for maternal and child health services, services to crippled children, and child-welfare services. In 1940, appropriations for these services amounted to nearly $10,000,000.[2] Most of these funds are allotted to states which have health and welfare plans approved by the Children's Bureau and with an agreement to match the allotment with an equal amount from state funds.

3. PROHIBITION OF HARMFUL MATERIALS. In one instance the federal government has undertaken to aid occupational health. In 1912, Congress placed a tax of 2 cents per hundred on matches made with white phosphorus,

[1] Perrott, G. S., and Holland, D. F., "Health as an Element in Social Security," 202 *Ann. Am. Acad.*, pp. 116–35 (March, 1939).

[2] 28th *Ann. Rep. Secretary of Labor* (1940), p. 153.

and prohibited import or export of such matches. Thus, the power of taxation was employed practically to prohibit the use of this substance, so dangerous to the health of workers in match factories. This case of regulation, admirable as it was, has unfortunately not been duplicated, in spite of the fact that other substances dangerous to health, such as white lead, have been outlawed in foreign countries.

4. Federal Regulation: Problems and the Future. The federal government has not done a great deal in direct safety and health regulation, outside of the field of interstate transportation. Perhaps one of the reasons for this is the belief that its powers are too limited. Another reason is the general opinion that safety and health matters are more properly within the sphere of state governments. At the same time, there seems to be a growing feeling that, if the constitutional power to do so exists, the federal government should enter upon this field in a much more comprehensive fashion. The existence of such great variation in state laws, the fact that some states seem to place a premium upon keeping pecuniary, rather than human, labor costs low, and the pronounced public interest in safety and health account for a growing public opinion in favor of federal control.

The federal government has entered upon this field to a somewhat greater extent in recent years. The expansion of public-health services under grants made by the Security Act and the child-labor provisions of the Labor Standards Act are notable examples of this trend. Recently, bills have been introduced into Congress to force establishment of a national health-insurance plan. Enheartened by the popular success and legal validity of old-age insurance and unemployment insurance, presently to be discussed, supporters of additional federal safety and health legislation have been pressing their case in Congress. Their efforts appear to have definite possibilities of success.

C. OLD-AGE INSURANCE

An indigent old age is one of the important risks of labor which has been receiving particular attention in recent years; the problem has increased in severity in the last few decades. With increasing longevity and a declining birth rate, a larger portion of the population is falling within the age brackets above sixty-five. Meanwhile, industry has tended more and more to prefer younger men, and individuals over forty-five or fifty are usually too old to find new employment if once they lose their jobs. The shift of employment from agriculture into other industries has also had its effect in causing old-age insecurity, since the man on a farm can usually find something to do, even though he be over sixty-five. With the dissolution of the family as the central economic unit, older members can no longer so easily take refuge in the support of younger ones. Between 1890 and 1930 the proportion of men sixty-five years of age or older gainfully employed declined from 74 per cent to 58

per cent.[1] The Committee on Economic Security estimated in 1935 that approximately one half of the people above sixty-five were dependent upon others for support.[2]

There are four ways in which the loss of earning power during old age can be met. The worker may save enough through investments, or by purchasing retirement insurance from a private insurance company; he may be taken care of by his family or friends; he may become a public charge either through an old-age pension or commitment to an almshouse; or the state may establish a system of compulsory old-age insurance to provide a retirement income.

Much as one may extol the virtues of thrift, experience has amply indicated that private savings cannot be relied on to meet the problem. With wages for the mass of workers what they are, and with losses due to sickness and unemployment often high, the ordinary worker simply has not been able to accumulate enough to care for his old age. Even where savings are made, investment is a hazardous matter with the poorer and less educated workers, not to speak of the experience of the more well-to-do and sophisticated. From the social point of view, individual saving ample to care for the costs of old age is wasteful, since the same protection could be had at lower cost by pooling risks and resources. To some extent, this result is accomplished by the private insurance company, but voluntary private insurance is subject to many objections advanced against individual savings.

Care of old age through charity of the family or friends is not only degrading to the recipient, but is subject to the risk that sources for such aid will become non-existent or inadequate. To force children to care for older persons, assuming that these persons have children, is to place an economic burden on the latter which may involve real hardship.

Commitment to an almshouse is degrading in the extreme, and the fear of going to the "poorhouse" has probably been the greatest that the worker turning fifty has had to face. The cost of administering almshouses has been high, although it is difficult to get a fair picture of the cost, as compared to that of a pension system, because of the hospital care furnished by such institutions to the ill and infirm. It is fairly safe to conclude that, for the able-bodied, the cost of caring for the indigent old in almshouses is probably not much less than that of a modest pension adequate to provide bare subsistence.

If public support must be given to the aged — and there appears to be no doubt of the need — a system of retirement allowances is to be preferred. Because an old-age pension not based upon contributions of the worker often bears the stigma of charity, as well as because some reasonable contribution may represent a fair means of helping finance such pensions, allowances based upon some individual contribution are the most satisfactory. An allowance permits the individual to buy his own goods and to retain a degree of independ-

[1] Millis, H. A., and Montgomery, R. E., *op. cit.*, p. 359.
[2] *Ibid.*, p. 362.

ence. A retirement benefit based upon contributions has these advantages, and the additional one that the recipient feels it to be his by right and not an act of charity.

Since the Social Security Act of 1935, the United States has been committed to the policy of contributory old-age benefits. But because it takes time to bring an insurance plan into effect, and since not all old persons in need will always be able to qualify for contributory benefits, this policy has been supplemented by a plan of non-contributory pensions.

1. STATE OLD-AGE PENSIONS BEFORE 1935. The first old-age pension plans adopted by government, except for pensions to war veterans and government employees, were enacted by state and territorial governments. The first permanent old-age pension law was enacted by Alaska in 1915, and the first state to pass an effective law was Montana in 1923. By 1929, ten states and Alaska had such laws, and by 1934 twenty-eight states, Alaska, and Hawaii. Some of these laws were inoperative for one reason or another, and others which left operation of pension systems optional with county commissioners were in effect in only a few counties of the states. Under the impetus furnished by the Social Security Act, however, every state had an old-age pension law in operation by 1938.

Until 1929, many state old-age pension laws were of the optional type, giving county commissioners the authority to choose whether indigent old people should be supported by almshouses or by a system of pensions. The result was that few people were granted pensions, in spite of the fact that they were generally less costly than support in almshouses. After 1929 nearly all effective laws required payment of pensions, but as late as 1934 many state pensions were grossly inadequate. During 1934, the average monthly pension paid in North Dakota was only $0.69, in Nebraska $1.22, and in Indiana $4.50. More than half the twenty-seven states and territories paying pensions in 1934 expended an average of less than $10 per month per pensioner.[1]

2. FEDERAL ASSISTANCE FOR STATE PENSIONS SINCE 1935. The Social Security Act of 1935 made grants to states for approved pension plans equal to one half the total pension up to $30 per month for individuals sixty-five years of age or older, if not inmates of public institutions. In addition, the federal government granted to states an amount equal to 5 per cent of the pension grant for administering the state system. In order to get the grant, the state plan has had to be mandatory on all subdivisions of the state, to provide for financial participation by the state, and to be administered by an agency approved by the federal Social Security Board. The state administration, to be approved, is required to allow a fair hearing for any applicant whose pension is denied, to provide for such methods of administration, including since 1939 those relating to selection, tenure, and rating of personnel, found necessary for efficient administration of the plan, and to make such reports to the Social Security

[1] Millis, H. A., and Montgomery, R. E., *op. cit.*, p. 381.

Board as found desirable by the federal agency. State plans were further forbidden to place an age limit above sixty-five after 1940 (above seventy before 1940), to exclude any citizen of the United States, or to fix residence requirements higher than five years in the nine years immediately preceding application for a pension.

By amendment in 1939, the federal grant to states was raised to half of any pension up to $40 per month, so that the federal government's share may be as high as $20 instead of the $15 provided in the original act. This change does not mean that state pensions will be as high as $40. The state may pay more if it wishes, although the federal government's contribution is limited to $20. Or, as has actually been the case in practically all states, the state pension may be lower, since the state government share on higher pensions acts as a deterrent to taking full advantage of the federal subsidies.

The effect of the Social Security Act has been to cause all states to adopt mandatory pension schemes and to provide pensions for all qualified individuals at sixty-five or over. The result has been that the average pension increased from $14.53 in 1934 to $20.11 in 1940, and that the total number of pensioners rose from 235,265 in 1934 to 1,972,781 late in 1940.[1] The Social Security Act has also caused marked reduction in the residence requirements for pension qualification, although many states are still perhaps too strict in fixing the degree of economic dependency. These states generally use a means test for fixing pension amounts and attempt to permit pensions which, with other income of the pensioner, will make a monthly income close to the maximum. But in estimating the other income of the pensioners, state administrators often calculate what relatives ought to contribute. While this may seem fair, state laws have often been administered so that a real burden is placed on relatives or on pensioners, one of the very things that old-age pensions are designed to prevent. The wisdom of considering any other means than those of the applicant or spouse is questionable. On the other hand, some states, acting under political influence, are too liberal, and grant maximum pensions without much regard to a means test. In some states little investigation of the applicant's economic situation is made, and the maximum pension becomes a sort of general grant. Thus, relatively large pensions are found in California and Colorado.[2]

From an administrative point of view, the old-age assistance program has been subject to several weaknesses. Until the law was amended in 1939 the Social Security Board had practically no authority to supervise standards for selection, tenure, and compensation of state administrative personnel. But the law was changed to allow the Board to require merit standards for personnel responsible for the operation of social security programs. Furthermore,

[1] "Old Age Assistance in the U.S.," 49 *Monthly Labor Review*, pp. 72–73 (July, 1939) and 5th *Ann. Rep. Social Security Board* (1940), pp. 103–08.

[2] *Ibid.*

except for residence and age requirements, the federal government has little to say about the qualifications for pensioners. The question of adequacy of the pension is left to the individual states, although amendment in 1939 required that applicants' incomes be considered, and resulting standards from state to state vary considerably. Monthly pensions were found to average as low as $7.57 in Arkansas in 1940 and as high as $37.95 in California. Of the fifty-one state and territorial pension laws in effect in 1940, seven states had average pensions below $10 per month, twenty-one between $10 and $20, and twenty-three more than $20.[1] Nevertheless, it must be recognized that great strides have been made in the direction of adequate pensions since 1935, and if good sense prevails over visionary liberal pension schemes providing funds beyond the ability of the economic system to pay, the risk of insecurity due to old age will be substantially alleviated.

3. Retirement Provisions for Railroad Workers. The first compulsory old-age insurance law for workers in private industry was the Railroad Retirement Act, passed in 1934. Although this law was found unconstitutional in 1935 as an improper regulation of transportation and because of procedural infirmities,[2] later provision, which is almost certainly constitutional, was made for retirement insurance for railroad workers.[3]

4. Retirement Provisions of the Social Security Act. To supplement and eventually largely to replace straight state pensions, the federal government provided in the Social Security Act of 1935 for a national system of contributory retirement benefits. Strictly speaking, the plan does not provide for direct connection between contributions and benefits and does not represent a contractual system of retirement insurance. The law is set up in two parts, one levying taxes which go into general funds, and the other providing benefits under yearly appropriation laws. However, since this separation was made primarily to insure constitutionality, and since amendment in 1939 provided for automatic annual appropriations equal to tax revenues, the law may be regarded as a compulsory and contributory retirement insurance scheme.

a. Persons covered by the law. With certain exceptions, the Social Security Act, as amended in 1939, covers all persons who are employed in the United States after December 1, 1936. Excluded from the provisions of the law are the following: (1) agricultural labor; (2) domestic labor in a private home; (3) casual labor not employed in the regular course of an employer's trade or business; (4) federal or state government employment; (5) certain student employment and services of student nurses and internes; (6) employment covered by the Railroad Retirement Act; (7) and service performed in the employ of

[1] "Old Age Assistance in the U.S.," 49 *Monthly Labor Review*, pp. 72–73 (July, 1939) and 5th *Ann. Rep. Social Security Board* (1940), pp. 103–08.

[2] *Railroad Retirement Board v. Alton R.R.*, 295 U.S. 330 (1935). This decision, made by a 5 to 4 vote, is probably no longer controlling, so far as concerns the propriety of regulation, on account of the affirmance of the old-age insurance aspects of the Social Security Act in 1937. See *infra*, p. 741.

[3] For discussion of the railroad retirement acts, see *supra*, pp. 144–45.

any organization operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which accrues to the benefit of any private person. Because the act applies only to those employed by others, additional exclusions include self-employed persons, such as proprietors and professional people. With these exemptions, it is estimated that approximately two fifths of the gainfully employed are outside of the law.

The reason for excluding the first three groups mentioned above is the administrative difficulty of applying the law. Calculation of insurance taxes and collection from farmers, housewives, and casual employers would be so difficult that it was thought best not to extend the system to persons hired by these employers, at least for some time. Similar difficulty would also be encountered with student work. Other exemptions were made because of the belief that old-age insurance protection was available elsewhere. This is true in the case of railroad workers and government employees. Non-profit institutions often have private pension plans, and this fact may account in part for the exclusion, but there was really no sound reason for it.

b. Method of financing. The original act provided for income taxes on employees and excise taxes on employers of 1 per cent for each (total 2 per cent) on wages paid in any calendar year up to $3000. This rate was to prevail for the calendar years of 1937 through 1939, rising to 1½ per cent (total 3 per cent) during 1940 through 1942, to 2 per cent (total 4 per cent) from 1943 through 1945, and to 2½ per cent (total 5 per cent) from 1946 through 1948, after which the rate would be stabilized at 3 per cent (total 6 per cent). This schedule was changed by amendment in 1939 so that the 1 per cent rate will be frozen until 1943, after which it is supposed to go up to 2 per cent. Both the income tax of the employee and the excise tax of the employer are payable to the United States by the employer.

These taxes are paid into the general funds of the United States and then appropriated for benefit purposes. Until 1939 the Secretary of the Treasury was required to set up an old-age reserve account, a sort of "paper" reserve indicating payments made by the millions of individuals paying the tax. In 1939 an old-age and survivors' trust fund was established to which the tax receipts are automatically appropriated. This trust fund must be invested in bonds of the United States or bonds fully guaranteed by it, and must be invested so as to bear interest equal at least to the average rate on outstanding public debt. Although the details of the millions of individual accounts are kept by the Social Security Board, the benefits, as well as the expenses of the Board in administering the system, are charged against the fund as they are paid. Under the original tax rates, it was estimated that this fund would reach forty-seven billion dollars by 1980, but the problem of such a large reserve was partly solved by the amendments of 1939 which increased benefits and reduced taxes under those planned at first.

c. Retirement benefits. As the law was amended in 1939, retirement benefits were made available on or after January 1, 1940, for any person covered by the act who becomes sixty-five on or after January 1, 1937, provided he has paid taxes on $50 or more in half the calendar quarters between then and retirement. But persons reaching sixty-five between 1936 and 1940 could qualify with six quarters, and any worker with forty eligible quarters becomes permanently insured, even if he ceases work in a covered employment.

Those workers who meet the minimum requirements may retire any time after they reach sixty-five and receive benefits according to the following formula: 40 per cent of the first $50 of the average monthly wage, plus 10 per cent of the average wage between $50 and $250, plus 1 per cent increase in the amount so calculated for each year in which the worker earned more than $200 in a covered employment.[1] These benefits are subject to limits of a minimum of $10 and a maximum of $85 per month.

d. Family benefits. As the Social Security Act was passed in 1935, no insurance was provided for wives, widows, or dependent children. While monthly benefits for retired workers were generally larger than now, especially in the higher pay brackets, wives or children received no insurance payments, and, on the death of an insured worker, only a lump sum payment of 3½ per cent of the wages upon which taxes were levied was paid to his estate. Under the 1939 amendments, payments were provided for wives reaching the age of sixty-five during the life of the retired worker, for dependent children, and for widows and dependent children upon the death of an insured worker.

If a worker retires he receives a benefit as noted above. When his wife reaches the age of sixty-five, she receives a supplementary benefit equal to one half of the worker's benefit, and dependent children under eighteen get a like amount. If a worker dies either before or after retirement, benefits are provided for survivors. If an insured worker leaves no children, his widow, if she does not remarry, receives benefits at the age of sixty-five equal to three fourths of the benefit to which the worker would have been entitled. If an insured worker leaves a widow with one or more children in her care, she immediately receives a current benefit equal to three fourths of her husband's assumed benefit, plus one half of it for each dependent child under eighteen. However, her benefits may not exceed $85, or twice the husband's assumed benefit, or 80 per cent of his average wage, whichever is lower.[2] These benefits remain the same until the children reach eighteen or quit school to go to work, or the widow remarries.

[1] Thus, a worker who had received an average of $150 per month in every year for ten years in a covered employment would receive per month $20 plus $10 plus $3, or $33.

[2] For example, if a worker earning $100 per month and entitled to $33 per month in individual benefits dies and leaves a widow aged forty-five and three dependent children under eighteen, the immediate payment to the widow and children would be three-fourths of $33 plus three times one half of $33, or a total of $74.25. But since this is more than twice the primary benefit, the payment would be limited to $66 per month.

If an insured worker dies leaving no widow or young children, each parent who was dependent upon him for support at the time of his death may receive a monthly benefit equal to one half the worker's assumed benefit, when the parent attains the age of sixty-five. If the worker leaves no survivor entitled to monthly benefits, then a payment equal to six times the assumed monthly benefit is made to a relative or a friend paying the funeral expenses.

The benefit provisions of the amended Social Security Act indicate an attempt to protect the whole family, rather than the individual, from the insecurity of old age or the loss of the family provider. The benefits are also clearly based upon the principle that the lower-paid workers should draw relatively higher allowances than the higher-paid, so that a certain minimum necessary for subsistence can be paid to every insured worker. A worker earning an average of $100 per month for twenty years would receive benefits equal to $30 per month upon retirement at sixty-five, while a worker earning $200 per month for the same period and retiring at the same time would be entitled to only $42 per month.

Furthermore, the persons insured do not receive benefits commensurate with the period over which taxes are paid. A worker earning $100 per month for ten years would be entitled to $27.50 per month, but if he had paid taxes on the same wage for forty years, his monthly payments would be only $35. This system, therefore, tends to make the cost of insurance to the worker who retires soon much lower than to the one who pays taxes over many years.

In order to understand the tendency to grant relatively higher benefits to low-paid workers and workers who will retire within a few years, it is necessary to appreciate the desire of the framers of the act to make the benefits adequate for a minimum standard of subsistence for all insured workers, and to make them available soon after the system was put into motion. Nevertheless, the system is open to some criticism on the ground of higher cost to the younger and better-paid workers. There is reason to suspect that they are being called upon to pay part of the cost of annuities to older and lower-paid workers whose contributions are far less than necessary to support the expense of their benefits.

e. The problem of administration. The extent of the administrative problem in old-age and survivor insurance is indicated by the fact that some fifty million individual worker accounts must be kept by the Social Security Board. While the number of employees currently covered by the law is much less than this number — probably not more than thirty-five million, accounts must be kept for every worker who at any time in his life labors in a covered employment. Additional administrative problems arise in the determination of claims of millions of annuitants, widows, children, and other persons. To accomplish this, over three hundred field offices have had to be set up, each with a personnel trained to deal with the problems of advising claimants, employers, and others concerning the meaning of the law. Although the test of effectiveness with which the Social Security Board has met these problems cannot yet be

answered, the job is apparently being well done. At least, one hears little criticism of the way in which the act is being administered.

f. Problems and conclusions. The old-age insurance provisions of the Social Security Act represent a revolutionary change in the concept of the rôle of government in the United States. Contemplating the virtual solution of most of the problem of old-age insecurity by one piece of legislation, passed without too many years of thoughtful discussion, the law naturally raises many problems. Some of these have been dealt with in amendments enacted in 1939, but other problems, mostly of an economic and social nature, still exist.

The fact that it has been found necessary to restrict the coverage of the old-age provisions gives rise to problems. In the covered employments, both employees and employers contribute taxes for purposes of old-age benefits. In excluded employments, the full cost of pensions of people over sixty-five becomes a general government expense through the state old-age pension plans. The funds for these pensions come from general taxation which the employer and employee in covered businesses have to pay in addition to social security taxes. However, employees may tend to move toward the covered employments, thereby increasing the supply of labor in them. If this should result in lower wages, some of the disadvantage of higher labor costs of employers would tend to be offset.

Questions may be raised concerning the method of taxation and the tax costs in relation to benefits. The relatively higher cost of benefits to younger and higher-paid workers has already been mentioned. So long as tax rates remain low, these workers are apparently not paying more than the fair cost of insurance to them, and the government is bearing the higher cost of insurance for older and low-paid workers. But if the tax should reach 6 per cent per year, it seems probable that workers earning $250 per month or workers paying in for a period of forty years will be paying, including employers' taxes, more than the cost of the insurance to them.

The incidence of the payroll taxes by which old-age insurance is supported is worth examining. Clearly, some of the tax will fall on the employee in the form of forced saving. If the tax becomes high enough — and it will tend to be high as the years go on and if one considers additional taxes for unemployment insurance — labor may press for higher wages. If higher wages occur, a part of the worker's share of the tax, along with the employer's tax, will be assumed in the first instance by the employer. But this condition has the same effect as increased labor costs, which tend to reduce the quantity of labor demanded. This result appears to be true whether one regards the tax as the equivalent of higher wages or of a lower value of labor's marginal product. The extent to which the quantity of labor demanded would fall depends upon the elasticity of demand for it. In most industries, the employer may find it to his advantage to replace some labor by machinery, the quantity of displacement varying among occupations.

The employer may attempt to shift the tax to consumers through increasing prices. But there are checks on this shifting. Under monopolistic competition, advertised prices tend to be rather inflexible. Furthermore, the ability to shift a tax in any industry will be limited by the elasticity of demand for the good. If the demand is relatively elastic, higher prices will affect sales so adversely that the shifting becomes highly impracticable.

On the other hand, the payroll tax may increase total savings, if the government does not use the proceeds for consumption spending. Whether it uses them to invest directly in industry or to purchase government debt, the effect is the same: funds are removed from probable consumption use. Increased savings, well invested, should help to increase the efficiency of labor, and, as such, should in the long run increase the demand for labor.

The original Social Security Act contemplated financing of the old-age insurance plan through reserves similar to those used by private insurance companies. Since the reserve funds were to be invested in government bonds, critics held that the reserve was simply a paper one which worked a fraud on the workingman. This criticism is not exactly valid. If it can be assumed that Congress would not become spendthrift as the result of tax income from payroll levies, the effect of collecting for the next thirty years more taxes than the benefits paid out would be to reduce governmental debt in the hands of the public, and to use interest payments, which would otherwise be made to private holders of bonds, for the payment of old-age benefits. In other words, if a reserve is not accumulated, the government will have to make up by general taxation at some time in the future not only interest on the public debt, but the deficiency arising when benefits exceed current payroll tax collections.

Another method of financing which has been suggested is to "pay as you go" by collecting in taxes each year only enough to pay benefits. But this would mean very low taxes in early years, and later taxes probably as high as 10 per cent of payroll.[1] As a compromise plan, the present amended law provides for somewhat lower taxes than originally contemplated, and proposes to build up a reserve of much smaller proportions than that contemplated in the original law. The new law may be a makeshift, but it allows the government to avoid the problems of administering a forty-seven-billion-dollar reserve, it removes some of the temptation of Congress and the public to spend high tax income, and it may make the adjustment to payroll taxes a little easier.

The social security program has been criticized on the ground that it is not contractual and that the actual payment of benefits depends upon Congress. Some of the meaning of this criticism was removed by the amendments of 1939 whereby a definite trust fund was set up. However, as Congress changed the law in 1939, it may do so again. The danger lies not in whether the workers have a contractual right to benefits; political expediency would hardly allow Congress to withdraw from its obligations now. The greatest danger from

[1] Millis, H. S., and Montgomery, R. E., *op. cit.*, p. 402.

the power of Congress to change the law at will appears to arise from its possible liberalization until the economic system is unable to stand the cost. Share-the-wealth plans are far from dead. If Congress should become convinced that $200 per month could be paid as easily as $40, the economic effects might be so disastrous as to wreck the whole plan of social security.

5. CONSTITUTIONALITY OF OLD-AGE ASSISTANCE AND INSURANCE. The power of the state to care for the poor, and hence to pay old-age pensions, has long been held to be proper.[1] Moreover, the power of the national government to aid states in paying old-age pensions has not been seriously questioned. Its power to set up a nation-wide system of old-age insurance through taxes and benefits was challenged after 1935. As a matter of fact, the United States Supreme Court had held in 1935 that a system of railroad retirement pensions was "outside the orbit of Congressional power." [2]

When the old-age insurance plan of the national government reached the Supreme Court in 1937, the minority view in the railroad retirement case prevailed, and the law was held to be within the constitutional power of Congress.[3] The Court held that the tax on payrolls was a proper one, and that the power of Congress to tax for the general welfare included that to spend funds for the general welfare. The majority insisted that the problem of old age was "national in area and dimensions" and that expenditures for old-age insurance were clearly for the general welfare.

D. UNEMPLOYMENT INSURANCE

The extent and nature of the problem of unemployment have been noted in the first part of the chapter. The severity of this risk, which probably affects more workers than any other, was dramatically impressed upon the public by the depression following 1929.

The risks and costs of unemployment are so great that no single plan of government is adequate to cope with them. Many people become permanently unemployed and can best be aided only by some form of relief. Some unemployment can be eliminated by a program of public works. But these are primarily construction projects, and even if the expenditure in building were enough to make up for the depression in private construction, the problem of unemployment in many other fields would still exist. The recurrence and existence of some unemployment can be eliminated by improving labor's bargaining position, through public employment offices and otherwise. Some of the hardships of unemployment can be alleviated by a national system of com-

[1] See, for example, *Kelly v. Pittsburgh*, 104 U.S. 78 (1881).

[2] *Railroad Retirement Board v. Alton R.R.*, 295 U.S. 330 (1935). This was a 5 to 4 decision.

[3] *Helvering v. Davis*, 301 U.S. 619 (1937). The decision in this case was by a vote of 7 to 2. However, two justices apparently concurred on the precedent of the case upholding the unemployment insurance law, in which case they had dissented. The unemployment insurance law was upheld the same day by a vote of 5 to 4. That case is discussed below, at pp. 747–48.

pulsory unemployment insurance, through which benefits are paid to workers thrown out of work from funds contributed by employers or employees. Ideally, all unemployment, except possibly for unemployables who ought to be public charges, should be compensated for by a system of insurance. But to make possible an actuarial basis for unemployment insurance, all such systems in the United States have limited their benefits to rather short periods and have tended to apply them only to those temporarily unemployed.

The reasons why alleviation of unemployment cannot be left to private initiative are practically the same as the reasons for compulsory old-age insurance. Workers either cannot or will not save enough to tide them over periods of idleness. Public charity is regarded as degrading, and the building up of reserves by each individual worker to take care of the full costs of his possible unemployment may be socially wasteful.

1. Development of Unemployment Insurance. As in so many fields of social legislation, European countries have taken the lead in furnishing compulsory unemployment insurance for their workers. Great Britain adopted it in 1912, and by 1927 almost every leading country in Europe had such plans in effect.

Compulsory unemployment insurance received attention in the United States from time to time after 1912, particularly at times of downswings in the business cycle. In 1931, compensation bills were introduced in the legislatures of a number of states and several special investigating committees were appointed to study the problem. Early in 1932, the State of Wisconsin passed the first unemployment insurance law in the United States. Although many other states seriously considered enacting such laws after 1932, no more were passed until 1935, because of the fear that the cost of such insurance would place industry within the enacting state at a disadvantage with other states.

The Social Security Act of 1935 unleashed state action on unemployment insurance laws by providing a strong inducement to states to pass them. While the federal law did not directly establish a national system of unemployment insurance, it made it highly unwise for a state to refuse to enact a law, and provided means whereby no state could gain economic advantage from not doing so. As a result, every state and the territories of Alaska and Hawaii, and the District of Columbia have unemployment insurance laws in effect.

2. Encouragement to States under the Social Security Act. The Social Security Act was designed to encourage states to set up their own laws. It did so by two different inducements. In the first place, competitive costs to employers were equalized by the imposition of a federal tax against which an employer could credit up to 90 per cent of the federal tax for payments made to a state unemployment insurance plan. Secondly, the federal government offered the states a subsidy to cover the entire administrative cost of their unemployment insurance plans.

a. Tax and offset provisions of the federal law. Under the Social Security Act, a

tax of 1 per cent of wages paid by employers of eight or more individuals was provided for 1936, reaching 3 per cent of payrolls in 1938. No federal tax was levied on employees. Exempted were the following employments: (1) agricultural labor; (2) domestic service in a private home; (3) crews of vessels on navigable waters; (4) individuals in the employ of a son, daughter, or spouse, and children under twenty-one in the employ of a parent; (5) public employees; (6) employees of non-profit institutions operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. By amendment in 1938, railroad workers were also excluded, since a special unemployment insurance law was enacted for them.

Payments under approved state compensation plans might be credited against the federal tax to an amount not exceeding 90 per cent of it. After 1937, additional credits were allowable to an employer who, because of favorable employment experience or adequate reserves, was permitted by a state law to reduce his payments, subject to the following conditions:

(1) If the employer contributed to a pooled state fund, the lower rate granted must be based upon not less than three years compensation experience.

(2) If the employer contributed to an account guaranteeing a certain minimum of employment, the lower rate is permitted only if the guaranty was fulfilled during the preceding year and the account amounts to not less than 7½ per cent of the total wages paid in the preceding year.

(3) If the employer contributes to a special and separate reserve account held by the state in his name, the lower rate is permissible only if (*a*) compensation has been payable from the account throughout the preceding calendar year, (*b*) the account is equal to five times the largest amount of compensation paid by the employer in the previous three years, and (*c*) such account amounts to 7½ per cent of wages paid during the preceding year.

For a state plan to be approved for the allowance of credit against the federal tax, it must include the following provisions:

(1) All compensation must be paid through public employment offices or other agencies approved by the Social Security Board.

(2) No compensation must be payable until after two years of contributions in the state.

(3) State unemployment compensation funds must be deposited in the Unemployment Trust Fund of the United States Treasury.

(4) Money withdrawn from the Trust Fund must be used exclusively for unemployment compensation, and not for administrative expenses.

(5) Compensation is not to be denied to any individual for refusal to accept work if (*a*) the position is vacant because of a strike, lockout, or labor dispute, (*b*) the wages, hours, or conditions of work are substantially less favorable to the individual than those prevailing in the locality, or (*c*) the individual would be required to join a company union or resign or refrain from joining a *bona-fide* labor union.

The unemployment fund of the state is kept as a deposit in the Unemployment Trust Fund in the United States Treasury. It is invested by the Treasury

and bears interest at the average rate paid by the United States on interest-bearing obligations. A separate account is maintained for each state, and states make requisitions for funds for benefit payments against these accounts.

b. Federal grants for administration. The Social Security Board is authorized to certify to the Secretary of the Treasury the amounts of grants to states for administration of unemployment compensation plans. The amount is to be determined in the light of the population of the state, the number of persons covered by the state law, the proper cost of administering the plan, and other factors deemed to be relevant by the Security Board.

To be eligible for state grants, the state compensation law must fulfill certain requirements. These include the following:

(1) All provisions necessary for approval of allowance for credit against the federal tax.

(2) Such methods of administration, including since 1940 a merit system for administrative and technical personnel, as are found by the Social Security Board to be reasonably calculated to insure full payment of unemployment compensation when due.

(3) Opportunity for a fair hearing, before an impartial tribunal, for individuals whose claim for compensation is denied.

(4) The making of adequate reports as demanded by the Security Board.

(5) The making available to federal agencies administering public works of the names of unemployed individuals.

The Social Security Board is authorized, after reasonable notice and hearing, to revoke administrative grants to states if it finds that the provisions of the law are not being complied with, or that a substantial number of persons entitled to compensation are being denied it.

3. The Nature of State Laws. The fifty-one state and territorial unemployment compensation laws present so many variations in detail that generalizations are difficult. At the same time, the federal act and the influence of the Social Security Board in formulating model bills make it possible to summarize some of the more important aspects of these laws.

a. Coverage provisions. State laws follow fairly closely the coverage provisions found in the federal law as the basis for application of the unemployment compensation tax. Most states cover employers of eight or more individuals, although some laws include employers of one, three, four, six, or seven or more individuals. Practically all states exclude those employments exempt from the federal tax. The total coverage is probably slightly in excess of half of the normally gainfully occupied persons.

b. Contribution provisions. All state systems levy a payroll tax on employers, generally at a rate of 2.7 per cent.[1] A few states levy taxes on employees in addition, but the tendency is away from such taxes.[2]

[1] This rate is based upon 90 per cent of the federal tax of 3 per cent, the maximum allowable credit. Thus the employer customarily pays 0.3 per cent to the federal government and 2.7 per cent to the state government.

[2] In 1937 ten states required contributions from employees, often at a rate of one half the employer's contributions. By 1940 only six states still required employees' contributions.

c. Financing arrangements. All state funds must be deposited with the United States Treasury. This provision in and of itself precludes any system of financing by private insurance companies or by the employer, as is so often the case in accident and health compensation laws. But the set-up of the state fund varies as between "pooled funds" and "employer reserves." In the former case, all contributions of employers in the state are maintained in a general state account, and benefits are charged to this account or fund irrespective of the employer who laid the workers off. In the case of employer reserves, each employer has a separate account with the state fund; his contributions are credited to this account and the costs of compensation for employees laid off by him are charged to it. Forty-eight state and territorial laws provided for pooled state funds in 1940, and only three allowed for employer reserves.

The purpose of the employer reserve type of fund is to make for automatic merit rating. Under such a plan, since each employer pays for the unemployment caused by his own action, employers with good employment records have lower insurance costs. To guard against the depletion of an individual employer's fund, state laws allowing for such reserves usually provide that an employer's tax rate be raised as soon as his reserve falls to a certain point and appears to be in danger of depletion. The federal law does not require a state to do this, although it does place safeguards as to the adequacy of the reserve before a lower tax rate may be allowed, where the employment record of an employer is good enough to merit reduction of taxes below the standard rate.

Because there is some danger that an individual employer's reserve may be depleted in spite of safeguards, nearly all laws have provided for state pooled funds. These plans represent insurance principles at their simplest, all contributions being pooled and all costs being charged against the pool. As long as funds remain in the state fund, payments may be made to unemployed workers. Yet a simple pooled plan means that all employers, both those with good employment records and those with poor ones, pay the same rate. This has not seemed too fair or desirable, for it produces no economic incentive for an individual employer to undertake methods to prevent unemployment.

To meet the objection to simple pooled funds, most states now apply a merit-rating principle to govern individual employer contributions. These plans operate through statistics of the employment record of each employer. Employers with good records may have their tax reduced below the standard, and those with poor records may have their tax increased above it, though not usually higher than 4 per cent of payrolls. Strictly speaking, pooled plans with merit rating cease to be such, and are really closer to employer reserve plans, even though all contributions are credited to, and all costs are charged to, a single fund.

d. Computation of benefits. The greatest variation in state and territorial

laws is found in the methods of computing benefits; yet the results are surprisingly similar. Benefits are generally equal to 50 per cent of the employees' wage rate, subject to limitations usually of a minimum of $5 and a maximum of $15 per week. Most laws make provision for benefits for partial unemployment to encourage workers to take any part-time employment they can get. These benefits are usually equal to the difference between the amount earned and the benefit for full unemployment, plus a small addition, often $2 per week or one sixth of partial-employment earnings.

Qualification for unemployment insurance benefits depends upon several factors, including a waiting period, the amount of earnings previous to being unemployed, and the reasons for the unemployment. All states require a waiting period, varying from two to three weeks for the first benefit, and generally not more than five weeks in any year for further benefits.[1] Most states require for qualification a certain minimum-earnings record in the previous calendar year, or the first four of the last five quarters preceding the claim for compensation. The requirements differ between states, but usually provide for a minimum of eight to ten weeks full-time wages in the year preceding application for benefits. This provision is to safeguard the fund from the expense of carrying workers who do not have much of an employment record. Some states refuse unemployment benefits to workers who leave a job voluntarily without a good reason, are discharged for misconduct, refuse suitable employment (as limited by the national law), or participate in a labor dispute. In many states, however, the benefits are not entirely denied in these cases, but the waiting period is merely extended.

To economize reserve funds and to make possible adoption of actuarial principles in calculating costs, all laws limit the total payment of benefits to a qualified unemployed worker. Benefits are customarily limited to fourteen to sixteen weeks in any year or to fourteen to sixteen times the weekly benefit amount. This latter provision makes it possible for a partially employed worker to enjoy benefits over a longer period of time.

e. The problem of administration. Unemployment compensation laws are complex, difficult to understand in many cases, and fraught with many administrative problems. The collection of taxes and the determination of employers liable for taxes under the state laws involve some difficulties. But the greatest complexities arise from determining qualification of workers for benefits, from computing the amount of benefits and keeping account of their allowable duration, and from maintaining accurate records of employer unemployment experience for merit rating.

In order to determine qualifications for benefits, as well as for calculating the appropriate benefit, the state administration must get wage reports from

[1] Thus, if an employee becomes unemployed, he may have to wait three weeks before getting benefits. If he draws benefits for a time and then gets employment, if he should be laid off again his waiting period is only two weeks. Further layoffs following employment in the same calendar year require no waiting period.

employers, keep an individual account of employees' wage records, and maintain memoranda of benefits paid to each employee. Recently, legislation in many states has permitted wage records to be computed quarterly rather than weekly, and weekly wages have been computed as an average. The use of percentages in calculating benefits means extensive arithmetical computation. Beginning in 1939, state legislation permitted the use of wage classes, under which benefits payable in each class were the same. Fifteen states had allowed such a procedure by the end of 1939 and the administrative task of computation of benefits was materially lessened.[1] The determination of eligibility for benefits necessitates investigation of the reason for dismissal, the availability of suitable work, and the question of whether work offered but refused was "suitable." In addition, if merit rating is employed, individual accounts must be kept for all employers, and every case of unemployment compensation must be charged to that record.

The administration of state laws is helped by the institution of public employment offices. An employee must register there upon losing his job and must call to receive his benefits. This system not only makes the local employment office the point for clearing unemployment information, but, by making the office an agency to list jobs, renders it easier for officials to check on refusals to accept work. As these offices develop into effective clearing houses of job information, the sound administration of unemployment insurance will be vastly aided.[2]

4. Constitutionality of Unemployment Compensation. Both the state and the federal laws have been upheld by the courts as being within the constitutional powers of government. The highest courts of many states have upheld state unemployment insurance laws,[3] and the United States Supreme Court has upheld both the state and the federal laws.

The law of the state of Alabama was upheld by the Supreme Court in 1937.[4] This law was challenged as being contrary to the due-process clause and as being a surrender of state power under the coercion of the national government. The unemployment insurance tax was upheld both as a tax and as a proper objective of taxation. The majority pointed out that payrolls were proper objects of taxation and that the exemption of employers of less than eight individuals and of particular classes of employers was a reasonable means of classifying for tax purposes. As for the devotion of the tax revenue to unemployment compensation and the payment of benefits, the Court held that, since such expenditures were for the relief of unemployment, the system was for a reasonable public purpose. As for the coercive effect of the federal law,

[1] Malisoff, Harry, "The Emergence of Unemployment Compensation III," 54 *Political Science Quarterly*, pp. 577–99, at p. 591 (December, 1939).

[2] For discussion of public employment offices, see *infra*, pp. 758–61.

[3] See, for example, *Chamberlin v. Andrews*, 271 N.Y. 1 (1936), and *Gillum v. Johnson* (California), 62 Pac. (2d) 1037 (1936).

[4] *Carmichael v. Southern Coal and Coke Co.*, 301 U.S. 495 (1937).

the Court referred to its decision on the national law and noted that, while the federal law induced co-operation, it did not compel the states to establish unemployment insurance laws.

On the same day in which the Alabama decision was handed down, the United States Supreme Court upheld the constitutionality of the unemployment insurance provisions of the federal law.[1] This law was challenged on the grounds that the tax was improper and that the law coerced the states in contravention to the Constitution. The majority held that employment was a perfectly proper object for excise taxes, and that the exemptions were not so arbitrary as to vitiate the tax. Nor did the Court find that the tax-credit provisions unlawfully coerced the states to set up unemployment insurance plans. Admitting that "every rebate from a tax, when conditioned upon conduct, is in some measure a temptation," the Supreme Court declared that under the law states did not have to adopt unemployment insurance plans. In view of the national aspects of the unemployment problem and the fact that the burden of relief tended to fall on the federal government, the Court found ample justification for levying a general tax and offsetting a part of it by credits to states which assumed some responsibility for unemployment through compensation laws.

5. Unemployment Insurance: Some Economic Effects. Many economic problems arise concerning the effect of the unemployment insurance system upon costs, employment, wages, and the economic system. Although the unemployment insurance taxes, by being levied in addition to the old-age insurance taxes, accentuate the economic effects, the results to be expected do not differ materially from those already discussed in connection with old-age insurance. The increased cost must be included in the labor cost of production of goods and tends to reduce the marginal product of the workers. The extent to which the higher cost may be passed on to the consumer depends upon the elasticity of demand for the good being produced; and the degree to which this cost can be escaped by employers depends upon the ease and economy with which capital may be substituted for labor. But unless the demand for labor in an industry is inelastic, or means are found to use labor more efficiently, the higher labor costs incurred by unemployment insurance may have some adverse effects upon employment.

From the point of view of the unemployment insurance levies as proper taxes, it can readily be seen that they do not follow the principle of ability to pay. In instances in which they are levied on an industry furnishing consumptive necessities and can be readily passed on to the consumer through higher prices, owing to an inelastic consumer demand, the tax may become definitely regressive, by falling proportionately more heavily upon those

[1] *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937). Both this decision and the one in the Alabama case were decided by a 5 to 4 vote. Mr. Justice Roberts, who had voted against social security measures for railroad employees in 1935, sided with the majority in the social security cases of 1937.

least able to pay. Consequently, if the unemployment insurance taxes are regarded as a means of obtaining government funds to defray relief costs, their soundness may be open to question. On the other hand, much can be said for regarding them as necessary costs of production, similar to accident compensation insurance costs, which should properly be levied upon those persons who purchase the finished goods.

Some rather interesting possible effects of the unemployment insurance system upon the mobility of labor and rigidity of wages may be noted. There are several aspects of the system which may contribute to immobility of labor. In the first place, the separate state plans mean that a worker cannot move from one state to another without losing his accumulated employment record, upon which, in most cases, the duration of benefits is calculated. Second, since most states penalize the individual who quits work voluntarily by increasing the waiting period before benefits become payable, the unemployment insurance system tends to make workers unwilling to leave one job and attempt to get a better position. A third deterrent to mobility is the right of the unemployed worker to refuse a new job if the wages or conditions of work are substantially less favorable to him than those prevailing in the locality. Hence, an unemployed worker may be fully eligible for unemployment insurance and still not be required to enter a less favorable employment. Since this less favorable job has often been interpreted as being an employment in which wages or working conditions are less favorable than his previous job, an element of immobility in shifting from one type of employment to another is introduced.

From the point of view of rigidity of wages, there appear to be some grounds for believing that unemployment insurance may assist in maintaining rigid wage levels, especially in the face of falling wages. Although waiting periods for benefits are customarily lengthened somewhat for stoppage of work due to a strike, if the dispute lasts long enough the unemployment funds may aid in financing striking workers. In this event, the waiting power of workers would be increased and their power in enforcing a demand for wages would be strengthened. Moreover, if a trade union obtained wages above the marginal productivity of labor, and some unemployment ensued by workers' being laid off, the unemployed workers would be eligible for benefits without penalty, and objections to the trade-union policy by the unemployed would be softened somewhat by the receipt of unemployment insurance benefits. To the extent that such benefits would enable members out of work to pay their union dues, the insurance system would also strengthen unions in their program of collective bargaining and maintenance of wages. At the same time, some possibility exists that unemployment insurance benefits, along with other legislation protecting labor and its living standards, may remove some of the attractiveness of labor unions to workers, with resultant diminution of their importance.

In discussing the incidence of unemployment and old-age insurance taxes,

the point has been made that the shifting of these taxes will depend to a great degree upon the elasticity of demand for the product which an industry produces. As a result, the dislocating effects of these taxes are likely to be exerted on some industries far more than on others. Enterprises operating under monopolistic competition with a highly elastic demand for their goods necessarily feel the weight of these taxes more than other businesses. Even where competition is relatively "pure," if the total demand for the goods of sellers is quite elastic the marginal firms in the industry may be unable to keep in business.

The introduction of merit rating in unemployment insurance may also cause some noteworthy economic effects. If businesses with poor records of employment stability are penalized by the unemployment insurance taxes, speculative expansion of existing businesses and the rise of new and untried ones may be hampered by the possibility of high unemployment insurance taxes.

Although the above economic effects are indicated by the unemployment insurance plan, the student should recognize that future experience may seem not to support them. So many other factors influence costs, wages, employment, and prices that the effects of a single piece of legislation are likely to become buried in these other forces. For example, when business is caught in the upward spiral of a boom and is fed by tremendous governmental expenditures, as has happened with the armament program beginning in 1940, the economic effects of an unemployment insurance tax may be relatively insignificant.

6. Unemployment Insurance: Problems and Conclusions. Compulsory unemployment insurance is still in an experimental stage in the United States. With the great number of jurisdictions having such laws and with the rapid development of these laws after 1935, it is only natural to find existing many problems the solutions of which have not been found or have not been enacted into law. Only a few of these problems can be referred to here.

Most state laws provide only for employer contributions. This practice has been supported on the same grounds upon which accident and health compensation laws have excluded employee contributions. It is said that unemployment is an industrial hazard the cost of which should be included in the cost of producing goods. Proponents of employee contributions claim that the employee should in fairness aid in defraying the cost of insurance, that the benefits will have the stigma of charity unless contributions are made, that employee contributions are necessary if enough money is to be raised to pay adequate benefits, and that the employee, through the monopolistic power of labor organization, is often partly responsible for unemployment.

Not all these contentions seem valid. The employee does bear a large share of the real cost of unemployment by having to wait to receive benefits, by being paid benefits much lower than wages lost, and by having the period for benefit payment limited. Moreover, no evidence has ever been adduced to show that the receipt of accident compensation ever proved demoralizing by bearing the

stigma of charity. Real merit, however, lies in the other arguments advanced by those believing in employee contributions. If funds from taxes on employers turn out to be inadequate, the desirability of a financially sound and adequate unemployment insurance plan would seem to justify employee contributions. Furthermore, if employees had to contribute something toward unemployment insurance, workers might take more interest in the administration of the law, and might be encouraged to study the economic effects of union monopolism on the volume of employment.

Another problem arises out of the use of merit rating. Unemployment is a social problem which should be the concern of all industry.[1] If the concept of insurance is to be kept as the central thesis of unemployment compensation, the advent of merit rating should be carefully studied. If each employer pays only the costs of unemployment occasioned by his own experience, the unemployment risks of society are not really pooled. Moreover, merit rating assumes too much that individual employers are responsible for and can control unemployment. Although attempts by employers to prevent unemployment should admittedly be encouraged, a modified system of merit rating, whereby a small part of the savings attributable to the efforts of individual employers, is probably all that is needed. In this way prevention could be aided without losing most of the advantages of insurance.

Benefit provisions are needlessly complicated in most present laws. Calculation of percentages of wage payments often involves more detail than is necessary. Most European laws provide for flat rates for unemployed men and women, or for a series of flat rates based upon certain defined wage groups. Whether a worker should get $8.67 a week or $9.01 a week does not seem to be a very vital matter. In the interests of simple administration, the flat-rate system might well be adopted universally in America, and it is interesting that about one third of the states had done so by 1940.

Difficulties are encountered respecting the qualification of unemployed workers for benefits. The detailed calculation of wage records, the troublesome investigation of causes for unemployment, and the difficult job of determining whether a worker has refused "suitable" employment are only a few of the complications. Perhaps these requirements are necessary for economical and fair administration of unemployment insurance funds. But legislators should ever be on the alert to make changes which will reduce or eliminate such complexities.

One problem of fundamental importance has to do with the question of adequacy of the whole system of benefits. A large part of the working population is outside the laws. Weekly benefits are still so small, waiting periods so long, and benefit periods so short that a relatively small cost of unemployment

[1] Not to mention the general taxpayer. Indeed, a good case can be made out on these grounds for contribution to unemployment insurance from governmental funds, as has been the case in Great Britain.

is borne by the system. It may not seem to matter much whether the unemployed are supported by government relief, by unemployment insurance, or by other means of assistance. But in the interests of uniformity, adequacy, and self-respect of recipients, the scope of unemployment insurance should be materially broadened. The system should probably not be tainted by furnishing a dole for unemployables, but people willing and able to work who can find no employment might well be aided by the unemployment insurance plan. To do this, more funds would be necessary. Perhaps tax contributions of employers should be raised, or workers forced to contribute a small amount. To obtain most of the increase in funds needed, contributions out of general government funds should be made. The burden not handled by present unemployment insurance laws is financed out of general governmental funds anyway.

In concluding this brief discussion of the problems of present unemployment insurance legislation, one may well raise questions about the system of federal-state laws. At present, in addition to the federal law, there are more than fifty separate state and territorial laws. This means that a definitely national problem is being treated through a great many different jurisdictions operating under laws which vary widely in details. The system of federal-state laws means that some states will have ample funds to pay unemployment-insurance benefits and that others, unfortunately with industries in which employment is variable, will have to default on insurance payments, or unduly to restrict benefits, because of inadequate funds.

At the time the federal-state system of unemployment insurance was established, it was done for two main reasons. In the first place, a compulsory national law was believed to be unconstitutional; in the second place, local conditions were thought to be so different and the unemployment problem such a local matter that the states should set up the funds. On the first score, the reason apparently no longer exists. Decisions of the Supreme Court upholding all aspects of the social security program give the impression that a national system would be legally valid. As for the second point, the universal adoption of unemployment insurance laws by states, the fact that these laws follow generally similar lines, and the fact that the problem of unemployment does not change its complexion with the political boundaries of states lead one to believe that the local-problem theory is unsound. If these observations are generally correct, then the time may be at hand for adopting a truly national system of unemployment insurance.

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CHAPTER

28

THE BARGAINING POSITION OF LABOR

LABOR has sought to improve its bargaining position so that it may obtain high working standards and avoid some of the risks which imperil the economic condition of workers. The individual worker cannot afford to bargain on equal terms with an individual employer, since he generally lacks the resources with which to support himself and his family if he fails to make a contract. The employee, acting alone, can seldom place any pressure upon the employer to modify the wage or other conditions of work, because his only alternative to employment at the terms offered is unemployment. Moreover, individual workers have often been afraid to make complaints to employers for fear of being regarded as troublemakers and being discharged. The individual out of work is also in a poor bargaining position. He may not always know where a market exists for his labor, and he may not know what are fair and reasonable terms upon which to sell it.

Workers long have resorted to collective means to increase their bargaining power. Trade unions have been organized in crafts and in industries. These organizations have generally sought a large membership so that the employer may be obliged to deal with a unified front. They have also become mediums through which laborers have been able to force their views upon legislators and leaders in government.

Legislation to improve labor's bargaining position has been of several kinds. The economic need for placement of labor led to the private employment agency. But the abuses of the latter made its regulation necessary in the interest of both labor and the public. The fact that the private employment agency proved to be inadequate for the business of job placement, and involved expense to individuals who could ill afford to bear it, has brought about public employment agencies, formed, operated, and supported by the federal and state governments.

Improvement of bargaining power has also accounted for measures protect-

ing labor against certain kinds of competition. The United States has undertaken to restrict competition in the field of labor by limiting immigration and by permitting states to curb the sale of goods made by convicts.

It is not surprising that collective action of labor should cause conflicts with traditional rights of private property, and should meet with opposition from employers. In order to define the proper sphere of union activity, the government has placed restrictions upon the bargaining activities of employees and of employers. Some of these rules are found in the common-law decisions of courts, although the tendency in recent years has been to place them in the written statute. In addition, the government has undertaken on occasion to devise means for the settlement of labor disputes.

In recent years, the government has been dedicated to the policy of encouraging collective bargaining as a solution to the traditional conflict between labor and management. This encouragement has taken the form of legislation drawn to protect labor in the privilege of organizing and bargaining, without hindrance by management, through representatives chosen by the workers. This policy has meant that virtually all employers must consider the legal rights of organized labor in dealing with employees. The relationship of management to labor has become an important problem in government regulation of business.

A. REGULATION OF PRIVATE EMPLOYMENT AGENCIES

One of the more important labor problems is the placement of labor. Much unemployment exists simply because of the disorganization of the labor market. Labor locates its job opportunity and management finds its desired labor in many different ways. The most inefficient of such ways is the "help wanted" sign placed in a store window or at a factory gate. This method is haphazard and costly, since the right worker for the job is seldom expeditiously found by the employer, and the individual laborer loses much time walking the streets in an often futile search for work. Labor is also often placed through the influence and information of relatives and friends. But this method is not always satisfactory for the employer and has too much of a chance element for the worker. The classified advertising columns of newspapers also furnish a means for job placement; but this involves expense for the employee in answering a number of advertisements, does not insure the allocation of labor supply to points where it is needed most, and often puts the employer to needless expense in advertising and in interviewing workers to find the few who are qualified for the job.

The economic loss to employer and employee in unsystematic placement of labor has led to the organization of private employment agencies. Some of these are operated by educational or charitable institutions and no fees are charged. In other cases, some of the trade unions operate employment offices

through which their members are placed in positions. These offices have generally been efficiently conducted, but they apply only to relatively few trade-union members, and depend for their effectiveness on a strongly organized trade union either having control of a part of the labor supply, or enjoying the confidence of employers in the vicinity.

The majority of private agencies are operated for profit, and in the larger cities many such agencies are found. Until an effective national system of public employment offices was set up in 1933, most organized placement was handled by private agencies. At the time the national program was adopted, there were from four to five thousand private fee-charging employment agencies in operation in the United States. A few agencies have specialized in handling skilled, executive, and professional labor, but most have been organized to place domestic, theatrical, and unskilled labor.

1. Abuses of Private Agencies. Many commercial agencies have been conducted efficiently and on a plane of good business ethics. Nevertheless, so many abuses have been practiced in such a large number of cases as to create a social problem calling for regulation. Agencies have often charged extortionate fees, taking advantage of the economic distress of the unemployed and increasing fees when placement service is most needed by them. Fees have often been split between agencies and employers or foremen. It has been charged that private agencies have had three paying workers for each job, one coming from the job, one going to it, and another at work. Short-time employment and frequent discharges following upon fee-splitting not only defraud the workers but result in a wastage of the labor supply. The fee system has also been criticized because the entire cost of placement is levied on the worker, even though placement involves service to the employer as well.

Other abuses of the private agencies arise from anti-social practices. Job conditions have been misrepresented, and workers have found the pay and working conditions far different from those described. Agencies have also acted, either consciously or because of inadequate investigation, as mediums for soliciting employment in houses of prostitution or in vice rings.

2. State Regulation of Private Agencies. Nearly all states have enacted legislation restricting the practices of private employment agencies. These laws vary from the detailed and complete statutes of California and New York to the Florida law, which merely requires a license tax of ten dollars from agency operators. In all the states where there are large cities with many private employment agencies, however, the laws are fairly complete and follow a well-defined pattern.

Certain provisions are usual in the more advanced state laws. Employment agencies of educational and medical institutions are generally excepted, as well as agencies not charging fees. Agencies are required to obtain licenses and to post bonds to assure responsible operation. Fees vary from a few dollars to $500, and bonds from $500 to $5000. Much of the regulation is ad-

ministered through these licenses and bonds. If an agency does not abide by the law, the license may be revoked or application for renewal may be refused. If an agency defrauds a worker, or if a worker has other cause for damage suit, the bond is used as a means of insuring the payment of the damage.

Agencies are required to furnish job applicants with adequate information concerning the employer, the nature of employment, and the wages offered. They are generally obliged to return fees upon demand if employment does not materialize through their recommendation, or if an employee is discharged without fault of his own shortly after receiving employment. Misrepresentation of employment opportunities is forbidden. Private agencies are forbidden to send applicants to houses of ill repute or other places kept for immoral purposes, or to place labor in any business not abiding by the state labor law respecting such matters as regulation of child labor, minimum wages, and maximum hours. They are also made responsible for the moral character of the surroundings of their offices, which may not be located in saloons, boarding-houses, or houses of immoral character, and must keep away from the offices persons of bad or immoral repute.

While the above regulations have not been subject to any serious question on the score of constitutionality, the police power of the state being ample to support them, other state regulations have had some legal difficulties. In 1914 Washington enacted a law prohibiting private employment agencies from collecting fees from employees, although permitting fees from employers. This law was found unconstitutional by the United States Supreme Court in 1917.[1] In a 5 to 4 decision the Court held that, since the law in effect prohibited private employment agencies from operating, it was arbitrary and oppressive in that it unduly restricted the liberty of individuals to enter a useful and commendable business.[2]

Many states have also attempted to regulate the fees charged by private agencies. According to a decision by the United States Supreme Court in 1928, states are without power to do so.[3] The state of New Jersey had provided for approval of fees charged by employment agencies by the Commissioner of Labor. The Supreme Court, by a vote of 6 to 3, held that the law was a price-fixing one in a business which was not affected with a public interest. While the court admitted that abuses of employment agencies furnished grounds for regulation, it held that such regulation could not extend to price-fixing.[4]

[1] *Adams v. Tanner*, 244 U.S. 590 (1917).

[2] The attitude of the minority was that the abuses of private employment agencies were proper subjects of control under the police power, and that statutes under it might be valid even though they forced discontinuance, in whole or in part, of a business.

[3] *Ribnik v. McBride*, 277 U.S. 350 (1928).

[4] In view of the decision of *Nebbia v. New York*, 291 U.S. 502 (1934), regulation of fees of private employment agencies may now be valid, although the Supreme Court has not yet overruled the Ribnik case (see previous note). For discussion of the Nebbia case, see *supra*, pp. 287–89.

B. PUBLIC EMPLOYMENT OFFICES

Public interest in reducing unemployment and helping labor to find suitable jobs quickly has accounted for the development of a national system of public employment offices. Although these offices were not placed on a national basis until the last few years, the interest of government in them dates back to 1890, when the state of Ohio made provision for the establishment of some public offices.

The public employment office is a clearing-house for job information, soliciting opportunities from employers and listing applications from employees. The cost of this service has been borne by government, and the management and operation have been conducted by government. With the advent of compulsory state unemployment insurance, the public employment agencies have taken on new importance. They have become the agencies for handling applications for unemployment insurance benefits and for determining the eligibility of unemployed for them.

1. DEVELOPMENT OF PUBLIC EMPLOYMENT AGENCIES. The first public employment agencies, as has been noted, were provided for by Ohio in 1890. Similar laws were enacted by other states shortly after, so that by 1915 nearly half the states had provided for such offices. In addition, several municipalities set them up. Despite all this legislation, however, by the time the United States entered the World War in 1917 there were less than one hundred public employment agencies in the country, operating with aggregate appropriations of about $400,000 per year.[1]

With the entry of the United States into the first World War, the drain of man-power from industry and the need for labor in the war industries made a system of labor placement and clearance imperative. Congress quickly provided for a national system of public employment offices, so that by the time the war ended in 1918 there were over eight hundred offices in operation in every state of the Union. The amount of work of these offices is indicated from the fact that expenses ran around a half-million dollars monthly, and that between January, 1918, and March, 1919, the service registered over 10,000,000 applicants for work and made nearly 3,800,000 placements.[2]

Although the wartime public employment service made a good record and could have formed the basis for the development of an excellent peacetime system, Congress cut appropriations for the fiscal year 1919–1920 to $400,000, in spite of a budget request for $4,600,000. This meant the destruction of a real federal system. The federal employment service became merely an agency to compile and disseminate employment information, to assist state and

[1] Commons, J. R., and Andrews, J. B., *Principles of Labor Legislation* (New York: Harper and Brothers, 4th rev. ed., 1936), p. 12.

[2] Millis, H. A., and Montgomery, R. E., *Labor's Risks and Social Insurance* (New York: McGraw-Hill Book Company, Inc., 1938), p. 62.

municipal offices, and to give other minor services to public agencies. With occasional insignificant changes it remained at the same low level until the national government again actively entered the field in 1933.

The reasons for the apathy toward the public employment agencies between 1919 and 1933 are not completely clear; but it is certain that neither employers nor employees were very enthusiastic about the wartime service. The former believed that the employment offices favored union employees and attempted to aid unionism; union members criticized them for placing workers in industry without adequate regard for closed-shop policies. The fact that no very articulate public opinion in favor of public offices was found in the 1920's is due also to the development of personnel policies in private industry and to the relative prosperity of the decade.

In 1931 Congress passed a law providing for the establishment of a federal-state system of employment offices, much like that now in existence. This bill was vetoed by President Hoover, however, since he evidently favored a federal system, if he was strongly in favor of employment offices at all. Furthermore, employers urged the veto upon the President, largely because they felt that public employment offices would aid the cause of unionism.

The Wagner-Peyser Bill, similar to the bill vetoed by President Hoover, was passed by Congress and approved by President Roosevelt in 1933. This law provided for a federal-state system of public employment offices, with the states setting up the offices and the federal government encouraging state action through grants. The federal government also maintained supervisory control over the state offices. Under authority granted by the Reorganization Act of 1939, President Roosevelt has placed the national employment service under the direction of the Federal Security Agency, where the service is operated in conjunction with the unemployment insurance plan set up by the Social Security Act.

2. The System of Public Employment Offices. The Wagner-Peyser Act of 1933 created a United States Employment Service in the Department of Labor. It was the duty of this agency to encourage development of a national system of state employment offices, co-ordinate their work, supervise it and prescribe minimum standards of efficiency, promote uniformity in administrative and statistical procedures of state offices, and provide for publication and clearance between offices of important information bearing on labor demand and supply.

To encourage the states in opening offices, the law provided that three fourths of the appropriations of $4,000,000 per year [1] be allotted to the states on the basis of population, if they spent an equal amount on offices and if they maintained systems in conformity with standards prescribed by the federal agency. In response to this offer, all states and the territories of Alaska and Hawaii had established approved systems of public employment agencies by

[1] $1,500,000 for year ending June 20, 1934, and $4,000,000 thereafter for four years.

1939. In addition to the state system, the Wagner-Peyser Act provided for the establishment of a Veterans' Placement Service, a Farm Placement Service, a service for the handicapped, and a service for junior applicants. These agencies are under direct federal control but work in conjunction with state offices. With the enlargement of the program and the combination of unemployment compensation work with public employment agencies, approximately $35,000,000 was spent for the entire national system in the fiscal year 1938–1939.[1]

The federal program for employment offices, then, includes encouragement and supervision of state offices and the establishment of services to groups selected for special consideration. All the special services, however, operate within the framework of the regular state offices. The Veterans' Placement Service does not set up different offices, but supplies to every office a representative with the duty of investigating and promoting employment of war veterans. Similar provision is made for the other special groups.

The national plan of employment offices is based upon the state offices. The law recognizes that employment placement is a local matter, although federal supervision and clearance are desirable. To obtain and to continue to receive federal aid, state systems must meet certain requirements. Besides an agreement to match funds, they must agree to conform to standards of the federal service relating to personnel, premises, procedure, and other matters, and to make such reports of expenditures and operations as the federal government may require. The state laws must also establish advisory councils, composed of representatives of employers, employees, and the public, to make suggestions to the state employment office administration for the improvement of the public offices.

The influence of the national-state system of public employment offices has been growing steadily larger. As an emergency measure, the federal government created the National Re-employment Service, with offices in every state, shortly after 1933. This agency handled a large volume of placement work over a period of five years, although it gave way as state offices began to function so that, by 1939, it had almost ceased to exist. The Bureau of Employment Security of the Federal Security Agency (before 1939 the United States Employment Service) had succeeded by 1939 in having state offices set up all over the United States. At that time there were 1665 offices and 2750 itinerant points operating employment services throughout the country. The importance of these offices was enhanced by the beginning of payment of unemployment compensation in 1938, since application for benefits had to be made through them.

The federal agency charged with overseeing state public employment offices

[1] *Employment Service News* (July, 1939), p. 28. This periodical is published monthly by the Bureau of Employment Security in the Federal Security Agency (formerly the United States Employment Service in the Department of Labor). It is probably the best source of current information on public employment agencies.

has done much to make them an effective part of a national system. The standards for approval of a state system include the setting up of a merit system for office personnel, adoption of standardized methods of job classification, reporting, and accounting, and use of approved methods of office practices and procedures. The administration of the national system has been predicated upon the belief that these offices must be operated free of political influence, by a personnel trained in employment placement, and by procedures which will convince business men of the desirability of using the service.

In some respects, it has been unfortunate that the public offices have necessarily had to handle placements of applicants for relief jobs. This has often made some private employers dubious about the character of applicants which the public offices might want to place. As the national system has developed, however, the public offices have succeeded in placing a larger percentage of workmen in private industry. This is denoted by the fact that of 237,000 placements made by state offices in September, 1936, less than 48 per cent were in private industry; in June, 1940, however, 84 per cent of the 308,000 placements were for private employers.[1] These data indicate that the public employment offices are being regarded with more confidence by private employers.

3. Public Employment Offices and Bargaining Position. During the six years of the present national-state employment office system, the file of applicants and the record of placements have steadily increased. During the period from July 1, 1933, to April, 1939, nearly 75,000,000 applications were received and almost 26,000,000 placements were made and during the fiscal year 1939–1940, over 16,000,000 applications were received and 3,500,000 placements were made.[2] The average monthly active file of applicants has been around 6,000,000 and placements per month have ranged between 200,000 and 300,000.

The public employment offices have become genuine exchanges through which streams of applications from employers and unemployed have passed. As these offices increase in effectiveness, they cannot but help to improve labor's bargaining position. By studying the labor market, by offering information on jobs without cost, and by making competent efforts to fit workers to available jobs, the national-state employment service is reducing the time between unemployment and re-employment of labor. Thus, from the point of view of the economic system these offices have promoted the mobility of labor.

[1] 43 *Monthly Labor Review*, p. 1260 (November, 1936) and 51 *Monthly Labor Review*, p. 625 (September, 1940).

[2] 6 *Employment Service News*, p. 30 (July, 1939) and 5th *Ann. Rep. Social Security Board* (1940), p. 56.

C. PROTECTION AGAINST COMPETITION

The governments of both the states and the United States have taken occasion to protect labor from the competition of certain kinds of sub-standard work. In a sense, the regulation of child labor, the restriction of hours, and the requirement of minimum wages tend to protect labor against competition of those willing or forced to work under undesirable conditions. But, beyond the incidental effects of such legislation, the government has attempted to protect the bargaining position of labor by the restriction of immigration and by the prohibition of sale of prison-made goods in competition with those produced by free labor.

1. RESTRICTION OF IMMIGRATION. The problem of immigration is concerned not only with the economic effects of an increased labor supply, but with the effects of unrestricted immigration on the social and political institutions of the country. Restriction of immigration has been motivated by all these considerations, and legislation cannot be regarded merely as a means of protecting labor from competition. At the same time, limitation of labor supply, especially of labor willing to work at sub-standard wages, has been an important influence in the development of immigration laws.

Although state government action to limit incoming aliens antedated corresponding attempts by the federal government, effective restriction of immigration has been largely the result of national laws. Federal legislation on this subject began with a law of 1862 forbidding American ships to transport Chinese coolies. The first general immigration restriction act was passed by Congress in 1882. This law provided for a head tax of fifty cents on all immigrants and for the exclusion of such undesirables as coolie laborers, idiots, lunatics, and persons who might become public charges. In 1882 also, Congress passed the Chinese Exclusion Act, by which all Chinese labor was excluded for ten years, although certain classes of Chinese were exempted, including teachers, students, officials, travelers, and others coming to join lawful wives, husbands, children, or parents. The law of 1882 was extended by treaty until 1904, at which time Congress made an indefinite extension of it. Through a "gentlemen's agreement" between the Japanese and United States governments in 1907, Japanese were excluded on the same basis as the Chinese, and after 1913 this agreement was bolstered by laws of the Pacific states, which discriminated against Japanese in land-holding and the use of educational facilities. In 1917, the federal government enlarged the group of exclusions by barring immigrants from certain areas in Asia and Indo-China. The main purpose of this act was to exclude Hindus as well as members of the yellow race.

Laws of the federal government to restrict other immigration have been of two kinds. Until 1924, immigration laws were based upon the principle of selection, although during the period from 1921 to 1924, they provided for

both restriction and selection. After 1924, while principles of selection were not abandoned, the primary emphasis of immigration legislation was placed on restriction.

Application of selective principles during the period from 1882 to 1924 may be noted from the immigration laws passed during that period. The law of 1882 has been mentioned. Criminals and prostitutes had already been excluded by legislation passed in 1875. Polygamists were barred in 1891, and anarchists and professional beggars were excluded in 1903. In 1917, Congress provided for a literacy test for entry into the country and also raised the head tax to $8. The provisions of the law of 1917 were looked upon as a sort of protective tariff for labor, since literacy tests and the higher head tax were expected to keep out some of the immigrants with a lower standard of living.

Economic considerations concerning the supply of labor and competition of immigrant with American labor dominated the legislation of 1921. Without repealing any existing law, it provided for restriction for an emergency period. Immigration in any fiscal year was limited to 3 per cent of the number of each nationality resident in the United States according to the census of 1910. The quota restrictions were not applied to countries of North and South America, except the Central and South American colonial possessions of countries in the eastern hemisphere. Under this law, the total allowable immigration became about 375,000, or about one third of those entering in 1920.

When the law of 1921 expired in 1924, Congress passed an immigration law which further applied the quota principle. Annual quota percentages were reduced from 3 per cent to 2 per cent. The basis of calculation was shifted from the census of 1910 to the census of 1890. This not only resulted in a lowering of total allowable immigration, but placed much greater restrictions on immigration from southern and eastern European countries than upon northern and western nations, since the great tide of immigration from the former countries came after 1890. The law of 1924 provided that in 1927 a planned program of immigration should be put into effect by presidential proclamation. After 1927, the total number of immigrants was to be limited to 150,000 annually, and the quota for each quota nation was to be determined by the proportion of inhabitants of the United States in 1920 whose national origin might be traced to that country, except that the minimum quota was to be 100 per year. Thus, after 1927 the quota was influenced not only by the percentage of foreign-born, but also by the national origins of American-born citizens. This provision was put into effect in 1927, with the result that nearly 43 per cent of the total immigration quota was allocated to Great Britain and Northern Ireland, almost 12 per cent to the Irish Free State, and approximately 18 per cent to Germany and Austria.[1]

The quota system is far more restrictive than appears on the surface. Although around 150,000 immigrants are permitted each year, many less actu-

[1] 28th *Ann. Rep. Secretary of Labor* (1940), p. 106.

ally enter, since many countries do not use their available quotas. As a matter of fact, in 1933 only 8,220 immigrants entered the country under quotas, and in 1940, with pressure on certain groups to leave Europe, the total was only 51,997.[1] Moreover, the restrictive influence of the selective provisions should not be overlooked. Under the provision that immigrants must have enough means so that they will not become a public charge, many individuals are excluded. Furthermore, the law of 1924 forbids quota entry to immigrants ineligible to American citizenship. Since only white persons and persons of African descent are eligible for naturalization, other races are barred from entry. These laws have been extremely effective in halting immigration, the annual number of immigrants at the present time being almost negligible as compared to the wave of immigration before the World War, and the unnaturalized foreign-born population being only about 3,600,000 in 1939 as compared to 6,200,000 in 1930.[2]

2. Convict Labor. American labor has long objected to competition with prison labor. Because production is undertaken by prison labor largely to give prisoners something to do and to train them for trades, rather than for profit, because the cost of prison labor is unimportant and its products are subsidized, and because of the abuses in employing out prison labor in many states, free labor has attempted to remove the products of prison labor from competition with it. In response to this demand, states have passed various laws limiting the sale of prison-made goods, and the federal government has enacted legislation to aid in their enforcement.

The state laws attacking this problem vary in many respects. Some limit the quantity of any kind of goods produced by prison labor; others prohibit entirely the sale of prison-made goods in the open market, allowing sales to state institutions only; others allow a few exemptions to such prohibition; and some states restrict the employment of prison labor to production of things used by the state government and in certain public works and highways. By other laws, prison-made goods must be so labeled, the price at which they are sold is regulated, and prisoners are prohibited from use as strikebreakers.

For effective restriction of prison-made goods in competition with other goods, state action alone is not enough. To meet the problem created by the sale of prison-made goods in one state from a prison in another, Congress passed the Hawes-Cooper Act in 1929. This law simply divested convict-made goods of their interstate character and allowed states to apply their laws to the goods received by them from other states. Thus, the Hawes-Cooper Act did not forbid the channels of interstate commerce to prison-made goods, nor did it penalize the shipment of such goods in interstate commerce. It simply made interstate shipments of them susceptible to the law of the receiving state, just as though the goods were manufactured within it. Since

[1] 28th *Ann. Rep. Secretary of Labor* (1940), p. 106.
[2] 27th *Ann. Rep. Secretary of Labor* (1939), p. 109.

this law left enforcement of restriction entirely to the states, and since such enforcement was often difficult, the federal government passed additional legislation in 1935. By the Ashurst-Summers Act of that date, labeling of prison-made goods shipped in interstate commerce was required, and it was made a federal offense to ship such goods into a state in contravention of its laws.

Both the Hawes-Cooper Act and the Ashurst-Summers Act have been held constitutional by the United States Supreme Court. When the state of Alabama attacked the former law in 1934, the petition to enjoin enforcement of state laws against the sale of prison-made goods from Alabama was unanimously rejected.[1] And when a dealer was convicted of selling interstate prison-made goods in contravention of the Ohio law, the Supreme Court unanimously turned down his appeal in 1936, holding that the law did not involve an unlawful delegation of national power to the states.[2] The Ashurst-Summers Act was upheld by the Court in 1937.[3] Holding that the states under their police powers could regulate or prevent the use of goods reasonably believed to be harmful, the Court declared that Congress could aid the states in such regulation through its control over interstate commerce.

Aided by federal laws which allowed them to exclude interstate prison-made goods, the states have expanded their program to protect free labor from prison labor. The result is that approximately two thirds of the states have laws which prohibit the importation of prison-made goods from other states.

The restrictions placed upon prison-made goods raise several questions. In the first place, they make it difficult for penal institutions to work out adequate rehabilitation plans. Prisoners need work of the kind they may expect when they are released from confinement, in order to train them for private jobs and to make prison life less abnormal. In the second place, it is in the best social interest to have prisoners contribute to the cost of their maintenance through producing goods which can be used. The restrictions placed upon the sale of prison-made goods make these objectives of sound prison administration hard to attain.

There is clearly a conflict of interests in the prison-labor problem. Prison labor, if used for productive purposes at all, is bound to compete with outside free labor. Even where prisoners are allowed only to produce goods for state use, they are competing with free labor, although the competition does not appear to be so direct as in the sale of prison-made goods in the open market. The fundamental issue is really whether prisoners should be allowed to produce anything at all which free labor might produce. When put in such terms, the social inadvisability of the present restrictions seems clearer. From the point of view of personal rehabilitation, the cost of penal administration, and the

[1] *Alabama v. Arizona*, 291 U.S. 286 (1934).
[2] *Whitfield v. Ohio*, 297 U.S. 431 (1936).
[3] *Kentucky Whip and Collar Co. v. Ill. Cent. R.R. Co.*, 299 U.S. 334 (1937).

elimination of waste of man-power, there can hardly be any doubt but that prison production should be encouraged rather than discouraged. To curtail efficient prison production is to restrict the total of society's possible material benefits for the questionable purpose of protecting certain local producers and workers.

Although sound social and economic policy would appear to disprove the wisdom of present prison-labor restrictions, there are certain unfair aspects of prison-labor production. To the extent that unfair competition with private industry arises from the subsidy of prison labor by the state, legislation might be passed to eliminate it. But to prohibit prison labor or to enforce restrictions placing it at an unfair competitive advantage does not seem to be in the interest of maximum output of goods and services at lowest costs.

D. COLLECTIVE BARGAINING: INTRODUCTION

Perhaps the most far-reaching influence of government in respect to the bargaining position of labor has come from its attitude toward collective bargaining. As industry has become more complicated and individual laborers have come to sense a common bond of mutual interests set off from the interests of owners and managers, labor has tended to organize and to supplant individual bargaining by collective bargaining. As collective bargaining has become general and organized labor has adopted methods of enforcing its collective power in making wage bargains, it is only natural that many of the property rights, traditionally the prerogatives of ownership of capital, should be challenged.

With the challenging of these rights, the rôle of the government has become increasingly important. Legislation, as well as judicial principle, has been forced to redefine the rights and privileges of both labor and management. There are two main spheres of governmental influence in collective-bargaining activities, the adjustment of conflicts in strike activities and the protection of the right to organize. They will be dealt with in the two main sections to follow. In this section, the theory of collective bargaining and the development of its legal aspects will be noted.

1. THE THEORY OF COLLECTIVE BARGAINING. The justification for collective bargaining is found in the weak economic position of the individual laborer. This lack of "withholding" power often means that, while there may be real and effective competition between individual laborers, bargaining between the buyer and seller of labor service may be virtually non-existent. If it can be assumed that effective bargaining is an important element in the American system of capitalism and is significant as a goad to efficiency in production, low prices, and a high standard of living, the public interest in effective collective bargaining is clear. Without it, sellers of labor become an easy prey to unfair and inefficient employers of labor. The result may very

well be that the economic system will not function as efficiently as might be desired. A system of individual bargaining between buyers and sellers of labor is practically a system of no bargaining.

Collective bargaining has other advantages for society. Strong unions and fair collective contracts make for greater stability in labor supply, tend to reduce sporadic stoppage of work, and make it possible for employers to calculate their future labor costs more accurately, with resultant curtailing of risks in future production. Through the relative standardization of labor costs, employers tend to be placed on a fairer competitive level. From a political and social point of view, collective bargaining may be in the public interest. Discontent of workers over the results of the labor bargain may be lessened. Jobs may be made more secure and exploitation of labor may be reduced. Associations of workmen large enough to have some voice in the decisions of industry may raise the morale of labor and introduce a higher sense of self-respect.

On the other hand, collective bargaining may lead to results not altogether in the public interest. Organizations of employees may become so strong as to be able to dictate business policies. Laborers may insist upon terms so high as to increase the cost of production and limit output. If costs are increased too much, or output unduly restricted, the public pays a higher price for goods and services than may be economically justifiable. Labor organizations may restrict membership and adopt monopolistic policies, with harmful effects upon the consuming public similar to those which have made monopolies of capital feared. Combination of labor presents many of the same problems and hazards that combination of capital has shown.

2. Development of Collective-Bargaining Law. Real collective bargaining by organizations of workmen may be said to date from the eighteenth century, when English laborers combined to enforce their demands for higher wages. Although workmen had organized in groups prior to that time, it can hardly be claimed that they organized for purposes of collective bargaining. Thus, the English guilds of the thirteenth century were powerful organizations of workmen, but they were really made up of managers and workers engaged in a co-operative business rather than of laborers working together to bargain with employers. The beginnings of genuine collective bargaining can be found in the early years of the Industrial Revolution, and, while not confined to factory workers, collective bargaining has developed in scope and intensity with increased mechanization and mass production.

The attitude of the English Government toward early attempts of unions to bargain collectively was one of suppression. Not only were unions which attempted to raise wages found to be conspiracies under the common law, but statutes were enacted providing penalties for such combinations. These statutes were not repealed until 1824 and 1825. Labor unions in England did not gain freedom from the common-law doctrine of conspiracy until 1875,

when the criminal aspects of conspiracy were held not to apply to them, and 1906, when they were exempted from civil liability under the conspiracy doctrine.

The attitude of the government in the United States until 1933 and 1935 has been somewhat difficult to assess. The common-law doctrine of conspiracy, with its criminal and civil penalties, was never so generally adopted by American courts as it had been in England. Nevertheless, in a number of cases in the nineteenth century, labor unions attempting to bargain collectively found themselves in trouble on grounds of being conspiracies against employers. The question of legality of labor organizations was at least great enough for several states to adopt laws after 1860 specifically making such combinations lawful.

Although little evidence exists that any of the governments in the United States have attempted any outright suppression of labor unions, the attitude of the federal government until 1933 was primarily one of toleration of labor organization itself and restraint of labor-union activities through common- and statutory-law concepts of private property and restraint of trade. The use of injunctions after 1880, issued by courts to stop labor activity where an employer claimed irreparable damage might result, placed union activity in a strait-jacket of judge-made rules respecting strikes, picketing, and boycotting. The Sherman Anti-Trust Act, discussed in a previous chapter, has turned out to be somewhat restrictive of union activity, since the labor union which acts in unreasonable restraint of trade may be found guilty and be assessed with triple damages.[1]

Some encouragement was given by states and the federal government to unions in legislation designed to outlaw "yellow-dog" contracts [2] and to limit the use of injunctions. In both instances the legislation was thwarted by the courts. In the case of laws prohibiting the use of yellow-dog contracts, both a federal law applying to railroad workers and a state law were found unconstitutional by the United States Supreme Court.[3] The Court held that these laws interfered unduly with the right of the employer to contract freely. The anti-injunction laws were either so narrowly interpreted by the courts that they meant little to labor, or, where construed broadly, were found unconstitutional as taking away remedies necessary for the protection of rights of liberty and property.[4]

The first effective encouragement by the United States to collective bargaining by labor organizations followed the depression of 1929. The Norris-LaGuardia Act of 1932 represents the first successful action of the federal gov-

[1] See *supra*, pp. 449–50.

[2] A yellow-dog contract is one made by an employer with an employee under which the employee agrees, as a condition for employment, to refrain from joining an independent labor union while he is employed.

[3] *Adair v. U.S.*, 208 U.S. 161 (1908), and *Coppage v. Kansas*, 236 U.S. 1 (1915).

[4] *Truax v. Corrigan*, 257 U.S. 312 (1921).

ernment to limit the granting of labor injunctions and the making of yellow-dog contracts. Its constitutionality was insured by not forbidding to courts the power to issue injunctions where property is endangered, but by prescribing injunction procedure and requirements more favorable to labor. Likewise, yellow-dog contracts were not forbidden, but were made unenforceable in the federal courts by placing them outside of the jurisdiction of such courts.

The significance of the Norris-LaGuardia Act has been largely lost in the developments of 1933 and 1935. In 1933, the National Industrial Recovery Act provided for the setting up of codes of fair competition in all industries, and required that these codes should include clauses safeguarding the right of employees to bargain collectively, without interference by the employer, through representatives of their own choosing. While the Recovery Act was invalidated in 1935, the clauses of the law protecting labor in its right to bargain collectively without employer coercion or dominance were included in the National Labor Relations Act of 1935, popularly known as the Wagner Act. This law not only granted broad collective bargaining rights to organizations of workers, but was specific in its restrictions on employer activity designed to interfere with organization of labor. It also established an administrative agency, the National Labor Relations Board, to administer the law.

In noting the precursors of the present Wagner Act, it is generally thought that the Recovery Act provisions were the first definite steps taken by a government in the United States to encourage collective bargaining through independently organized unions. It is interesting, however, that the War Labor Board — a commission set up in the first World War to settle labor disputes — formulated a statement of principles encouraging collective bargaining through representatives chosen by workers free from employer dominance or interference. The first statutory move to encourage collective bargaining was the Railway Labor Act of 1926. This law gave railway workers the right to bargain collectively through representatives of their own choosing without interference by employers. The constitutionality of the law was upheld by the United States Supreme Court in 1930.[1]

Neither federal nor state governments have done much to intervene in the settlement of labor disputes. While the courts have often taken an important rôle in labor disputes by enjoining certain kinds of union activity and entertaining damage suits arising out of such activity, the federal government has set up complete machinery for the adjustment of labor disputes only in the railway industry.[2] Many states have established labor departments with authority to intervene informally in labor disputes with a view to assisting parties in reaching an agreement. In Kansas, for a time, a state agency was charged with such intervention and given further power to force agreements. The compul-

[1] *Texas and N.O. Rwy. Co. v. Railway and Steamship Clerks*, 281 U.S. 548 (1930).

[2] For discussion of this machinery, see *supra*, pp. 134–38. In 1936 some of the intervention machinery applicable to railroads was extended to air carriers.

sory aspect of this plan, however, met with difficulty in the courts and was dropped from the law.

At the present time, except for the special machinery set up for railroads and air carriers, the activities of government in the process of collective bargaining are confined to the following matters: (1) restrictions on strike activities; (2) informal aid in adjustment of labor disputes; and (3) protection of the right of labor to organize and bargain collectively. The nature of, and problems involved in, these aspects of the government program will be discussed in the following two sections of this chapter.

E. COLLECTIVE BARGAINING: LABOR DISPUTES

The part played by the government in the carrying on and settlement of labor disputes is based upon both the common law arising from court conceptions of property rights and the statutory laws defining proper strike methods and objectives and outlining means for the settlement of these disputes. Since labor has found the strike and devices supporting the strike to be its strongest weapons in enforcing bargaining claims against employers, most of the law affecting labor disputes directly has to do with the definition of the proper scope of strike activities.

1. THE RIGHT TO STRIKE. In general, the right of labor individually or collectively to quit work is not denied. This right follows from the very nature of the labor contract, which is ordinarily a daily renewable agreement and seldom calls for specific service over a specific period of time. Even where a definite contract exists, if labor breaks it there is generally little that an employer can do. He cannot force performance of service, since to do so would be involuntary servitude forbidden by the Thirteenth Amendment. He may sue for damages, but this is of little help in view of the financial position of most workers.

2. RESTRICTIONS ON STRIKES. While the general right to strike exists, this right is not free from legal restraints. These arise from the public interest in continuance of work where danger to the public is involved, from the illegality of certain purposes of strikes, and from the illegality of methods used in enforcing the strike and its objectives.

a. Government employees. Employees of the government are sometimes prohibited or discouraged from joining independent labor unions. Federal government employees are permitted to organize in unions, but are prohibited from striking during their term of employment. As a general rule, all government employees are forbidden the right to strike. The attitude of government administrators and the courts is that no one has a right to strike against the government and thereby endanger the public safety and the stability of governmental processes.

b. Public-service employees. While the law is not quite as clear in the case of

employees in businesses affected with the public interest, one can say that their right to strike is much more circumscribed than that of workers in private industry. The LaFollette Seaman's Act of 1915 definitely forbade to seamen the right to strike while at sea. Railroad and public utility workers have been refused the right to leave their jobs under circumstances which might endanger public safety. Even where the public safety may not immediately be harmed by collective quitting of work, there is question whether employees in public-service companies have a right to strike. It seems fairly certain that legislatures could deny to these employees the right to strike under any circumstances, although in the absence of statutory requirements this may not be true.

c. Unlawful purposes. In private industry, the right to strike is restricted through common-law declaration of unlawful purposes of certain collective stoppages of work. The distinction between lawful and unlawful purpose is not always easy to make. In general it may be said that a strike intended to secure better wages, shorter hours, or improved working conditions has a lawful purpose. While the law of the state of California makes all strike purposes legal, in other states there are many illegal purposes. The attitude of the federal courts and that of the state courts differ materially. In almost every jurisdiction, strikes to obtain the closed shop and to stop the employment of non-union workers have been held to be illegal as an interference with the liberty of individuals to contract for services. Strikes to eliminate use of non-union materials, to secure removal of objectionable foremen, to gain reinstatement of discharged employees, and to enforce the employment of one union over another union in a job the proper union jurisdiction of which is disputed, are open to question on grounds of illegal purpose. Strikes with the intent of maliciously harming an employer or his property are generally held to be unlawful.

In many jurisdictions the sympathetic and the general strike are held to be unlawful. These strikes involve a stoppage of work by employees who have no grievance against their own employer, but who desire to aid the employees of other employers in their attempt to gain demands. Some courts have shown a tendency to regard these strikes as unlawful conspiracies harming an employer against whom the workers have no immediate or direct dispute.

d. Unlawful means: picketing. Strikes may be found unlawful not only because of their illegal purposes, but even where the purposes are legal, if unlawful means are used to gain this lawful end. One such unlawful means is illegal picketing.

Picketing is the attempt by striking employees to acquaint other employees with the nature of the strike and to persuade them to join it. Peaceful picketing is always regarded as lawful, but the use of violence, coercion, or intimidation in picketing has been held to be illegal. The principle involved is clear, but its application to individual cases is extremely difficult. Some students

and jurists have taken the position that, practically speaking, picketing cannot be peaceful if it is to be effective.

Some idea of lawful picketing can be obtained from decisions of the courts. The United States Supreme Court once held that pickets should be limited to one person at each point of ingress or egress of a plant or place of business.[1] In another case it declared that mass picketing is in itself illegal in that such group activities necessarily result in intimidation and take away rights and liberties guaranteed by the Constitution.[2] However, in a case decided in 1937, the Court reversed this position and upheld the right to peaceful picketing, whether by individuals or by groups.[3]

The essence of unlawful picketing lies in a finding of intimidation, violence, or coercion. This depends upon the facts in individual cases and to some extent upon the attitude of the presiding judge. But judges have held that abusive language, veiled or direct threats, creation of an unfriendly atmosphere, possession of weapons or bricks by pickets, interference with entry of workers to a plant or office, and too large a number of pickets constitute unlawful intimidation even though no definite acts of violence have been committed.

Some states and the federal government have enacted laws in regard to picketing A few states have had laws prohibiting all picketing, but these have been declared to be unconstitutional.[4] Through section 20 of the Clayton Act of 1914 and the Norris-LaGuardia Act of 1932, the federal government has made some attempt to limit the issuance of injunctions in cases of peaceful picketing, but has done nothing significant to stop their issuance in other cases or to broaden the scope of lawful picketing. Some states have followed the lead of the federal government in this respect.

e. Unlawful means: boycotts. To support their case in a labor dispute, unions often act collectively in refusing to patronize the employer against whom a strike is in progress. This kind of boycott is called a *primary* boycott. More often unions have attempted to induce customers of the employer to refuse to deal with the employer. This introduction of a third party and the bringing of force to bear on the third party results in a *secondary* boycott. Generally the employer is a manufacturer or other producer selling his products through a middleman. To reach this employer, labor must induce customers not to patronize the seller or user of the employer's products, so that this party will be forced not to deal with the employer. This type of boycott also introduces a third party subject to harm in order to bring pressure upon the person against whom the workers have their grievance.

Under the common law, a secondary boycott amounts to a conspiracy and is illegal. Such boycotts fit well into the conspiracy doctrine, both as to pur-

[1] *American Steel Foundries Co. v. Tri-City Central Trades Council*, 257 U.S. 184 (1921).
[2] *Truax v. Corrigan*, 257 U.S. 312 (1921).
[3] *Senn v. Tile Layers Protective Union*, 301 U.S. 468 (1937).
[4] See *Thornhill v. Alabama*, 310 U.S. 88 (1940).

pose and as to means. The purpose is to enlist the aid of third parties in order to destroy the property rights of a second party, the employer. If the means of inducing such support from third parties involve coercion, intimidation, or violence, as is likely to be the case, the means become unlawful. While some courts have upheld the right of labor peacefully to induce customers not to patronize an employer against whom a strike is in progress, the weight of court decisions is against the legality of all secondary boycotts.

f. Unlawful means: the sit-down. A method which was used rather extensively by labor unions after 1936, but which is no longer widely practiced, is the sit-down strike. The technique is for the workers to remain inside the plant, where possession of the machinery is maintained, strikebreakers systematically excluded, and plant administrators and guards usually kept out. The advantage to labor unions in this technique obviously is that it makes sure that the industrial processes are paralyzed and that the strike cannot be broken by scabs.

Although the possession of the producing property of an employer by workers under the circumstances of the sit-down would seem to be a clear case of trespass and to be illegal under almost any conception of the law, some individuals have thought that such strikes might not be illegal. They have pointed out that all strikes tend to interfere with the free use of property by the employer and tend to cause him to undergo losses, and that the sit-down strike merely injures the employer's property rights in a different way. However, the courts have been uniformly hostile to the sit-down strike, and the United States Supreme Court has held that such strikes are clearly illegal as an unlawful seizure of property.[1]

g. The employer and strike activities. The restrictions placed upon labor in enforcing terms of collective bargaining through strike activities give some idea of the legal position of the employer. Since it is his property rights, including the valuable right to do business, which are at stake in a labor dispute, the strong tendency of the law to protect these rights gives him a naturally favored position. Nevertheless, the fact that workers may lawfully carry on strike activities, and the fact that unions are often supported by public opinion in tactics which are not strictly lawful, make the strike and its concomitants, picketing and boycotting, powerful weapons against the employer.

The legal position of the employer in labor disputes is also affected by measures enacted into law which force him to recognize and deal with organized labor. In a few instances in the United States, the employer has been virtually required to mediate or arbitrate labor disputes. But the greatest change in his position in labor disputes has been effected by the fact that he must allow employees to organize and bargain collectively through representatives of their own choosing. These measures will be discussed presently, and the student should keep in mind how they affect the position of the employer, as well as that of the laborer, in matters of dispute between the two.

[1] *N.L.R.B. v. Fansteel Metallurgical Corporation*, 306 U.S. 240 (1939).

3. METHODS OF RESTRICTING STRIKE ACTIVITIES.[1] Because the objections of organized labor to the position of government in labor disputes have arisen from the methods which have been used, as well as the bases for restriction, it may be well to note how these restrictions have been enforced. The means generally used have been prosecution of offending laborers, damage suits, and the injunction.

a. Prosecutions. There are clearly many legal bases upon which individual laborers who participate in strikes may be prosecuted. A striker may be arrested for serious crimes ranging from assault to murder. He may easily be subjected to arrest for misdemeanors, such as intimidation, obstructing traffic, disorderly conduct, or refusal to obey an officer. The number of arrests depends largely upon the attitude of the community in which the strike takes place, and the instructions respecting leniency or severity given to the police. There have been instances where police have arrested strikers for simply being at the scene of disorder, and there have been cases where police have refused to make arrests even where violence exists. Moreover, once a striker is arrested, the severity of the penalty depends upon the attitude of the community and the court. These penalties vary from light suspended fines or sentences to long periods in jail or prison. It has not generally been the penalty that has caused strikers so much concern, since the record of severe penalties is not great; but the stigma of being arrested and getting a criminal record has often fallen as a tremendous blow to the morale of strikers.

b. Damage suits. Since the destruction of property of some kind almost always accompanies strike activities, the employer generally has adequate legal grounds for suing unions and their members for damages. Although the number of damage suits has not been very large and the instances where damages have actually been won against strikers have been even fewer,[2] there have been several cases where the amount of damages has been very large. In the famous Danbury Hatters case, in which damages were upheld by the Supreme Court, some two hundred members of the hatters' union were held liable for nearly $234,000. Although the American Federation of Labor paid most of the damages, individual members of the unions lost much of their personal property. Another striking instance of the importance of damage suits is the $712,000 judgment allowed the Apex Hosiery Company against the Hosiery Workers' Union in 1939 by a federal district court, because of damage in a sit-down strike in 1937.[3]

[1] The organization and much of the content of this section have been drawn from Commons, J. R., and Andrews, J. B., *op. cit.*, pp. 411–17.

[2] One labor authority found that up to 1932 there were at least 314 cases in which unions were sued for damages arising out of strike activities, and that in at least 66 cases damages were awarded. See Witte, E. E., *The Government in Labor Disputes* (New York: McGraw-Hill Book Company, Inc., 1932), pp. 138–39.

[3] This award was invalidated by the United States Supreme Court on the ground that the suit was not properly brought under the anti-trust laws. See *Apex Hosiery Co. v. Leader*, 310 U.S. 469 (1940). A case in 1941 apparently removes labor disputes from the ban of the anti-trust laws. See *supra*, p. 450.

Even though unions are generally unincorporated associations, the courts have held that they may be sued as an entity. This means that suits for damages need be aimed only at the offending union, and the individuals accused of causing the damage need not be mentioned separately in the complaint. The liability of an unincorporated union in damage cases extends not only to the funds of the organization but to an unlimited extent to the funds of the members of the union. Thus, the responsibility of union members for damaging acts caused by the unions is greater than that of stockholders of a business corporation. Stockholders are seldom liable for anything more than the amount of their stock.

Several factors tend to make damage suits fairly unimportant as a means of restricting strike activities. The number of cases where sizable damages have been won and collected are so few that the employer may not wish to go to the expense and trouble to sue. Even where damage suits are won, the collections are difficult to make and public opinion is generally on the side of the worker whose home and savings are being threatened. Most employers hesitate to try to collect in the face of such difficulty and the weight of public opinion, and also dislike to alienate present or future workers whose later cooperation may be needed. Should union organizations become stronger and more financially responsible, as it appears they are doing, however, the damage suit may return to prominence as a means of curbing unions.

c. The injunction. Of all devices used to restrict strike activities, the injunction has been the most hated by labor. An injunction is a common-law device whereby a court may order parties to do or to refrain from doing certain acts. It is technically issuable against a party when his action, or inaction, would cause irreparable damage, a loss which either could not be atoned for through civil suit or in which assessed damages could not be collected. If an injunction is violated, guilty parties may be punished for contempt of court and be subjected to fine or imprisonment.

The usual procedure in granting a labor injunction is for the employer to present a formal complaint to the appropriate judge, detailing the activities which place his property in danger of irreparable damage. The judge may then issue a temporary restraining order requiring all parties to maintain the status quo, which means that the labor union must stop all those activities which endanger the property of the employer. After notification of the labor union, a preliminary hearing is held by the judge, and if no settlement is reached, the case goes to trial to determine whether a permanent injunction should be allowed. But during all this procedure the temporary restraining order remains in effect. In the meanwhile, any attempt by the labor union to continue activities forbidden by the injunction subjects guilty members to penalty in contempt of court. Until some modifications in procedure in federal courts in 1932, these contempt cases were almost always tried in the court of the judge who had issued the injunction.

The injunction has been widely used in the United States as a means of hampering unions in carrying on strikes.[1] Labor has strenously objected to the use of injunctions. It claims that temporary restraining orders which may remain in effect for months are generally issued without a fair opportunity for it to present a case. If strikers abide by the terms of the injunction, the strike may be broken, for interest lags and strikes lose their effectiveness if activities are stopped. Even though the temporary restraining order may be dropped after several months of hearings and appeals, the elapsed time is almost certain to kill strike fervor. If workers continue their strike activities in the face of an injunction, they may be adjudged in contempt of court and penalized. Moreover, to disobey an injunction is to flout the law, and this behavior often alienates public opinion from the cause of the union.

Unions have further objected to the use of the injunction because the blame is almost always placed on the union. The employer may be guilty of some unfair practices, but unless it can be shown that he has broken the law and comes into court with unclean hands, the danger to his property rights has tended to supersede any danger to labor's "human" rights. Furthermore, labor has claimed that the law respecting legal strike activities is so confused that courts differ as to what may be enjoined, labor does not know exactly what it can do, and the employer has generally gone to the court in which treatment most favorable to him might be obtained. The practice of the same judges issuing injunctions and trying cases of contempt has also angered labor. Labor has maintained that under such circumstances, it is difficult for strikers to get a fair hearing and reasonable treatment. The fact, too, that workers have been imprisoned for contempt of court, without benefit of a jury trial, has further irked labor.

In order to meet some of the abuses in the use of labor injunctions and to satisfy some of the objections of labor, Congress passed the Norris-LaGuardia Anti-Injunction Act in 1932. By this law, Congress has sought to prevent the federal courts from granting injunctions to which labor has objected.[2] The law enumerates acts which no federal court has jurisdiction to restrain, and makes certain specific findings necessary before any temporary or permanent injunction may be issued. Other changes are made in contempt proceedings, the issuance of temporary restraining orders, and the liability of union officers.

Courts of the United States are not given jurisdiction for the issuance of injunctions under the following conditions:

[1] While the number of injunctions which have been issued against labor cannot be ascertained accurately, Witte found records in 1931 of 508 cases in federal courts and 1364 cases in state courts where injunctions had been issued at the instigation of employers. See Witte, E. E., *op. cit.*, pp. 84–85.

[2] Earlier federal legislation to curb the use of injunctions was ineffective. Under section 6 of the Clayton Act of 1914, courts were instructed not to issue restraining orders unless necessary to prevent irreparable damage. Section 20 of the same law prohibited the issuance of injunctions to interfere with terminating employment, peaceful picketing, and other lawful activities in labor disputes. Needless to say, this legislation made no material changes in the common law.

1. Stopping of work by employees or the giving of publicity to the facts concerned in a labor dispute by advertising, picketing, patrolling, or any other method not involving fraud or violence.
2. Assembling peacefully to act or to organize to act for promotion in the interests of a labor dispute.
3. Becoming or remaining a member of any union irrespective of any promise to refrain from such affiliation.
4. Paying or withholding any strike or unemployment benefits.
5. Aiding by any lawful means any person interested in a labor dispute who is being proceeded against in any federal or state court.
6. Peacefully doing any of the above acts in concert with others.

Both temporary and permanent restraining orders in cases involving labor disputes may be issued by courts of the United States upon finding in open court, in which witnesses for both sides must be allowed to give testimony, that the following facts exist:

1. That unlawful acts have been threatened and will be committed unless restrained, or have been committed and will be continued.
2. That substantial and irreparable injury will follow.
3. That as to each item of relief granted, greater injury will be inflicted upon complainants by denial of relief than on defendants by the granting of relief.
4. That the complainant has no adequate remedy at law.
5. That the public officers charged with the duty to protect the complainant's property are unable or unwilling to furnish adequate protection.

Further provisions of the law modify injunction procedure. If a situation is extremely hazardous and irreparable damage might follow before witnesses from both sides can be heard, a court is allowed to make a temporary restraining order upon the complaint of an employer, but in such cases the order is limited to a period of five days, and the employer must post a bond to cover losses caused to workers by the delay. A petitioning employer can come to court only after having complied with every law concerning labor disputes, and after having made reasonable effort to settle the dispute by other means than the injunction.

Unionists are made liable to damages only upon clear proof that they actually participated in the cause of the damage or actually authorized or ratified the course of action which led to it. Thus, the liability of labor-union members and the liability of union officials for actions with which they had nothing to do is limited. Moreover, in cases of contempt of court, an offending person has the right to a trial by jury, unless the contempt is in the presence of the judge. Where the contempt arises from an attack upon the character or conduct of a judge, the offender is given the right of trial before another judge.

The Norris-LaGuardia Act appears to be constitutional in view of several decisions of the Supreme Court. In one case, the constitutionality of the law was upheld by a district court and the Circuit Court of Appeals, and, upon appeal to the United States Supreme Court, a hearing was denied by that tribu-

nal.[1] In another case, the United States Supreme Court overruled a decision of a lower court which had not completely followed the requirements of the law.[2]

Since the Norris-LaGuardia Act does not affect the issuance of injunctions in state courts, organized labor has pushed for state anti-injunction legislation. Approximately half the states have such laws, most of which follow the federal law closely.

The Norris-LaGuardia Act and the state anti-injunction laws remove many of labor's objections to injunctions. Such laws do not mean that injunctions may not be used, but they would seem to mean that they may not be issued as indiscriminately as has often been the case in the past. The limitation of time during which a temporary restraining order, issued at the instigation of one party, may be effective makes the injunction a less useful weapon to the employer who merely wishes to delay strike activities. The requirement that the employer must have tried all other lawful means to settle the dispute before asking for an injunction places a much greater burden upon him than was formerly the case. The requirement that the loss threatened must be greater to the complainant, by denial of relief, than to the defendants if an injunction is issued, forces judges to consider the harm done to labor unions by injunctions. Moreover, by placing certain activities of labor beyond the scope of injunctions, the law protects labor in several simple rights which have been regarded as so important by organized labor.

As already stated, the Norris-LaGuardia Act and the state laws patterned after it do meet some of the objections of labor to injunction practice. But there are still many state courts which are not bound by such laws; and even those federal and state courts which are under them have ample opportunity for finding grounds for the issuance of labor injunctions. The injunction is still an important weapon against labor unions. Even though the device may still be abused, it is so valuable for the prevention of damage to property and the protection of individual rights that it should certainly be preserved. As labor unions become strong and contracts are entered into between employers and organized employees, labor itself may be aided by legal principles and devices which protect private property and liberty, through the acceptance of a collective-bargaining agreement as a form of property.

4. Methods of Adjusting Labor Disputes. Government sometimes intervenes in labor disputes with a view to obtaining some kind of amicable settlement. There are four forms which this intervention usually takes: (1) mediation or conciliation; (2) investigation; (3) voluntary arbitration; (4) compulsory arbitration.

a. Mediation. Mediation or conciliation ordinarily represents a procedure by which a third party attempts to induce the parties to a labor dispute to agree

[1] *Levering and Garrigues Co. v. Morrin*, 71 Fed. (2d) 284, cert. denied, 293 U.S. 595 (1934).

[2] *Lauf v. E. G. Skinner and Co.*, 303 U.S. 323 (1938).

to terms. The third party generally suggests a compromise to the disputants and attempts informally to have them accept terms which will be mutually agreeable. Under this procedure, no compulsion is placed upon the disputing parties and the disinterested position of the mediator is depended upon to bring about agreement.

Government in the United States has often furnished facilities for mediation. The Department of Labor of the federal government has established a conciliation service which acts both to prevent strikes and to obtain the settlement of labor disputes already in progress. In the year ending June 30, 1940, the United States Conciliation Service disposed of 1977 labor disputes involving 1,015,540 workers and participated in establishing more satisfactory relationships in 1774 other situations involving 129,665 workers.[1]

A National Mediation Board was also established in 1934 to intervene in a conciliatory manner when disputes arise in the making of agreements between railroad and aviation management and labor. Most of the state labor departments also provide for mediation in industrial disputes. Of all methods to settle labor disputes by governmental intervention, mediation is the most widely used and has an excellent record of successful achievement.

b. Investigation. Investigation is similar to mediation in that parties are not compelled to come to terms. It involves the setting up of a special board whose function it is to make a study of the causes of the dispute and to publish a finding of facts and a recommended course of action. Reliance is placed on public opinion to bring about a settlement. Investigation is often compulsory, and parties to a dispute may not be allowed to conduct a strike or lockout during the investigation and for a short period after it. Such a compulsory system is provided by the federal government for railway and air carrier disputes after efforts at mediation have failed.[2] The state of Colorado has a system of compulsory investigation with a requirement of delay pending investigation, as has the Dominion of Canada. Other states in the United States have provided for investigation but have not attempted to require the delaying of strikes or lockouts. Where investigation is compulsory, it has often caused delay in strike activities, with consequent disapproval by many organized workers.

c. Arbitration. Arbitration involves the submission of a dispute to a third party and the agreement by disputants to abide by the decision of the arbitrator. If the government merely provides the machinery for arbitration, leaving it to the disputing parties whether the disagreement will be submitted to the arbitrator, the system is called voluntary arbitration. But even in voluntary arbitration, once the disputing parties have agreed to it the award is generally binding upon them. Where a dispute must be submitted to arbitration, the award being binding, the system is referred to as compulsory arbitration.

[1] 28th *Ann. Rep. Secretary of Labor* (1940), pp. 17–22.

[2] For discussion of this matter as applied to railroads see *supra*, p. 138.

Although formal arbitration methods have been used by other governments, notably in Australasia, little intervention of this kind has existed in the United States. Voluntary arbitration is provided for railroad and air common-carrier disputes. The state of Kansas attempted to establish compulsory arbitration in a law passed in 1920, but this law has become inoperative owing to constitutional difficulties and the apathy of enforcement officers. Most of the states allow their labor departments to participate in, or appoint boards for participation in, voluntary arbitration. Hence, if disputing parties can agree to arbitrate, the facilities for doing so can usually be found.

F. COLLECTIVE BARGAINING: THE RIGHT TO ORGANIZE AND BARGAIN

Instead of attempting to solve the problem of labor disputes by developing strictly interventionist techniques, the policy of the government in the United States in recent years has been to encourage organization of labor and to safeguard it in the process of bargaining collectively. The government has attempted to strengthen the bargaining position of labor by granting organization rights, by limiting employer interference in respect to these rights, and by forcing the employer to bargain collectively with organized workers. The purpose of this approach is to strengthen the hand of labor, and by equalizing the bargaining position of labor and employer to remove most of the causes for serious disputes.

The federal government has taken the lead in this program by enactment of the Wagner Labor Relations Act of 1935. Although several states have passed acts patterned after the national law in order to extend the protection to collective bargaining which is outside the jurisdiction of the federal government, it does not seem necessary to discuss these laws.[1] They follow the federal law closely, raise the same problems and questions, and have become relatively unimportant in view of the extension of federal jurisdiction to local industries through interpretation of business and labor disputes "affecting" interstate commerce.

1. THE PROGRAM OF THE WAGNER ACT. The Wagner Act created the National Labor Relations Board, an agency of three members appointed by the President with the consent of the Senate, each member serving for five years and being removable by the President for neglect of duty or malfeasance in office. The Labor Board is entrusted with two main tasks, the protection of certain organization and bargaining rights of employees against unfair practices of employers, and aid in the determination of proper bargaining agents for organized employees. The scope of the Board's jurisdiction is limited to matters "affecting commerce," that is, to matters by which the free flow of in-

[1] By 1940, Massachusetts, Minnesota, New York, Pennsylvania, Utah, and Wisconsin had such laws.

terstate or foreign commerce might be obstructed, burdened, or impeded.[1]

Section 7 of the Wagner Act declares that "employees shall have the right to self-organization, to form, to join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in concerted activities, for the purpose of collective bargaining or other mutual aid or protection." By section 8, the law makes it an "unfair practice" for employers to do any of the following:

> (1) Interfere with, restrain, or coerce employees in the exercise of rights guaranteed in section 7.
>
> (2) Dominate or interfere with the formation or administration of any labor organization, or contribute financial or other support to it.
>
> (3) Encourage or discourage membership in any labor organization by discrimination in regard to hire or tenure of employment, or any other term or condition of employment; provided that nothing shall hinder an employer from requiring as a condition of employment membership in a labor union which is independent of the employer and which has been properly selected as the exclusive bargaining representative.
>
> (4) Discharge or otherwise discriminate against an employee because he filed charges or gave testimony under the act.
>
> (5) Refuse to bargain collectively with properly qualified representatives of employees.

In order to safeguard the workers' right to bargain collectively through representatives of their own choosing, the law establishes machinery and rules for this purpose. Section 9(a) provides that a majority of the employees in a unit appropriate for collective-bargaining purposes may select representatives which shall be exclusive bargaining agents for employees in such units, with respect to rates of pay, wages, hours, and other conditions of employment, except that any other group or individual may present grievances to an employer. Section 9(b) gives to the Labor Board the authority to determine whether the employer unit, a plant unit, a craft unit, or some other unit is to be the appropriate grouping of employees to insure full bargaining rights. Section 9(c) authorizes the Labor Board to investigate any controversy respecting the proper representatives of employees, and to certify, after election or other means of ascertainment, the names of representatives designated by employees.

The procedure of the Labor Board in respect to unfair labor practices is similar to that of the Federal Trade Commission in connection with unfair trade practices. Whenever a complaint is received, the Board investigates and takes testimony through an examiner. Cases may be decided informally without trial before an examiner, they may be decided by resort to a stipulation, they may be dismissed or withdrawn, or, as a last resort, the Board may issue an order to cease and desist. If this order is not obeyed by the employer, the

[1] Exempted from the law are agricultural workers, domestic workers in a home, and individuals employed by a parent or spouse.

Board may proceed for its enforcement in the United States Circuit Court of Appeals.

2. THE PROBLEM OF REPRESENTATION. Because the question of existence of an unfair labor practice often depends upon the certification of proper representatives for collective-bargaining purposes, the problem of representation may well be discussed first. In this connection the Board has two functions, the determination of an appropriate bargaining unit, and the certification of the representatives selected by a majority of employees in that unit.

One of the most difficult problems facing the Labor Board is the determination of the proper bargaining unit. Since the unions affiliated with the American Federation of Labor have generally been organized along craft lines, and the unions affiliated with the Congress of Industrial Organizations have tended to follow industrial or plant organization, the Board has necessarily been thrust into the dispute between these two rival factions of American labor. If it decides that a craft unit offers the most effective possibilities for collective bargaining, an industrial union may have little chance of qualifying as exclusive representative. But if the better kind of unit for purposes of collective bargaining appears to the Board to be a plant or employer grouping, the craft union has virtually no chance of being elected to the position of exclusive bargaining agent. Although the craft-industrial union controversy and the A.F. of L.–C.I.O. struggle are not entirely the same, since these labor groups are not developed completely along either craft or industrial union lines, in given cases the determination of the appropriate union has much to do with the selection of the actual union. Obviously a union which has undertaken to organize workers along lines which the Board decides constitutes an appropriate bargaining unit should have an advantage over one which has only organized a portion of the employees in an appropriate unit.

In determining the appropriate unit for bargaining purposes, the Labor Board has set up several considerations which it allows to influence the selection. These are: (1) the desires of the workers themselves; (2) the history of labor relations in the industry and between the particular employer and his employees; (3) the community of interest or lack of interest of employees in qualifications for work, experience, duties, wages, hours, and other working conditions; (4) the organization of the employer's business according to labor functions, or physical or geographical divisions; (5) the eligibility of workers to membership in a union.

In following out these principles, the Board has at times set up large plant units, at other times found craft units to be appropriate, and has sometimes broken off strong craft units from the rest of an industrial plant and set up several divisions of employees as appropriate units. Whatever units are established, the Board has generally excluded supervisory, office, and maintenance employees from plant employees. Usually, employees are not asked to state their preference for one type of bargaining unit over another. But

where other factors make it difficult for the Board to decide, it has referred the question of an appropriate bargaining unit to the employees.[1]

Once the appropriate unit is determined, the Board may be called in to investigate and certify the proper representatives for it. The Board certifies the representatives either after an election or upon other evidence. If the union submits membership cards which have been voluntarily signed, the Board may certify the union as exclusive bargaining representative. If the union does not submit such proof, or if there is doubt of the accuracy of the membership list and cards submitted, the Board will hold an election by secret ballot. The ballot allows employees to vote in favor of the union they desire, or to vote against all the unions. If a majority of the employees vote against the unions, then no organization on the ballot can be certified as representative of the employees. If there are two or more unions on a ballot, the one polling a majority of all votes cast is certified as the representative. If neither union obtains a majority of the votes cast, but a majority of the employees vote for some union, the practice is to have a run-off election between the two unions receiving the highest votes.[2]

Until 1939, the Labor Board held that petitions for elections to determine bargaining representatives could be made only by workers. The reason for so holding was that the employer might select times which would be most favorable to him in asking for elections and might interfere with the collective-bargaining purposes of the law. In 1939 the Board amended its rules to allow employers to petition for an election where two or more labor unions claim a majority but none petitions the Board for certification.

3. Unfair Labor Practices. The second class of cases with which the Labor Board deals has to do with allegations that the employer has interfered with the right of employees to bargain collectively through representatives of their own choosing. Such interference gives rise to an unfair labor practice. These have been noted in the discussion of the Wagner Law above.

The first unfair labor practice is a catchall. All conduct which violates any other part of the law on unfair labor practices is sure to interfere with rights granted under the law. Some practices, however, may only violate this part, section 8(1). Statements by employers to the effect that a union will not be tolerated, threats to close a plant if unionized, employer-instigated threats or acts of violence, and general schemes of employers to discredit the union may fall in this class.

The second class of unfair labor practices is the domination or interference with the formation of any labor union. This section of the law forbids what have been known as "company unions." During the decade following the

[1] This doctrine of "self-determination of homogeneous groups" was not adopted by the Board until 1937 in *Re Globe Machine and Stamping Co.*, 3 N.L.R.B. 25 (1937).

[2] Prior to 1940, it was the practice of the Board in the run-off election to have the employees designate whether they wished to have the union with the highest votes in the first election as their bargaining representative.

first World War, it became accepted industrial-relations policy for employers to foster the development of plant unions made up of employees of a single employer. While many of these company unions became real instruments for the expression of worker opinion and collective bargaining, the company union was subject to the disadvantage that individual workers, for fear of losing their jobs, might not be willing to press a point of dispute very far with the employer. This section of the law, by making company unions no longer possible in businesses subject to the act, gives expression to the well-recognized fact that, generally speaking, effective collective bargaining demands labor organizations wholly independent of the employer. As this part of the law has been applied, an employer may not in any way contribute to or help a labor organization, allow officials or other supervisory employees actively to solicit aid for or disparage a labor union, advance money to workmen to pay membership fees, or grant any facilities, such as bulletin boards, office space and equipment, or mailing lists to preferred labor organizations. The employer may be guilty of an unfair labor practice on this score when he helps an A.F. of L. union or a C.I.O. union, as well as when he aids an independent or company union.

The third unfair labor practice, found in section 8(3), is the encouragement or discouragement by an employer of membership in a labor union. While the act does not contemplate interference with the right of an employer to hire, fire, transfer, lay off, or change wage rates or hours, it does forbid him to have such action motivated by his attitude toward a union. The only issue, then, presented by this unfair labor practice is whether the employee was discriminated against because of his labor-union affiliations.

This third unfair labor practice is an extremely difficult one for the Labor Board to interpret. A union employee who is discharged or placed in a poorer position of work is likely to claim that the action was based upon his union affiliation. An employer who discharges a worker or discriminates against him almost never admits that such action was due to the latter's union affiliations. When such cases come before the Board, it attempts to find the real reason for the discharge or other change of status of the employee. It must carefully sift the facts in each case, and perusal of the cases before it would indicate that it has done so. In examining this evidence, the Board has paid attention to the attitude of the employer toward unions, the efforts of the employer to ascertain the identity of union leaders, the length of service of the employee, his efficiency record, skill, and care in comparison with other employees, and whether an infraction of a rule is followed by a penalty in certain instances far more serious than is ordinarily the case. These and other factors are considered by the Board to determine the honest reason for the action taken against the employee. And if the evidence indicates that something else than union activity motivated the action, the Board has not hesitated to dismiss the charges.

The fourth unfair labor practice is discrimination by an employer in any way against an employee because of the making of charges to the Labor Board or because of his testifying before it. This provision of the law has caused no difficulty, and only a few cases have arisen under it.

As a fifth unfair labor practice, section 8(5) makes unlawful a refusal on the part of the employer to bargain collectively with certified representatives of a majority of his employees in an appropriate bargaining unit. As interpreted by the Labor Board, this provision requires that the employer negotiate in good faith with the union and make reasonable efforts to reach an agreement for a fixed period of time. The employer is expected to meet with union representatives, receive their proposals, and put forth counter-proposals of his own. Negotiations with an intent to delay and postpone a settlement do not constitute *bona-fide* collective bargaining. Bargaining with employees as individuals or adjusting individual grievances does not constitute collective bargaining within the meaning of the act.

However, the employer is not required to continue bargaining collectively when negotiations have already made it plain that further meetings would be futile. But the duty to bargain collectively does not end if new proposals are offered by either side, and the existence of a strike does not extinguish the duty of the employer to do so. The duty to bargain collectively does not require that any agreement be reached, but simply that the employer shall have acted in good faith in negotiating with the certified union representatives. Where an agreement is reached between an employer and a union, the employer may be required to put the agreement in writing, and a refusal to do so has been interpreted as an attempt to forestall the union in collective bargaining.

4. Constitutional Aspects of the Wagner Act. When one considers the status of constitutional law in 1935 and the revolutionary character of the Wagner Act, the successful legal record of the National Labor Relations Board has been extraordinary. No other administrative commission has had better support from the courts in its formative years, although the lower courts hamstrung the Board until the Supreme Court upheld the act in 1937. The change in philosophy of those on the bench and the infusion of "new blood" into the judiciary after 1937 do not entirely explain this success. Much of the credit can be laid at the door of the able group of lawyers and economists who handled these early cases. The National Labor Relations Board has never lost sight of the fact that it is limited to labor matters affecting interstate commerce, and in pleading its cases it has taken great pains to show that this relationship exists.

The Wagner Act was first upheld in a rather surprising group of decisions in 1937.[1] In the leading case of this group, the United States Supreme Court

[1] *N.L.R.B. v. Jones and Laughlin Steel Corp.*, 301 U.S. 1 (1937); *N.L.R.B. v. Fruehauf Trailer Co.*, 301 U.S. 49 (1937); *N.L.R.B. v. Friedman-Harry Marks Clothing Co.*, 301 U.S. 58 (1937); *Associated Press v. N.L.R.B.*, 301 U.S. 103 (1937); *Washington, Virginia, and Maryland Coach Co. v. N.L.R.B.*, 301 U.S. 142 (1937).

held that the Jones and Laughlin Steel Company, in view of its "far-flung activities," was in the flow of interstate commerce, and that a law designed to reduce stoppages of work in such a business was constitutional as legislation for the protection of interstate commerce from obstruction. The Court found no reason to question the methods of the labor law, finding them to be related to the ends in view and adequate for protection against arbitrary and capricious action by an administrative board. In the other cases handed down simultaneously, the Supreme Court upheld the Labor Board in applying the Wagner Act to a commercial trailer company with about 80 per cent of its business interstate, to a clothing manufacturer with more than 80 per cent of its business interstate, to a national news gathering agency, and to an interstate bus company.

All the above cases involved enterprises doing a major part of their business through the channels of interstate commerce. The cases still left open the question as to how much business a company must do in interstate commerce to fall within the provisions of the Wagner Act. By a series of subsequent cases, the scope of the law has been extended until enterprises with a minor share of their purchases and sales in interstate commerce have been brought under the scope of the law. In 1938 the Supreme Court upheld the Labor Board in applying the law to an agricultural packing company which sold 37 per cent of its products to customers outside of the state.[1] And in a case handed down the same year, the Court supported the Labor Board in finding an electric power company, selling a small part of its power locally to an interstate electric railroad company and other interstate instrumentalities, to be within the law.[2] In this case it is significant that the sales were to an interstate railroad, since this fact had much to do with making the Court see a direct and substantial relationship of the continuity of the power company's business to interstate commerce. Another business was found subject to the act by the Supreme Court because it received materials to be processed across state lines and shipped the product to points outside of the state, even though it never owned the goods and only processed them under special contract.[3] This business was a small shop hiring only sixty persons. The Court pointed out that the volume of interstate trade was not important, but that the significant thing was whether the employer was in interstate commerce to an extent that an unfair labor practice might lead to a labor dispute which would obstruct that commerce.

No percentage of business done in interstate commerce can be taken as the criterion of whether the business falls within the law. The fundamental question is whether the business is one in which a stoppage of work occasioned by a labor dispute would have a tendency to burden or obstruct the stream of in-

[1] *Santa Cruz Fruit Packing Co. v. N.L.R.B.*, 303 U.S. 453 (1938).
[2] *Consolidated Edison Co. v. N.L.R.B.*, 305 U.S. 197 (1938).
[3] *N.L.R.B. v. Fainblatt*, 306 U.S. 601 (1939).

terstate commerce. Because nearly all businesses either buy or sell in the stream of interstate commerce and a labor dispute would obstruct that stream, it is difficult to see where the authority of the Labor Board ends. Examination of the cases in which the Board has assumed jurisdiction discloses examples of virtually every kind of business, except some local service establishments, of both very small and large size.

Not only has the Wagner Act been generally held to be constitutional and most of the Labor Board's interpretations been supported, but in several cases certain portions of the law have been upheld. In one case the Supreme Court claimed that the inclusion within the category of employees of persons who have struck for wage increases was perfectly proper.[1] The Board has been upheld in its definition of the requirements for collective bargaining in good faith, even to the extent of the necessity for putting an agreement in writing if the agreement is reached.[2]

In a few cases, the Labor Board has been rebuffed by the Supreme Court. In one case, the Board had ordered a company to reinstate certain strikers who had been discriminated against because of union activity, despite the fact that these strikers were guilty of unlawful conduct in seizing the employer's property by a sit-down strike. The Supreme Court held that when the employees unlawfully seized the employer's property they placed themselves outside the protection of the Wagner Act.[3] Moreover, the Board has been reversed by the United States Supreme Court on the ground that a finding contrary to the evidence presented in a case was made by it.[4]

5. Results of the Wagner Act. The effectiveness of the Wagner Labor Relations Act is somewhat difficult to appraise. Since the purpose of the law was to encourage collective bargaining, and by doing so to remove the causes of labor disputes, results should be measured with such purpose in view. It may be too early to make an accurate appraisal, because the effective date of the law really is April, 1937, when it was held to be constitutional by the Supreme Court.

The growth of unionism in the last few years has been phenomenal. In 1935 the membership of the unions affiliated with the American Federation of Labor was somewhat over 3,000,000, but in 1939 the membership of unions affiliated with the American Federation of Labor and the Congress of Industrial Organizations was around 8,000,000.[5] This is the largest increase on record, both absolutely and relatively, for any similar period of time in history.

The number of collective-bargaining agreements has also markedly in-

[1] *N.L.R.B. v. Mackay Radio and Telegraph Co.*, 304 U.S. 333 (1938).

[2] *H. J. Heinz Co. v. N.L.R.B.*, 85 Law. Ed. (Adv. Sheets) 303 (1941).

[3] *N.L.R.B. v. Fansteel Metallurgical Corporation*, 306 U.S. 240 (1939).

[4] *N.L.R.B. v. Columbian Enameling and Stamping Co.*, 306 U.S. 292 (1939), and *N.L.R.B. v. Sands Mfg. Co.*, 306 U.S. 332 (1939).

[5] Address of E. S. Smith, member of the N.L.R.B., before the Harvard Law School, March 8, 1940. *N.L.R.B. Press Release*, No. R-2728 (March 9, 1940).

creased. Until recent years there were very few agreements in the automobile industry; by 1937 there were 270, and by 1938 there were 537.[1] The number of written agreements increased in the steel industry from 50 in 1937 to 532 at the end of 1938.[2] In the electrical-equipment industry, from a situation where there were virtually no written agreements in 1933, by 1940 there were more than 400 agreements calling for continuous collective bargaining.[3] Substantial increases in collective agreements can also be found in practically every other large industry.

The results of the Wagner Law as measured in terms of industrial strife are not quite so impressive, but they do indicate that it has brought some benefit. Of course, it is dangerous to judge the act by the quantity of industrial strife, for strikes are due to other factors than those which the act was designed to prevent. Strikes tend to follow the business cycle, diminishing as business activity wanes and increasing with rising business activity. The act makes no attempt to guarantee that agreements will be reached by negotiation, but merely tries to eliminate strikes called to obtain union recognition and the right to negotiate. Disputes about wages, hours, and other conditions of work continue to be beyond the scope of the Wagner Act. Another factor which should be considered in noting strike data for the last several years is the split in the ranks of labor itself and the strikes arising from this cause. The number of strikes and the amount of time lost by them showed an increase until the fall of 1937, since which time the amount of strike activity has been at levels lower than for any other year since 1932.[4] Since, as stated, the Wagner Law did not, as a practical matter, go into effect until the spring of 1937, this tendency may be noteworthy.

The volume of work and disposition of cases which have come before the Labor Board are an interesting commentary upon the results of the law. A great many cases are handled informally by the Board and never reach the formal records. But up to September, 1940, the Board records show that some 30,000 cases involving nearly 6,500,000 workers were handled.[5] Of the 27,000 cases which have been closed, 48 per cent were closed by mutual agreement of contesting parties, 17 per cent were dismissed by the Board, 27 per cent were withdrawn, and only 8 per cent were disposed of by some formal action taken by the Board. This formal action has resulted in compliance with the Board's orders, certification after election, reports of the Board finding no violation, transfer of cases to other agencies such as the Conciliation Service of the Department of Labor, or the issuance of cease-and-desist orders.

The most recurrent unfair labor practice charged has been the complaint of discriminatory discharge because of union affiliation or complaint of non-reinstatement after a strike. To March, 1940, the Labor Board brought about

[1] *N.L.R.B. Press Release*, No. R-2871 (April 7, 1940). [2] *Ibid.* [3] *Ibid.*
[4] *N.L.R.B. Press Release*, No. R-2728 (March 9, 1940) and No. R-3756 (October 31, 1940).
[5] *N.L.R.B. Press Release*, No. R-3756 (October 31, 1940).

the reinstatement of 268,268 workers after strikes and lockouts and of an additional 19,556 after discriminatory discharges.[1]

Another large part of the Board's work is in conducting collective-bargaining elections. To March, 1940, the Board held 2738 elections in which more than 1,000,000 valid votes were cast by employees. With such data as these in mind, the record of accomplishment of the Board is striking, even though one may disagree with the policy of the Wagner Act or the principles which the Labor Board has applied.

6. Some Economic Effects of the Wagner Act. The purpose of the Wagner Act is to reduce industrial strife through encouragement of collective bargaining. To the extent that this purpose has been, and may be, achieved, some rather interesting economic results may be expected to follow. In the first place, if industrial strife is lessened and labor-management difficulties come to be settled to a much greater degree by conference, the large losses to employees and employers caused by stoppage of work may be materially reduced. The consequent reduction of both labor and capital costs should tend to lower the costs and prices of goods, with resultant expansion of output and sales. In such an event, not only would the demand for labor tend to increase, with higher wages or more employment, but the more profitable employment of capital should be followed by some enlargement of productive capacity.

On the other hand, encouragement to unionization and collective bargaining, especially when one union can become the sole bargaining agent for a large group of workers, may give rise to labor monopolies. Although the public seems to find something "good" in a strong and unified labor force, it should be recognized that a large labor monopoly can follow questionable monopoly policies in selling its labor, just as a combination of enterprisers can in the field of production and sales of goods. If a labor union rises to a dominant position in an industry, it may have the power to force employers to pay wages above the marginal product of the workers under conditions of full employment. Such action would tend to raise production costs and cause employment to fall, and if the demand for labor in an industry should be quite elastic, the fall in employment might be considerable. Even if the demand for labor should be rather inelastic and a high wage would not cause much of a reduction in employment, the higher prices which the industry would have to charge would cause a fall in purchasing power for goods in other industries and a lowering of employment in those industries. Furthermore, if a labor union obtains a monopolistic position, it may be tempted to reduce the supply of labor in that field by arbitrarily keeping out members. In any case, monopoly position gives the holder tremendous power over the allocation of material resources, and, while this position may not be abused by labor, the public has reason ever to be on guard against possible abuse.

[1] *N.L.R.B. Press Release*, No. R-2879 (April 8, 1940).

7. Criticisms and Proposals for Reform. It is not surprising that the Wagner Act and its administration should be subject to criticism from a variety of sources. Employers, seeing their traditional rights to hire and fire as they please and deal with whomever they please greatly modified, can be expected to object to the law. The split in the American labor movement is certain to make labor factions criticize the Labor Board and those aspects of the law which they think harm their position. Many criticisms and suggestions advanced against the law and the Board hardly merit attention, but others are worth noting.

Criticisms and proposals for reform must be divided into two groups, those which are based upon the premise that the purpose of the Wagner Act is not justifiable, and those based upon the ground that, while the purpose of the law is valid, the law or its administration really does not bring about the proper realization of the purpose. It is not always easy to detect in criticisms and proposals for reform whether the philosophy of the law is attacked or whether the law or its administration is under fire.

a. The one-sidedness of the law. The most usual type of criticism found is that the law is one-sided in that it provides for restraining employers in their dealings with labor, but does nothing to restrain labor in its dealings with the employer or other labor. It is pointed out that a labor organizer may spread false tales about an employer and his working conditions in an effort to get members, coerce and intimidate workers to join a union, and even resort to violence in forcing individuals to join, but that an employer cannot even suggest to his workers the inadvisability of joining the union or fairly present his case to his own workers. It is claimed that a labor union may strike for any reason and make no effort to bargain before the strike; yet the employer is obliged to bargain collectively in good faith with the union. An employer is expected to do everything he can to reach an agreement, and to place an agreement, when made, in writing. But the law says nothing respecting the obligation of labor to live up to the agreement.

To meet the avowed one-sidedness of the law, critics propose two principal measures. One is to allow the employer to advise his employees concerning unionization, to present his case, and to express his opinion, all without intimidation or coercion. Another measure is to set up in the law a list of unfair labor practices aimed against labor to supplement those practices now in the law to limit the employer.

The first of these measures, by which the employer would be granted the right to present his case, is appealing as being in the interests of fair play and free speech. The employer should not have to sit by and see his employees duped by an unscrupulous organizer or see his labor policies misrepresented. On the other hand, it seems to be practically impossible to separate honest and fair employer advice which does not intimidate or coerce workers from attempts to interfere unfairly with employees' rights of self-organization. The

danger of allowing the employer freedom in this connection is that he may force his employees to adopt a form of collective bargaining similar to that existing in the old company union. Obviously, such a result would be in opposition to the entire purpose and philosophy of the Wagner Act. If it could be possible to work out means to allow the employer to state his case fairly, this would seem to be desirable. But the danger to the purpose of the law and the administrative work involved make this problem difficult to solve.

The second measure, providing for the setting up of certain unfair practices of labor, has already been written into the labor acts of most of the states having such laws. This measure would set up several unfair practices of labor against which the Labor Board would be given power to proceed. These unfair acts include the following: (1) coercion or intimidation of workers by unions in obtaining members; (2) false and vicious statements about the employer and his business to obtain membership or foment a strike; (3) violation of collective agreements by unions; (4) ordering of a strike without a vote of a majority of the members of a union; (5) striking before making an attempt to negotiate the subject matter of the dispute with the employer; and (6) doing violence to person or property in carrying on a strike. In addition to these widely advanced unfair labor practices, it has been suggested that the law might require union membership standards to be low enough to allow free entry into unions, subject only to certain necessary technical qualifications.

A declaration of unfair labor practices in the law would seem to be equitable. Although such provisions would violate the philosophy of the Wagner Act, by which it has been purposed to protect labor in its rights of collective bargaining, most of the unfair acts mentioned above would need cause no damage to the responsible labor union which exists upon the merits of its services and benefits to its members. If these measures were adopted, however, they would have to be judiciously handled. In the period of growth of a labor union, one can expect it to present its case to workers rather forcefully. Moreover, until a union becomes strong enough so that it can control its members, and perhaps be in control of all workers in a certain grouping of a shop, it may not be fair to hold it responsible for unauthorized strikes or violations of collective agreements.

b. Protection of minorities. The Wagner Act has been criticized because it forces the will of a majority of the workers upon minority groups. Especially in cases where the appropriate bargaining unit is large or covers an entire plant, there are likely to be groups of employees who do not wish a union elected by the majority to bargain for them. Under the law not only may the majority of workers bargain for the entire group, except for matters of individual grievances, but it may even consummate a closed-shop contract with the employer under which dissenters would have to join the union or give up their jobs.

Critics have proposed to amend the Labor Act to grant protection to these

minorities. Some proposals would grant them collective-bargaining rights along with the bargaining rights of majority groups. Other proposals would definitely ban the closed shop and forbid the check-off system under which union dues are collected by the employers by deduction from pay checks and turned over to unions.

There is a certain elementary fairness in giving minorities and dissenters rights to bargain individually or through representatives of their own choosing. But this fairness is rather specious. Rule by majority is not a strange principle in democratic government. Furthermore, bargaining can hardly be collective if small groups are permitted to bargain with the employer on matters of general interest to all workers. Employers, even, would find this system burdensome, for they would be forced to bargain on wages, hours, and working conditions with a number of independent groups, rather than with one representative union. Actually, in attempting to protect the dissenting minority, danger exists that the whole process and effectiveness of collective bargaining may be weakened.

c. The question of bias of the Labor Board. One repeatedly encounters criticisms that the Wagner Act is acceptable but that it has been so administered as to thwart its purposes. This criticism comes from all sides, including employers and labor alike. The specific criticism is either that the Labor Board has been unfair in the procedure it uses, or that its members have such-and-such a bias which they have allowed to dominate their decisions.

Employers particularly attack the Board's procedure. They point out that it is judge, jury, and prosecutor in that it investigates complaints, passes on their validity, and prosecutes them by orders in the Circuit Court of Appeals. The combination of administrative and judicial functions in one organization is characteristic of every independent regulatory commission. Virtually every such commission has been attacked at some time on this score, and amendments have been offered to separate these functions. Some proposals offered to amend the Wagner Act would make the Labor Board an investigating agency and place the power of enforcement in the hands of the Department of Justice, which would take the cases to the federal courts. Other proposals would allow court review of both the orders of the Labor Board and the findings of fact made to support them.

If any of these proposals were adopted, many advantages of the commission form would be lost. The flexibility and informality of handling complaints, the possibility of the development of a specialized staff, and the continuous supervision offered by an administrative commission would be endangered. Moreover, it should not be forgotten that administrative commissions, including the Labor Board, have divided their staffs into groups, with some members responsible for investigation, some others responsible for prosecution, and still others sitting in judicial capacities; and every precaution is taken to keep these groups as independent as seems wise.

One should not lose sight of the fact that, under the present law, appeals are still possible from decisions of the Labor Board. An order must be enforced through the courts. Even though the findings of fact of the Board are accepted by the courts, if they are supported by evidence, the Supreme Court has held that this evidence must be "substantial, that is, affording a substantial basis of fact from which the fact in issue can be reasonably inferred." [1]

Labor unions have contended that the Labor Board is biased against them whenever it has had to make a decision which places one union at a disadvantage over another, and employers generally claim that the Board is "labor-minded." The basis for the criticism from labor unions arises primarily from the function of the Board in determining the appropriate bargaining unit; the A.F. of L. claims that the Board favors the C.I.O., and the latter declares that the Board breaks down genuine national collective bargaining by favoring the craft organizations of the former. The basis for employer criticism lies in the whole gamut of Board decisions; the employers feel that the Board has extended the meaning of unfair practices so as to take away employer rights and to be lenient with labor to a much greater extent than was ever contemplated by the law.

The proposals for amendment to remove this bias are numerous. The most important is to abolish the Labor Board and set up a new agency of five members in which greater care will be taken in the selection of impartial personnel. The American Federation of Labor has recommended that the law direct the Board to allow craft units within an industry to set up representatives whenever desired by members of the crafts. The Congress of Industrial Organizations suggests an amendment to curtail the Board in allowing craft units to split off from larger groups, when to do so would hamper collective bargaining on a wide scale. It has even been proposed to take away from the Board its present power to determine the appropriate bargaining unit.

None of these proposals seem to have much merit. When one considers the purpose of the Wagner Act and examines the work of the Labor Board, the charge of bias does not seem to have much substance. The clear purpose of the act is to encourage unionization and collective bargaining and to stop employers in their interference with these ends. The Board would hardly be following out the mandate of Congress if it did not expend its efforts in investigating and halting employer activity to thwart unionism. Yet relatively few cases arising from complaints against employers have gone to the stage of formal action.

If it is in the public interest to encourage effective collective bargaining, the Board should be allowed to select the unit which it believes to be most appropriate for that purpose. This is a task which must be left to the discretion of a commission to decide on the merits of each case, and should not be frozen by inflexible legislative provisions. The record of the Board appears to be fairly

[1] *N.L.R.B. v. Columbian Enameling and Stamping Co.*, 306 U.S. 292 (1939).

commendable. It has taken into account a great many different factors in determining the appropriate unit. The fact that two rival factions of labor both criticize it for being biased is the best sort of evidence of a lack of bias in this field of its work.

While the Wagner Act might be conservatively amended by the inclusion of such matters as a few of the more important unfair practices of labor, care should be taken lest the purposes and principles of the law be wrecked by unwise amendment. The law and the Board are young. As time goes on, the Board may be expected to gather prestige and experience, and elements of unfairness and genuine bias will probably be eliminated. Over future years, too, employers will probably come to accept collective bargaining and find that dealing with unions can become a part of a program of co-operative industrial relations. When labor unions get over growing pains and responsible leadership is developed, many of the causes for just criticism of organized labor may disappear.

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Part Eight

GOVERNMENT PROMOTION AND OWNERSHIP OF BUSINESS

CHAPTER

29

GOVERNMENT AIDS TO BUSINESS

ASSISTANCE of the government in the operation of the economic system has grown to such proportions that it has become a major influence in the conduct of business affairs. Although the federal, state, and local governments have always undertaken measures to aid business in the United States, their scope and importance have increased rapidly in the last few years. In addition, new promotional activities have been instituted, until the government has taken on a decided paternalistic character.

It is not always easy to distinguish between government controls, government aids, and government ownership. Some instances of control are accomplished through assistance measures. The assistance to union organization and employment placement have a definite relationship to regulation of business in behalf of labor. The program of agricultural control is materially aided by various subsidies. Moreover, in carrying out control and assistance programs, the government is often obliged to enter business as an owner. Such has been the case with the Reconstruction Finance Corporation and the Federal Crop Insurance Corporation, to mention only two. Furthermore, government aids generally have a regulatory effect. The establishment of standards of value or weight clearly controls the conduct of business enterprises. The granting of credit or outright subsidies and the provision of such facilities as patent privileges are accompanied by duties and obligations which control business behavior. Even when the government becomes an enterpriser by operating a business, its dealings with other businesses and the effects of its operations serve to regulate the conduct of privately owned businesses.

Certain types of government aid have existed since the earliest days of the United States, among them tariff protection, standards, patent privileges, and other special benefits. Land grants for education and transportation, funds for encouraging and improving farming, and services to foreign trade were among the aids furnished long before 1900.

The present system of government aids is so complex that one cannot expect to note all the significant promotional activities. While the state and local governments have done much to aid business, the program of assistance of the federal government has been more important. The present chapter will place its primary emphasis upon the latter. It should be emphasized, also, that only those aids which bear rather directly upon business will be discussed; promotion of public health and education, it is true, are of great significance and have an important influence upon human activity, but they are not so closely related to business.

Government aids to business may be classified along the following lines: (1) establishment of standards of value, weight, measure, and quality; (2) special services to business; (3) financial aids, direct or indirect; and (4) special enabling legislation granting to business privileges which it might not otherwise enjoy. In some cases, aids to business have already been treated in discussion of regulation; these need only be noted in this chapter.

A. ESTABLISHMENT OF STANDARDS

Modern business could not be conducted as it is today if there were not certain definite standards of value, weight, measure, and quality. The system of buying and selling without previous examination of goods depends upon a mutual understanding by the parties as to the nature and volume of the goods exchanged. The unit of weight, measure, or quality must not only be mutually understood, but parties to a contract must know that it has a meaning that can be enforced at law. The present system also depends upon a definite and widely acceptable medium of exchange. Business can be conducted by barter, but business of the present volume and complexity could hardly be so handled. This makes the establishment of a monetary unit by the government of the utmost importance. Since the monetary unit and the money which embodies it are used as a medium of exchange, money becomes a storehouse of value, with additional significance to business.

1. THE STANDARD OF VALUE. Money, as distinguished from currency, is any good which is generally accepted in exchange for other goods in a certain community. The term "currency" has been used to denote all those things used as a medium of exchange and includes money, checks drawn on demand, bank deposits, postal money orders, and similar instruments. Currency items which are not money obtain their acceptability as mediums of exchange because they are rights to obtain money.

a. Provision of money. The nature of money makes it imperative that the government either furnish it or authorize others to do so under conditions of the strictest supervision. In most countries, including the United States, the provision of money is a function of the government. It defines the meaning of the "dollar" and its subdivisions. It mints or issues all money now in existence

in the United States, except the federal reserve notes; and these are issued by the federal reserve banks which are really controlled and supervised by the federal government. Other types of currency are issued by private organizations, such as the banks or by government agencies, such as the Post Office, in the case of postal money orders. Although deposits subject to check are handled by private organizations, these institutions are closely supervised, as was noted in Chapter 21.

In providing money to make possible the convenient and orderly conduct of exchanges, the government has had to define the meaning of the monetary unit, to furnish the monetary instruments to be used in exchange, to limit the agencies which may issue money, and to set up requirements of legal tender. The American dollar has been defined as the equivalent of 15 5/21 grains of gold, 9/10 fine, or 13 15/21 grains of fine gold. This definition is theoretically designed to attach the value of the dollar to a commodity — gold — which is generally acceptable by the peoples of the world.

With such definition of a monetary unit it is assumed (and was true before 1933) that any paper or silver money, called a "dollar" by the government, is the equivalent of the fixed quantity of gold and could be exchanged for it. However, one may not now freely obtain gold for his paper or silver dollar. While gold may be obtained for dollars to make foreign purchases, and this fact does tie the value of gold to the value of the dollar in foreign trade, the value of the dollar in domestic trade (and to some extent in foreign trade) has come more and more to depend upon the management of the supply of money.

Although the real acceptability of money by people over such a wide area as the United States depends upon their faith in its value, the government has encouraged the acceptability of money through its legal-tender laws. Money is legal tender when, according to law, it must be accepted in payment of debt expressed in terms of the monetary unit, and when it is acceptable in settlement of taxes and court decrees. This characteristic means only that if a debtor offers legal-tender money in payment of debt expressed in terms of the monetary unit, the creditor must accept that money or forego any power to force payment. Strictly speaking, the debt still exists after refusal of legal tender, but the creditor cannot force payment in any other medium, and the statute of limitations would eventually outlaw the debt. Since 1933, all money in the United States has been legal tender.

b. Control over money and credit. Obviously, the power of the government to control the issuance of money and to fix the value thereof, along with its power to regulate credit through its supervision of banking, is of tremendous significance to the public. These powers may be used to influence the quantity and character of money, and thereby to determine to a large degree its value. Money is not exempt from the law of supply and demand. If the supply of money increases, its value tends to fall, unless, of course, the demand for it likewise increases. If business should decline, or if people should lose confi-

dence in the soundness of money and make their exchanges with some other medium, its value would tend to decrease. Or factors influencing the demand for, or supply of, money could cause a rise in its value. Since a fall in the value of money is expressed through an increase in the number of dollars which all other commodities will command in exchange for dollars, a decline in the value of money results in a rise in prices. An increase in the value of money likewise causes a fall in prices.

Because most contracts for exchange and many claims against economic goods are expressed in terms of the monetary unit, changes in the value of money materially affect these economic relationships. If a debt is contracted for $1000 at one time, and if at a later due date the price level has fallen by half, in terms of the purchasing power of money at this later time, the debtor is obligated to pay back twice as much as he received. Opposite results follow when prices rise. Since the long-term internal debt of the United States, including debts of governmental units, businesses, farms, and homes, has been estimated alone to amount to $131,000,000,000,[1] the importance of changes in the value of money are apparent. Other billions of dollars in claims are represented by short-term debts covering ordinary loans and a host of credit transactions.

In every period of falling prices there has been a demand for governmental monetary control to increase prices and ease the burden of debt. Following every war and financial panic, the government has been pressed to increase the quantity of money. In almost every instance, this has been done. These measures have ranged from expansion of state bank notes after 1837 to the silver purchases since 1890 and the devaluation of the dollar in 1934. This last expedient is an interesting example of the character and importance of the government's monetary power.

The monetary panic of the winter of 1932–1933 was brought to a head in March, 1933, when, in connection with the bank holiday, the government ordered the cessation of redemption of money in gold. This meant that the dollar was cut loose from gold as the determinant of its value. In 1934, when a modified form of gold standard was adopted allowing the purchase of gold from the Treasury by private parties for the financing of foreign trade, the gold content of the dollar was reduced by more than 40 per cent. In other words, the price of gold was raised from $20.67 per ounce to $35.00 per ounce. While this move did not increase the quantity of money outstanding in the country, it did increase the value of gold stocks and lead to foreign sales of gold to the United States. Thus, largely because of the rise in value of gold and in imports following devaluation, gold stocks in the United States increased from a little over three billion dollars in 1929 to eighteen billion dollars in 1940. Since the reserves of banks are affected by the gold held by the government, by means of the increased deposits caused by exchange by the government of dollars for

[1] *Investigation of Concentration of Economic Power*, pt. 9, p. 3729 (1940).

gold, and because of the stimulus given to domestic prices by foreign sales of gold and purchases of American products, the gold-devaluation program has been a significant cause of rising prices since 1933.

The controversies following upon the devaluation of the dollar in 1933 and 1934 have served to illustrate the broadness of the federal government's power over money. The gold-devaluation legislation provided that all contracts, whether made in terms of dollars, or in terms of dollars of a specified amount of gold, or in terms of gold, should be payable in the devalued dollar. Had this not been provided by law, the devaluation of the dollar would have been exceedingly difficult, if not impracticable. Many bonds had been issued with the customary gold clause providing for repayment of principal and even payment of interest in gold dollars of a certain weight and fineness. Had the gold clauses been allowed to hold, the debtors would have had their obligations increased by about 75 per cent in terms of dollars. It is doubtful whether the devaluation could have been instituted in such an event. When the question of impairment of the gold contracts reached the Supreme Court, however, that tribunal held that the power of Congress to coin money and regulate the value thereof was plenary and that to enforce the gold contracts as written would be to obstruct Congress's powers over money.[1]

2. Standards of Weight and Measure. The federal Constitution authorizes the national government to fix standards of weight and measure; the importance of this standardization to the orderly transaction of business can hardly be overestimated. But in spite of the completeness of the power of the national government to fix such standards, the setting of practically all lawful standards is left to the state governments. This anomalous situation may seem difficult to understand, but there are several reasons which may explain it. The standards of measurement in existence in the states at the time of the establishment of the federal government varied somewhat and difficulty was encountered in arriving at an agreement. Moreover, disagreement was encountered as to whether to adopt standards according to the English system in preponderant use in the United States about 1800, or to adopt the metric system. The lack of federal control may also be explained by the difficulties the young government had in meeting other problems, and by the fact that state governments voluntarily followed federal government recommendations, thereby developing a surprising uniformity throughout the nation.

The federal government has, however, played a substantial rôle in the fixing of standards of weight and measure. By legislation passed in 1894 and 1915,

[1] See *Norman v. B. and O.R.R. Co.*, 294 U.S. 240 (1935); *Nortz v. U.S.*, 294 U.S. 317 (1935); *Perry v. U.S.*, 294 U.S. 330 (1935); and *Holyoke Water Pwr. Co. v. American Paper Co.*, 300 U.S. 324 (1937). Many other governmental policies designed to control the value of the monetary standard might profitably be discussed. For purposes of this text, however, an understanding of the nature and importance of the power of the government to fix the monetary standard and furnish the monetary medium is adequate. For the student interested in a study of government monetary policy, any good money and banking textbook will give him a beginning and will also furnish references for further study.

standards for electrical measurement and for the barrel were definitely prescribed by the law. As early as 1836, Congress ordered the Secretary of the Treasury to provide the states with detailed lists of weights and measures used in the calculation of import duties. Since 1901, when the National Bureau of Standards was created (placed a few years later in the Department of Commerce), the national government has assumed increasing leadership over the establishment and maintenance of uniform standards. Moreover, the standards used by various federal agencies, especially the many regulatory agencies, the Public Health Service, the Army, the Navy, and many service bureaus, have been made uniform and have influenced the establishment of like standards by the states.

The leading part in the establishment of standards has been taken by the Bureau of Standards. The Bureau not only maintains testing and experimental laboratories, but encourages assistance from scientists and business men in the setting and modifying of standards. It operates scale- and measure-testing services to check upon and aid in the administration of state weight and measure laws. The importance of this work is indicated by the experience in the year ending on June 30, 1939, when in one type of examination, the testing of wagon and motor-truck scales, the Bureau found that 71.6 per cent of the scales tested were inaccurate beyond an allowable margin of tolerance.[1] Such tests as these have served to sharpen state administration and to encourage states to procure improved testing equipment.

State standards are not always uniform as between states. In some states a "ton" may mean 2000 pounds, while in others it may mean 2240 pounds. These differences are minimized in some respects by the usual reference to "short" and "long" tons. Wider differences occasionally exist in capacity measurements, with gallons, baskets, and bushels varying in some of the states.[2] Although most of the standards of measurement are uniform, the small diversity that does exist, and the greater difference in efficiency of enforcing standards among states, would seem to make more complete treatment of weights and measures by the federal government highly desirable.

3. STANDARDS OF QUALITY. Consumers and business have been aided by state and federal specification of standards of quality. A bushel of wheat of one quality is a different good from a bushel of another quality, and one pound of butter or a drug may differ materially from another pound. Hence, if standards are to mean anything for purposes of exchange, it is practically necessary to have uniformity in quality classifications. Requirements of grading

[1] 27th *Ann. Rep. Secretary of Commerce* (1939), p. 51.

[2] In several states these standards of measure are quite diverse. In Wisconsin, a bushel of onions is 50 pounds, but in Idaho it is 57 pounds. In Texas, a bushel of sweet potatoes is 50 pounds, but it is 56 pounds in Florida. In the case of greens (mustard, spinach, turnip tops, etc.) a bushel varies from 10 pounds in North Carolina to 30 pounds in Alabama. See "Summary of Testimony Submitted to the Temporary National Economic Committee by A. H. Martin, Jr.," March 18, 1940, p. 22 (mimeographed).

and description may be onerous to business men, but business in general stands to gain from standards which make it difficult for a product to be passed off as a quality superior to that which it is. Establishment of standards of quality is closely related to the maintenance of fair competition, discussed in Chapter 20, in that the proper description and classification of goods remove one of the principal bases for practices which are unfair to competitors, and deceptive to consumers.

The federal government has done most of its work in establishing quality standards in the fields of agricultural products, foods, drugs, and cosmetics, and certain commercial goods. It has taken more definite action in establishing quality standards than in fixing standards of weight and measure. The state governments, however, still exercise an important degree of control, even in regard to quality.

a. Standards for agricultural products. The federal Department of Agriculture has broad powers to establish standards of quality and condition for agricultural products. Under the Cotton Futures Act of 1914, the Grain Standards Act of 1916, the Cotton Standards Act of 1925, the Tobacco Inspection Act of 1935, the Commodity Exchange Act of 1936, the Warehouse Act of 1916, and the Perishable Commodities Act of 1930, the department may fix grading standards for class, quality, or condition of practically every agricultural product traded through organized exchanges, terminal markets, or public warehouses.

The procedure used for establishing these standards differs somewhat, but in general follows the pattern provided by the Grain Standards Act of 1916. This law authorizes the Secretary of Agriculture to establish standards of quality and condition, and to modify them whenever the necessities of trade may require. It does not make compliance with these standards compulsory, except in certain trading on organized exchanges, but it does provide that when a product is sold by grade in interstate commerce, the federal grades must be used. Inspectors licensed and supervised by the Department of Agriculture are charged with the work of grading the grains included under the law. In cases of fraud or deceit in connection with the certification of grain for interstate shipment, the law provides for disciplinary action against the inspectors.

Agricultural grading is also undertaken by the states. Where the goods are sold within a state, even though they may be shipped from outside it, the police power may be used for setting up grades. These often conform to federal standards, but in some cases they differ from them and from the standards of other states. Often a state employs standards as a means of discriminating against products shipped from outside it. Inspection of the source of supply is sometimes required, with the result that producers from a distant state can hardly meet the grading requirements. Some states place rigid requirements for out-of-state goods, and may refuse to allow goods not meeting these standards to be sold, or may require that they be marked as "culls."

Although state grading laws may be necessary for the protection of the health and welfare of the citizens of the state, too often they are used to erect trade barriers against the products of another state. In view of this abuse of the use of the state police power and the interference with interstate commerce, action by the federal government to remove the discriminations would appear to be in the interests of both producers and consumers.

b. Special standards for foods, drugs, and cosmetics. The Food and Drug Administration of the Federal Security Agency has been given wide power to establish standards to be used in identifying the quality and contents of packages of food, drugs, and cosmetics. Failure to follow these standards, or failure to describe fully the nature of contents where standards are not, or cannot, be followed, results in "misbranding." Misbranding is prohibited by law, as is the use of certain ingredients harmful to the public. Since the food, drug, and cosmetic legislation has been discussed previously in the analysis of regulation for the maintenance of competition, further attention to the special establishment of standards for these goods is unnecessary here.[1]

c. Standards for commercial goods. The National Bureau of Standards has taken a leading part in the development and establishment of standards to be used for commercial goods. The interesting thing about the work of the Bureau in this connection is that legislation does not require the setting up of commercial standards nor compliance with them, but their creation and adoption are carried on through the co-operation of industry with the Bureau. Standardization may follow from recommendations of the Bureau for simplified practice, the promulgation of "federal specifications," or the development of "commercial standards."

Recommendations for simplified practice are made by the Bureau, after study and conferences with the businesses concerned, and include suggestions for reduction of the types and variety of a certain kind of good to a number adequate for normal demands. No one is obligated to follow these recommendations, but trade associations generally try to gain compliance from members. Businesses are also usually glad to follow the suggestions, if they find them to be reasonable and if their competitors comply with them, since the reduction of types and sizes economizes production, inventory, and sales costs. Through this standardization work the Bureau has been instrumental in reducing the varieties in types and sizes for dozens of goods. For example, the number of milk-bottle sizes has been reduced from forty-nine to nine, hot water storage tanks from one hundred and twenty to fourteen, paving bricks from sixty-six sizes to five, and the variety of shotgun shells to only 6.5 per cent of the types once made.

"Federal specifications" are quality standards set up to guide the federal government in making its many purchases, and cover a wide range of commodities which the government or its agencies may buy. They are drawn

[1] *Supra*, pp. 500–04.

up by a committee of technical experts, with the assistance of the National Bureau of Standards. As one might expect, they have been prescribed mostly for building materials. When specifications have been promulgated, they are distributed to manufacturers, and the Bureau currently publishes lists of manufacturers who are willing to produce in accordance with them.

Closely related to the establishment of federal specifications is the work of the Bureau in fixing "commercial standards." These are standards of content and quality for manufactured articles and are developed through co-operation of industry with the Bureau. At the request of trade associations, the Bureau has undertaken to set up standards for wood shingles, polo shirts, oil burners, moth repellents, and a host of other commercial goods. It gathers information from the industry, holds conferences with interested parties, and makes tests. When it has arrived at a suitable standard, this is submitted to the industry concerned, and if 65 per cent of the industry approve it, the Bureau publishes it as a commercial standard.

As in the case of federal specifications, the Bureau compiles and distributes lists of the companies which have indicated that they will produce according to the commercial standards. Private buyers may request the Bureau for such a list. Where federal specifications do not exist, government procurement agencies generally buy according to commercial standards. Because of the influence of public and private buyers in seeking products manufactured according to standards approved by the Bureau, manufacturers often find it to their interest to adopt them. However, their acceptance is purely voluntary; the government takes no steps to require compliance, nor does it guarantee that goods are actually produced according to the standards. But if a manufacturer professes to manufacture goods under them when in fact he does not, there is danger of a private suit by buyers for damages or of prosecution under the unfair trade practice laws.

B. SPECIAL SERVICES TO BUSINESS

The government gives so many special services to business that one can hardly present a complete picture of them. Many of the regulatory agencies give such services as accounting advice to business in the normal course of supervising it. Their published statistical reports and opinions often contain information of great usefulness. Furthermore, regulatory functions are sometimes intermixed with promotional ones, and in many instances the government aids have been discussed along with the regulation. This has been especially true in the previous discussion of government regulation in behalf of labor, and further treatment at this point is believed to be unnecessary. Some of the governmental aids to transportation have also been noted previously, and only the special services to maritime shipping need be noted in this chapter.

1. STATISTICAL INFORMATION. The state governments, and more particularly the federal government, are the chief sources of statistical information for businesses, as well as for other groups of the public. Nearly every government agency has contributed to the collection and dissemination of information of value to business. Some of these agencies furnish information as a by-product of their normal reporting of activities. Many of them do so for the express purpose of helping those persons operating the economic system. The justification for such services has been that, if an economic system is to work efficiently through the selection and pursuit of policies by business men, persons making business decisions can do so effectively only if they are well informed. The principal statistical aids of the government may be classified according to the subject matter of the data, such as those concerning foreign commerce, manufacturing and distribution, mining, transportation, agriculture, banking, labor, investment information, and consumer information.

a. Foreign-commerce statistics. For those businesses operating in foreign trade, numerous services are available. The statistical services of the Department of State, including the Foreign Commerce Service (which was in the Bureau of Foreign and Domestic Commerce of the Department of Commerce until 1939), are especially valuable. These services include data on imports and exports, foreign tariffs, exchange restrictions, movements of gold, and world commodity stocks. The Maritime Commission and the Bureau of Marine Inspection of the Department of Commerce collect and publish data of shipping operations in both the foreign and domestic trades. These data are generally published monthly or quarterly, and have been successful in representing fairly current operations. With all the complexities in foreign trade and the many factors which may influence demand and supply for exports or imports, the government's statistical information has proved to be indispensable to the foreign trader.

b. Manufacturing and distributive information. The Department of Commerce has had the leading rôle in collecting and disseminating information of advantage to domestic manufacturers, wholesalers, and retailers. The Bureau of Foreign and Domestic Commerce makes available statistics of production, domestic commodity stocks, finance, investments and savings, incomes, corporate financial policies and practices, business taxation, and costs of production and distribution. Special marketing services include retail trade indexes in the fields of automobile sales, retail sales, variety store sales, chain grocery sales, and mail-order house sales. In addition, special statistical reports are made of certain industries, some of the most important having been those on the construction, food, and chemical industries.

c. Mining industry statistics. The Bureau of Mines of the Department of the Interior prepares and distributes extensive information concerning mining operation and the processing of mine products. These include weekly, monthly, and annual data on such subjects as the products of mines, prices,

employment, stocks, and consumption. The Bureau also makes special reports on the record of mine accidents and on recommendations for mine safety based upon its researches.

d. Transportation statistics. The various government agencies concerned with transportation regulation and promotion collect and publish a wealth of information concerning the volume and costs of transportation, as well as the financial status of transportation companies. These statistics are not only valuable to the transportation businesses, but have significance for business in general, since they reflect the movement of trade in the United States.

e. Agricultural statistics. Practically every bureau or division of the Department of Agriculture contributes to the volume of agricultural statistics available to business. Statistics have been compiled and disseminated on benefit payments and other expenditures of the farm program, farm mortgages, farm taxation, farm insurance, population, income, prices, production, acreages, yields, stocks, consumption, processing of agricultural products, timber production and distribution, and trading and prices on organized commodity exchanges.

f. Banking information. The Governors of the Federal Reserve System and the federal reserve banks, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation publish a wide range of banking data. These include all kinds of monetary, loan, deposit, and bank-operation statistics, as well as much information on general business operation. As in the case of transportation statistics, the banking data have proved useful not only to bankers but to general business as well.

g. Labor statistics. The Bureau of Labor Statistics of the Department of Labor is the chief source of information on labor conditions in the United States and foreign countries. Through the medium of the *Monthly Labor Review*, other weekly, monthly, and annual reports, and many special bulletins, the Bureau of Labor Statistics gives wide publicity to data derived by its own researches and by the work of other government agencies and of many private students. The more important of these data include statistics of employment, payrolls, wages, hours, industrial accidents, occupational disease, industrial disputes, labor productivity, labor turnover, labor placement, and technological displacement of workers. The Bureau also distributes information concerning labor laws and their enforcement, expenditures and results in terms of employment for public works, and employment conditions in special industries. The work of the Bureau in studying cost of living and the publication of indexes of cost of living for given localities are also important. In addition, the Bureau makes public certain general price and production statistics which are of interest beyond the labor considerations involved.

h. Statistics for investors. In making a study of investment opportunities, the intelligent investor finds it to his advantage to draw from most of the statistics which are of importance to businesses. But in addition to the wealth of data

to be found therein, the government publishes information especially significant to investors. The requirements of full disclosure under securities and exchange regulations have already been noted. From registration statements and other reports which businesses must make to the Securities and Exchange Commission, that agency publishes a variety of financial information showing the trends of new capital flotation, the types of securities issued, the volume of transactions, the amount of margin trading, bond yields, and other information of consequence to investors. These data are also valuable for businesses in giving them official information upon which to base their plans for financing.

i. Information for consumers. The information which the government furnishes for consumers also indirectly aids businesses. By educating them to buy discriminatingly, it aids those businesses which might otherwise be at a disadvantage in face of the higher advertising appropriations of certain large companies, or against companies which sell on the basis of mildly or strongly deceptive practices. Education of consumers may harm certain businesses which rely upon consumer ignorance for their markets. Moreover, informational aids to consumers undoubtedly have a regulatory effect, in that they lead buyers to exercise choices more strongly and in more definite directions.

Many government departments undertake to publish information for the benefit of consumers. The Bureau of Home Economics of the Department of Agriculture carries on development of information for consumers. The Bureau is especially active in determining desirable qualities of food, clothing, household textiles, and housing, and in making these data available to the consuming public. The consumers' counsels of the Agricultural Adjustment Administration, the Bituminous Coal Division, and other agencies also compile information of interest to consumers. Other consumer information is published by the Rural Electrification Administration, the Bureau of Fisheries, the Federal Housing Administration, the Public Health Service, and by certain monographs of the National Bureau of Standards. Much of this information is published as government documents and is available to anyone who knows what to request from the Government Printing Office. In some instances, notably in the radio broadcasts of the Department of Agriculture and the preparation of consumer data for study groups, the government takes the initiative in bringing consumer information to the public.

Irrespective of the vast amount of consumer information published by the government and the extensive information which an agency like the Bureau of Standards does not publish, the government has still not done much to see that consumers have the best available information. Much of that published reaches only the few consumers who happen to be interested enough to write for it or who happen to listen to a radio program or attend an adult study group. Other information, such as the tests of commercial goods made by the Bureau of Standards for the government procurement officers, are never even made public. The Bureau has claimed that its tests generally include only

those goods which the government is about to buy, and that it has neither the authority nor the funds to include whole lines of competing products and make the results of tests available to the public.[1]

Legislation to authorize the National Bureau of Standards to become a consumers' research advisory organization has been introduced into Congress, and the Bureau has expressed a willingness to undertake this work. However, the influence of certain producing groups, having an advantage derived from product differentiation which might be impaired by such tests, has thwarted the passage of this kind of legislation. Many advertising agencies also fear that consumer advice on the value and nature of commercial products might seriously affect their business.

2. Special Services to Shipping. The federal government has long given certain special services to shipping. These include various kinds of inspection activities, survey and map work, and lighthouse services. Inspection of marine equipment is entrusted to the Bureau of Marine Inspection and Navigation of the Department of Commerce. The Bureau carries on regulatory functions in inspecting merchant vessels for safety and seaworthiness and in its administration and enforcement of rules and regulations governing construction, equipment, operation, and manning of vessels. While these inspection duties are helpful to shipping companies, the Bureau has in addition a technical division which makes studies of and recommendation concerning naval architecture, marine engineering, and electrical engineering.

An aid to the government which is practically indispensable for shipping is the surveying and mapping work of the Coast and Geodetic Survey of the Department of Commerce. Geographical data could hardly be developed upon such a broad scale by a private enterprise, and the wide sweep of shipping operations makes full and complete geodetic surveys a necessary and justifiable function of the government. The Coast and Geodetic Survey carries on extensive surveying operations and produces charts needed for safe navigation on the coastal and intercoastal waters of the United States. Aeronautical charts are prepared for airmen. Seismological studies are made for aid in designing structures to withstand earthquakes. Studies are made of tides and currents, of the earth's magnetism, and of gravitational and astronomical observations. Many of these studies are utilized for shipping and some for other businesses.

Another service which only government is able to furnish is the aid to water and aerial navigation by lighthouses, buoys, and radio beacons. These aids are administered by the Lighthouse Service, since 1939 consolidated with the United States Coast Guard in the Treasury Department. This service includes not only the furnishing of many navigation aids, but research into new methods to make navigation safe and efficient.

3. Special Services to Foreign Trade. The Department of State carries on a well-organized system of assistance to the operation of foreign trade

[1] *Investigation of Concentration of Economic Power*, pt. 8, p. 3478 (1939).

throughout the world. Through the establishment of consular offices in numerous cities of the world, the government furnishes facilities for the expedition of foreign trade with this country. These officers help businesses by furnishing them information of trade conditions, by aiding domestic firms to meet foreign buyers and sellers, by watching out for property rights of American business men in foreign nations, and by assisting in protection of American trade-marks and patents.

4. Special Services to Fisheries. Because of the common-ownership character of fishing grounds and the inability of private enterprise to control them, the special assistance of the government to the fishing industry is not difficult to understand. The Bureau of Fisheries of the Department of Commerce is charged with a variety of government aids, and also administers some regulatory functions respecting interstate shipments of fish and fishing in certain territorial waters. The aids include investigations of catches, propagation conditions, and marketing practices; technical assistance to fishery and hatchery administrators of the states; the operation of experimental hatcheries; and conservation of fur seals.

5. Special Services to Mining. Besides the statistical help given the mining industry by the Bureau of Mines, other assistance is granted through technical investigations carried on by the Bureau. These have centered about activities to promote safety and health of mining, and researches to show operators methods for efficiently mining and treating minerals. The constant research activities have contributed much to mine safety, one discovery alone, the use of rock dusting, having resulted in highly improved mine operation.[1] Causes of accidents and disease have been studied, and the Bureau has recommended many safety devices and has also established safety stations and mine rescue cars to be used in cases of disaster. The conduct of experimental mines has also brought about improved methods of mining and the elimination of much waste of natural resources.

6. Special Services for Agriculture. In a very real sense nearly all the regulations of agriculture operate to aid the farming group. But in addition to the assistance aspects of the farm-control program, the governments of both the states and the United States have aided farmers through special services. They are administered almost wholly by the Department of Agriculture and include extension services; plant and livestock research and disease control; and research in forestry, insects, and weather conditions. In addition, the Department aids the farmer through numerous informational services, already noted, and through the encouragement to the use of electricity by the Rural Electrification Administration.

The Department of Agriculture finances county farm agents and home demonstration agents in every county of agricultural importance in the nation. These employees are charged with the duty of representing the Department in

[1] *Supra*, p. 719.

various counties and with acting as assistants in helping farmers with their local problems. Through their work, the research program of the Department is brought to the attention of farmers, with recommendation for action along lines that studies indicate.

This research program includes extensive study of plant, soil, and livestock chemistry and biology, with attempts to develop more efficient production and to devise means for controlling disease and insects. Some of the results, especially those indicating more efficient methods of production, are left to the farmers to adopt voluntarily. In the case of disease-control methods, however, the Department of Agriculture co-operates with state agencies in enforcing the control and also undertakes by quarantine or destruction to eliminate diseases.

The Department makes extensive studies of weather conditions and forecasts their probable effect upon crops and markets. Where adverse weather conditions cause serious damage, the Department administers funds to relieve distress and to alleviate the effects of the conditions.

An important service is performed for farmers through the Rural Electrification Administration. This agency, created in 1935 and placed in the Department of Agriculture in 1939, has been charged with a program of encouragement to farm electrification. The Administration encourages groups of farmers desiring electricity to organize and lends funds upon favorable terms for the building of power lines to serve the farms. Furthermore, it encourages the introduction of electrical appliances and devices into farm homes and operation and aids in financing their purchase. The work of the Electrification Administration has not only served directly to increase farm use of electricity, but has caused private power companies to extend their facilities upon increasingly favorable terms to the farmers.

C. INDIRECT FINANCIAL AID—THE TARIFF

While all governmental aids involve the expenditure of a portion of the national income for the purpose of helping a particular group, there are certain kinds which place funds in the hands of the recipients. The more obvious type is the subsidizing of an industry, as has been done with the merchant marine and the aviation industry. A little less obvious, but nevertheless real, is the extension of credit to private groups through governmentally furnished facilities and upon the strength of government credit. Definitely in the same class of government aids is the imposition of protective or prohibitive tariffs [1] upon

[1] A tariff is simply a tax levied upon goods imported into the country. While it may be levied to obtain revenue, and often is, it may also be "protective" or "prohibitory." Technically, a protective tariff is one which is high enough to make the foreign price of the good, plus transportation charges, plus the tariff, equal to the domestic price of the good. This supposedly places foreign and domestic sellers on an equal competitive basis. A prohibitory tariff is one high enough to make it practically impossible for foreign sellers to compete in the domestic market. To the extent that a tariff is really prohibitory, no imports of the good come into the

articles imported into the country. Tariffs do not involve government expenditures to aid a particular industry, but, by allowing domestic industry to charge higher prices than would be possible without them, they give it a larger share of the national income than could be obtained otherwise. As such, tariffs, when protective, are the equivalent of government subsidies. The incidence of a tariff is, however, ordinarily different from that of taxation to raise government funds for outright subsidies. Its burden really falls upon the consumers of goods produced by the protected industry, while the burden for government subsidies would fall generally upon the taxpayers of the country.

1. DEVELOPMENT OF THE AMERICAN TARIFF. Customs duties have been levied upon a varying list of imports since the first tariff act of 1789. Although this first tariff had tax rates which were relatively low and has been referred to as a revenue tariff, the fact remains that the desire of manufacturers for protection played a part in the drafting of the measure, and that rates on some commodities were probably higher than those which would yield the largest revenues. The demand for tariff protection continued, especially after the War of 1812, when foreign trade increased rapidly, until by 1828, in the so-called "Tariff of Abominations," protectionism dominated the formulation of import duties. This law fixed rates averaging nearly 50 per cent of the value of goods presented for import, and represented the high point of protectionism until decades after the Civil War.

The Southern and Western planters, whose products were exported and who gained nothing and lost much by tariff duties which allowed high prices for manufacturers, opposed the high-tariff policy and forced downward revision between 1833 and 1861. These lowered duties, however, did not remove the fundamentally protectionist character of the American tariff. In the period between the beginning of the Civil War and the Wilson administration in 1913, tariff rates were raised to high levels and almost consistently maintained on a strongly protectionist basis. Throughout this period, the tariff was one of the leading political issues, with the Democratic Party insisting upon tariff for revenue only, and the Republican Party declaring for protection. The eight years of Democratic administration in 1885–1889 and 1893–1897 resulted in some modification of tariffs, but in no real departure from the principle of protection. Interestingly enough, during the latter part of the nineteenth century the Republican leadership, to assuage growing popular feeling against some tariffs, inaugurated a policy of commercial reciprocity. This involved making commercial treaties calling for a reduction of American import duties in return for lowering those of a foreign nation. The policy, however, introduced by the Republican Party purely to make a show of tariff reduction for agricultural exporters, had practically no effect in reducing tariffs.

country and no customs revenue accrues to the government. Since a domestic producer or seller is not really protected from foreign competition by a protective tariff, the tendency in this country has been to make "protective" tariffs prohibitory.

With the advent of a Democratic administration in 1913 and the apparent popular desire for downward tariff revision, a policy of real protective, or "competitive," tariffs was adopted. During the eight years of the Wilson administration, it is true, tariff duties fell until average rates were about 16 per cent of the value of dutiable goods in 1920. Through the increased admission of goods free of duties and the lowered rates, tariff rates became lower than they had been for more than a century. In considering these reductions, however, one should remember that the period was that of the first World War. During this time American exports increased rapidly through the assistance of foreign loans; and imports from foreign countries were hampered by war conditions and the increased demand for goods by European countries. Hence, this period was one in which protection was not particularly needed, and world conditions would not have allowed free trade had protectionism been abandoned entirely.

With the return of peace and increased production abroad after the war, popular opinion in America again favored upward tariff revision. The result was a series of tariff acts culminating in the infamous Hawley-Smoot tariff of 1930.[1] While this tariff enacted high rates upon agricultural products to appease farmers, most of which rates were ineffective because of the export situation, it also placed very high rates upon a long list of manufactured articles. The result was to raise average rates on dutiable goods to about 59 per cent, to cause retaliation against American exports by foreign governments, to reduce American imports and hence the purchasing power of foreign countries, and to all but ruin the export market for American agriculture.

The Democratic administration after 1933 made a gesture of lowering tariff duties through the adoption of a system of reciprocal trade treaties. Tariffs as a whole were not revised, but under the leadership of Secretary of State Cordell Hull, the administration negotiated a number of treaties calling for reciprocal reduction. The disorganized state of world affairs in the last few years, and the opposition of selfish groups who have been moderately harmed by the trade treaties, have made these treaties relatively unimportant as a means of tariff reduction. The American system of tariffs still remains predominantly protective, with rates at levels almost as high as the record tariff of 1930. Moreover, the tariff issue has lost much of its significance as a political question, since both major parties now show no inclination to depart from strong protectionism.

2. The Nature of the American Tariff. Most duties in the American tariff system are levied on articles upon an ad valorem basis. Under this procedure, the duty is a certain percentage of the value of the imported good.

[1] This act occupies nearly two hundred pages in the statutes at large and contains over thirty-two hundred dutiable items. When the "catchall" clauses are taken into account, it has been estimated that more than twenty-five thousand commercial articles ordinarily imported into the United States are covered by the law. See the Attorney General's Committee on Administrative Procedure, *Administration of the Customs Laws* (1940), vol. 1, pp. 2–3.

Other tariffs are levied as specific duties, or a certain amount for some unit of quantitative measurement. Special duties are provided for a large number of individual products, but the many thousands of dutiable goods fall under so-called "basket" or "catchall" clauses. For example, one clause of the tariff law of 1930 provides for a 25 per cent ad valorem tax upon "all chemical elements, all chemical salts and compounds, all medicinal preparations, and all combinations and mixtures of the foregoing, all of the foregoing obtained naturally or artificially and not specifically provided for." By this clause, it has been estimated that there are fifteen hundred dutiable chemicals provided for, not counting those upon which specific duties are levied.[1]

3. LEGAL ASPECTS OF THE TARIFF. The federal Constitution gives Congress the power to levy taxes, duties, and imposts for paying debts and providing for the general welfare of the country. It was long contended by some that, since a protective tariff was not for revenue but to restrict commerce for the benefit of certain domestic producers, it was not constitutional. Curiously enough, this question was not squarely dealt with by the United States Supreme Court until 1928. In a unanimous opinion concerned with various matters arising from the delegation of powers to the President, the Court upheld the power of Congress to enact protective tariffs.[2] It maintained that it could not question the motives of Congress in setting up a revenue act fixing import duties, so long as the act was levied at all for revenue-raising purposes. The Court held that the desire of Congress to fix rates which would protect local industry could not invalidate a revenue act. Inasmuch as some revenue may be collected under almost any tariff act, one can probably say that even a highly protective law may have a valid revenue purpose. But the effect of such laws as the tariff of 1930 has been largely adverse to the collection of revenue.

4. THE BASIS FOR TARIFFS. A number of arguments in favor of protective tariffs have been advanced over the years. Irrespective of their validity, they have had so profound an effect upon American thinking that the majority of American consumers, wage-earners, and farmers, as well as the industrial managers, have favored the principle of protectionism. What are some of these arguments which have been advanced and what may be said of their validity? Although often they are neither entirely "right" nor entirely "wrong," their faults should certainly be understood by the student of governmental economic policies.

One of the strongest arguments which has been advanced for the tariff is the "infant-industry" argument. When a country possesses a possible natural advantage over other countries for a particular industry, but, owing to the already established character of the industry abroad it cannot be established, then tariff protection for the new industry during its "infancy" is entirely justified. The argument for protection assumes that the industry is one which

[1] *Ibid.*, p. 3. There are two hundred and sixty-four "basket" clauses in the 1930 law.

[2] *J. W. Hampton, Jr., and Co. v. U.S.*, 276 U.S. 394 (1928).

can successfully compete in the world market, once it has been established, and that protection will not be extended beyond the years of development. Under such conditions, there can be no doubt of the desirability of the protective tariff. However, in actual practice the infant-industry argument has some infirmities. Protection should only be given to those industries which show promise of being self-sustaining; in the United States, infant-industry protection has been granted almost indiscriminately. A second deficiency of this argument in practice is that these protected industries seldom "grow up" and that, irrespective of their strength in the market, they prefer to be protected against foreign competition.

Another very effective argument for protectionism has been the claim that high protective tariffs preserve the American standard of living, and especially American wage levels, from impairment by the importation of competitive foreign goods produced by cheap labor. To the rank and file of voters, perhaps no other argument for protectionism has had so convincing an effect. This argument claims that high wages necessitate high cost and that high cost makes necessary high prices, which must be protected from foreign competition. This argument has a grain of truth in it, but it has flaws which are far more significant. In those industries which could not exist except for protection, the wages which are paid are probably higher than they could be without protection. But such an industry is one in which the country is less efficient than it must be in other industries, and these wages are paid at the expense of a higher cost to consumers than would otherwise be necessary. The real flaw in the standard-of-living argument is that high wages do not necessarily cause high prices; high wages result from efficient production and the high value productivity of labor. One might ask in this connection how otherwise American exporters could sell billions of dollars' worth of domestic goods to foreign countries, the wage levels of which are so much lower than American wages. Moreover, the standard of living depends upon the volume of material goods and services which can be purchased with money wages. If a protective tariff raises money costs of those things which labor buys, the net result may be to lower the real wages of labor and the material standard of living.

The effect of the tariff upon the material standard of living of a people is more adequately portrayed in answer to the home-industry argument. This argument assumes that if a nation buys from home industries, rather than from any foreign industries, it keeps its money at home and consequently enriches itself. It is based upon the fundamental fallacy of thinking of money as synonymous with goods and services. Clearly, the standard of living of a country depends not upon the amount of money in the country, but upon the volume of goods and services within it. If this were not true, it would pay the people of the United States to sell all their material goods and services to foreign buyers at any price in return for money. Obviously, if this were done, the people would have money, but nothing to buy with it, and the standard of living

would be practically zero. The absurdity of the buy-at-home argument is readily seen if one follows it to its logical conclusion. If it is sound to buy only from domestic producers, it also should be sound for the people of New York State to buy only from New York producers, and sound for the people of Buffalo to buy only from Buffalo producers, and the people of Seneca Street to buy only from Seneca Street producers. As a matter of fact, as one economist has pointed out, this argument comes down to the absurd conclusion that the sound thing for a buyer to do is to buy only from himself.[1]

The confusions over protectionism arise largely from the misunderstanding of the economic advantages of trade. Although money acts as a medium of exchange and goods are generally paid for by it, a moment's reflection will prove that in any system of exchange, goods are really exchanged for goods. A nation cannot export indefinitely unless it imports goods to pay for the exports. For a period of time, the exports can exceed the imports, the balance being paid for by the shipment of gold or the shipment of notes (foreign bonds, for example) payable to the exporting country. But if a country receives gold or I.O.U.'s, these are really imports which balance the exports, and which obviously have no great worth in increasing the standard of living of the importing country. If goods are exchanged for goods, then a country's stock of goods would seem to be increased to the extent that it will produce those things which it can produce most efficiently, and trade these goods for goods of other countries. This simple principle of comparative advantage is easily illustrated. It would hardly increase the standard of living for people in Detroit to produce only the automobiles they need and also produce all their foodstuffs, clothing, and building materials, and for the people of Iowa to limit their production to the corn and pork they would use and attempt to build their own automobiles. Even if people in Detroit should prove to be better farmers than those in Iowa, it would still not pay them to curtail automobile production in order to raise their own pork, since they can produce more value output by manufacturing automobiles than by producing corn. These simple advantages of specialization and trade are relatively obvious when dealing with the United States alone, but the principles are just as sound from an economic point of view when speaking of international specialization.[2]

It is quite true that vested interests have been built up in the United States under the protection of the tariff. If tariff reductions were brought about too abruptly, the effect might be to cause capital losses and disorganization of

[1] Meyers, A. L., *Modern Economic Problems* (New York: Prentice-Hall, Inc., 1939), p. 202.

[2] For more complete discussions of the economics of tariffs, the student is referred to the large volume of competent writing on this subject. See for example, Taussig, F. W., *Principles of Economics* (New York: The Macmillan Company, 4th ed., 1939), vol. 1, chaps. 34–37: *idem, Some Aspects of the Tariff Question* (New York: The Macmillan Company, 3d ed., 1931); Ellsworth, P. T., *International Economics* (New York: The Macmillan Company, 1938); and Ohlin, Bertil, *Interregional and International Trade* (Cambridge: Harvard University Press, 1935). Practically any good elementary economics text has a concise and accurate treatment of the economics of protectionism.

industry. Although this basis for maintaining protective tariffs is not fundamentally sound, but rests upon expediency, it does mean that, if tariff reductions were contemplated, they should be introduced gradually.

Aside from certain valid economic considerations, such as the infant-industry argument, the real basis for maintaining tariffs now lies primarily in political considerations. With world stability threatened by conflicts and with the possible need for a country to be as self-sufficient as possible, tariff protection may be justified to obtain this self-sufficiency. Industries might be encouraged to produce certain strategic materials, such as rubber or its substitutes, tin, manganese, or other necessary goods. While domestic production of full requirements would be very costly, as compared to purchase from foreign countries, this higher cost might be justified on grounds of political expediency. Even in this case, however, the government might be more justified in granting outright subsidies to the building up of these industries, and leaving normal trade as uninterrupted as possible. Moreover, outright subsidies would destroy future arguments based upon vested interests and would also place the cost of producing such goods in its true light.

The tariff problem is also fraught with political considerations in view of retaliatory policies of foreign governments against American exports. To gain properly the advantages of international trade, changes in tariffs should be negotiated upon a bilateral basis. This objective calls for political action through some device such as reciprocal trade treaties.

5. Some Evils of the American Tariff System. Apart from any of the professed bases for tariff protection and their questionable economic validity, there are other evils in the tariff system as it has developed in this country. Legislation has not been drafted according to any well-considered plan, but has degenerated into a system of pressures exerted by interested producers, of economic favors to producers for political contributions and influences, and of legislative logrolling through trades of votes by legislators interested in obtaining tariff doles for producers in their constituencies. About the only consistency in tariff policy has been the granting of protection for anybody and everybody, and the naïve belief that if a tariff helps one person, then tariffs for all will help everyone.

The methods of drafting tariffs and the lack of consistent plan have meant that tariff policy has been an ever-vacillating one. This instability has made it difficult for business to adjust itself to trade conditions and has introduced an unnecessary element of risk into the economic system.

The tariff also often has repercussions in foreign economic and political policy. A restrictive tariff policy leads not only to retaliation by foreign countries, but may actually cause the countries affected to feel less friendly toward the nation which has impaired their export markets. Moreover, restriction of trade by high tariffs has intensified the demand of countries without colonies for the natural resources and markets of colonies. The scramble for colonies,

which has had so much to do with causing the second World War, might have been avoided had freer trade been allowed. Certainly, the economic motive for colonial possessions is minimized if any nation has a free access to trade in raw materials of the various portions of the world.

6. GOVERNMENT AID AND CONTROL THROUGH TARIFFS. The extent of government aid to business through tariff protection is difficult to ascertain. If the subsidies effected by tariffs went through the United States Treasury, instead of being routed around it, the nation would not only know the extent of these subsidies but would no doubt be amazed at their volume. The amount of aid obtained by producers from the tariff cannot be accurately calculated. It depends upon the difference in domestic prices and world prices, multiplied by the difference in quantity of an article currently sold and the amount which local producers could sell without the tariff. When one considers the thousands of products protected, the total value of this aid must be very great.

The costs of tariffs to the American people must be reckoned in larger amounts than the value of aid received by industries in competition with foreign producers. The tariff has undoubtedly had an effect upon the shrinking of the export market. Since 1920 the export trade has shrunk (along with imports) from more than eight billion dollars to less than two billion dollars in 1932 and less than three and one half billion dollars in 1937. The export of foodstuffs has shown a far greater proportionate decline than these data would indicate. The effect of the loss of foreign markets for agricultural products has already been noted.[1] While other causes, especially war in Europe and Asia, have contributed to this situation, the loss of export markets is in part due to trade restriction imposed by protective tariffs. The result has been that some of the cost of subsidies and inefficiencies following from protectionism have been borne by export producers, as well as the general consumer.

Tariff legislation involves government controls as well as government aids. The size of an import duty not only controls domestic supply, but acts to regulate domestic prices of a good subject to import. Through its power to change tariff duties, the government is able to exert indirectly a wide influence upon prices. In addition, the power to levy and change tariffs places a sort of economic planning authority in the hands of the government. By changing, withdrawing, or imposing tariffs, it is able to encourage or discourage domestic production in certain fields. Where industries are subject to effective foreign competition in the absence of a tariff, the government has wide power to decide to what extent an industry may grow.

7. TARIFF REFORM. The shrinking of the export markets and its effect upon many important business groups in the country, the retaliation of foreign governments and the growth of strong nationalist self-sufficiency, and the search for methods to aid depressed industries, have all contributed to the beginning of what appears to be a more enlightened attitude toward the protective tariff.

[1] *Supra*, pp. 607–08.

While the unsettlement of affairs caused by war in many parts of the world has halted many plans to lower trade barriers and stimulate foreign trade, some steps have been made to reform the tariff.

The most promising of these steps has been the negotiation of reciprocal trade treaties under the Trade Agreements Act of 1934, which has been renewed by Congress to extend to 1943. This act empowers the President to enter into agreements to modify tariff duties within 50 per cent of the duties fixed in 1930. It also provides that when duties are lowered to one country, they shall be also lowered on the same item to any other country which does not discriminate against American exports. Under powers to negotiate these treaties, without necessity of congressional approval, the Secretary of State by 1939 had consummated twenty-two agreements with foreign countries.[1]

These trade agreements did not involve very large reductions in import duties, having reduced the average rate on all dutiable exports by about 9 per cent and the rate on those few items covered by about 35 per cent.[2] The second World War greatly influenced the normal effects to be expected from these tariff reductions, so that it is difficult to tell just how effective they have been. Available information does indicate, however, that where international complications have not unduly interfered, the increase in both exports and imports with trade-agreement nations has been much larger than in those with other nations.

Granting that the influence of the trade-agreement program may not as yet be very great in terms of the volume of trade, its significance as a recognition of the economic advantages to be gained from freer trade is very great. It is to be hoped that, as world political conditions allow, the policy of removing tariff restrictions will continue. There is always the danger that farmers will become greatly concerned over the import of cream to the extent of about 1/10 of 1 per cent of domestic production, and that import of shoes equal to around 1 per cent of domestic output may cause manufacturers to raise their voices in protest. But the better understanding of foreign trade by many political and business leaders and the pressing nature of the American agricultural problem will probably keep the United States on the path toward enlarged world trade.

D. FINANCIAL AID—CREDIT FACILITIES

Government aids to business have also taken the form of credit facilities established for the benefit of certain groups; they normally supplement private lending agencies, which are generally under government regulation, and replace some of the customary investment of private funds in business. The usual scheme is to set up an agency to administer loans, the funds for which are

[1] A detailed list of the items can be found in the statement of Secretary Hull in *Hearings on House Res. 407*, Committee of Ways and Means, 76th Cong., 3d Sess., p. 6 (1939).

[2] Lyons, L. S., Abramson, V., and others, *Government and Economic Life* (Washington: Brookings Institution, 1940), vol. II, p. 598.

obtained by direct appropriation or the floating of bonds, guaranteed either by definite legal provision or by an implied moral obligation.

In some instances, all the government aims to do is to act as a channel for investment of private funds, by borrowing at advantageous rates from the public and lending these funds to businesses at a lower rate than the latter could obtain directly. Many of the loans are made directly or indirectly through some kind of lending organization, and many are made to individual consumers to enable them to purchase goods from business. In either case, the credit facilities are advanced at least in part to aid business. In some cases, loans are made at rates to cover their full cost; while in others, such as many of the loans made to farmers, the rate is not high enough to cover the costs. In such a case, of course, the loan involves in part an outright subsidy.

The government makes loans to governmental agencies as well as to business. The loan of funds by the Public Works Administration to municipalities desiring to build or purchase electric power plants is a case in point. Other instances might be found; but our attention at present is confined to analyzing briefly some of the more important kinds of extension of credit for the benefit of private businesses.

The extension of credit for aiding those engaged in production was not unknown before 1932. After the first World War the federal government lent more than $350,000,000 to the railroads for making additions and betterments and for refunding maturing obligations. Beginning with special legislation in 1916, the government embarked upon a program of encouraging and furnishing special credit facilities for agriculture. It has also indirectly furnished credit facilities for business by the establishment of the Federal Reserve System, and by its power to force federal reserve banks to expand the credit base through open-market operations.

1. The Reconstruction Finance Corporation. The principal government agency providing for the extension of credit to industry has been the Reconstruction Finance Corporation, established by legislation in 1932. Intended to operate during an emergency in which private lending agencies appeared to be inadequate for business credit demands, the Corporation has had its life extended until many believe that it has become a permanent agency of government. As originally set up, it was endowed with a subscription of $500,000,000 of capital stock by the federal government and with power to borrow, by means of bonds or notes guaranteed by the government, up to three times its capital stock. This borrowing capacity was jumped to $3,300,000,000 in 1932, and with new duties placed upon the Corporation by subsequent legislation, it has become a tremendous government lending institution with $1,770,000,000 of loans still outstanding in 1940.[1] The magnitude of the operations of the agency is better indicated by the picture of total business done which may be found in Table XIV, p. 821.

[1] *Report of the Reconstruction Finance Corporation, First Quarter of 1940*, p. 44.

The lending powers of the Reconstruction Finance Corporation have been steadily extended since 1932, so that it now has authority to lend funds to many types of businesses, including banks, trust companies, building and loan associations, insurance companies, and other loan organizations. Loans to these agencies must be adequately secured, at rates fixed by the board of directors of the Corporation, for periods up to three years, and for amounts to each borrower limited to 2 per cent of the capital and authorized bonds of the Corporation. The Corporation has been authorized to purchase preferred stocks or debentures of banks to assist them in keeping open. It has also been empowered to make loans to railroads upon certification by the Interstate Commerce Commission that certain carriers cannot obtain the loans upon favorable terms through private channels and are not in need of financial reorganization.

Loans to states and territories for relief and work relief were also placed within the lending operations of the Reconstruction Finance Corporation. Provision was further made for loans to states, municipalities, and political subdivisions for self-liquidating projects, including slum clearance, bridges, and other public works. The Corporation has also been obligated by law to lend or subscribe capital for various public agencies, especially the federal home loan banks, the farm credit agencies, and the Home Owners' Loan Corporation.

For a time, the Reconstruction Finance Corporation was empowered to lend funds to finance agricultural producing and marketing associations. The direct lending to agriculture has now been taken over by the agricultural lending agencies in the Farm Credit Administration, but it is significant that the Corporation is still the agency which has furnished the major portion of funds to the lending institutions of the Department of Agriculture.

Since 1934, the Reconstruction Finance Corporation has had authority to make loans directly or through co-operation with banks to commercial and industrial businesses if capital at prevailing rates is not otherwise available, if adequate security can be provided, if a loan would help to maintain or increase employment, and if it does not exceed $500,000. At first, such loans had to be limited to a maturity of five years, but amendment in 1938 allowed the Corporation to use its own judgment in setting maturities. Since these loans are of particular interest to businesses, their character may be noted. At the end of 1938 the Corporation had authorized $384,000,000 loans to more than six thousand businesses in virtually every branch of manufacturing, commerce, and mining. Over 70 per cent of these loans were $25,000 or less, and nearly 37 per cent were for $5000 or less, thereby indicating that the "small" businesses were receiving credit from the nation's largest banker.[1]

In June, 1940, the Reconstruction Finance Corporation was given further powers and its life was extended to 1947. It was given authority to aid in the

[1] Klemme, E. M., "Industrial Loan Operations of the Reconstruction Finance Corporation and the Federal Reserve Banks," 12 *Journal of Business*, pp. 365–85 (October, 1939).

national defense program by lending funds to government or private plants manufacturing arms and other strategic materials deemed by the President to be necessary for defense. This interesting addition to the Corporation's lending functions is illustrative of its usefulness as a medium for furnishing funds for projects which the government wishes to encourage.

The extent of Reconstruction Finance Corporation aids to business and to governmental agencies can be noted from Table XIV, which shows the character of the Corporation's activities from February 2, 1932, to March 31, 1940.

On the whole, the Reconstruction Finance Corporation has been ably managed. Except for loans which have been made to government agencies at the direction of Congress and for which the Corporation can hardly be held accountable, the loans made by it have been fairly well secured and show promise of ultimate liquidation without serious loss to the government. On some business loans, of course, the Corporation will suffer loss, but in the case of some advances of funds made upon securities, it has resold the securities at a profit.

The operations of the Reconstruction Finance Corporation furnish an interesting example of government control effected through aids. Railroad bor-

TABLE XIV. LOANS AND OTHER AUTHORIZATIONS OF THE RECONSTRUCTION FINANCE CORPORATION, FEBRUARY 2, 1932 TO MARCH 31, 1940

(000's omitted)

Nature of Recipient	Amounts Authorized	Withdrawals or Cancellations	Disbursements	Repayments and other Reductions	Outstanding as of March 31, 1940
Banks and trust companies	$4,085,413	$702,542	$3,334,984	$2,673,201	$661,783
Building and loan associations	160,487	34,945	120,897	117,417	3,480
Insurance companies	138,915	13,747	125,168	96,664	28,504
*Mortgage loan companies	660,797	105,157	506,575	341,093	165,482
*Agricultural financing institutions	2,451,272	996,285	1,449,824	1,445,620	4,204
Railroads	817,060	106,966	689,980	222,093	467,887
Business enterprises	420,455	128,578	220,822	89,272	131,550
Mining, milling, or smelting of ores	14,923	7,472	5,430	2,426	3,004
*Self-liquidating projects	553,168	44,336	427,266	353,637	73,629
*Drainage, levee, irrigation and other districts	140,248	32,051	89,332	5,365	83,967
*Other loans (largely for relief work)	501,628	6,096	494,747	346,538	148,209
Total	$9,944,366	$2,178,175	$7,465,025†	$5,693,326	$1,771,699

* Nearly all immediate recipients were governmental agencies.

† In addition, approximately $500,000,000 was allocated to the Federal Relief Administrator under the Act of 1933.

Source: Report of the Reconstruction Finance Corporation, First Quarter of 1940, pp. 40–42.

rowers have been called upon to make changes in financial practices as a condition for receiving a loan. Banks and insurance companies have similarly been called upon to effect changes in policy, and the Corporation has insisted upon the right to examine the books of borrowing companies. The effect of competition of the government corporation with private lending agencies is also important. On several occasions, the Chairman of the Reconstruction Finance Corporation has intimated to private banks that they must adopt a more liberal business loan policy, or undergo the danger of severe government competition in the loan field.

2. Special Credit Facilities for Agriculture. The government has furnished a variety of credit facilities for farmers. In addition to many which have been discussed as a part of the control program,[1] the government has encouraged and assisted mortgage and intermediate credit banks and has subsidized loans upon farm mortgages. In response to insistence by farmers that the government furnish more adequate and less costly credit facilities than those previously available from private sources, the federal government has embarked upon a program of credit aid to agriculture which has been constantly enlarging.

a. Federal farm credit before 1933. In 1916 the federal government attempted to improve the organization of farm credit facilities by the enactment of the Farm Loan Act. This act created a system of twelve central farm land banks, supervised by the Federal Farm Loan Board, and charged with furnishing funds to support mortgage loans made by farm loan associations — co-operative organizations of ten or more owners or prospective owners of farm land. Under the plan, the farm loan associations took out stock memberships in the land bank and made mortgage loans to their members up to 50 per cent of the value of land and 20 per cent of the value of improvements. When a mortgage was made, it was endorsed to the land bank, the bank furnished funds for the loans, and in turn raised needed funds by selling bonds to the public. By this device conservative loans were made at low rates and at the end of 1932 over $1,128,500,000 in loans had been made. But the land bank system was none too successful from the point of view of agriculture because farmers distrusted the co-operative lending associations and the mortgage requirements were too high to satisfy a large portion of potential farm borrowers.

To create credit facilities for financing purchases of equipment and livestock and for financing harvest needs, Congress passed the Agricultural Credits Act of 1923. Federal intermediate credit banks were established in each city which had a federal land bank and were placed under the same management as the land banks. They were authorized to make loans to farmers for periods from six months to three years through two types of agencies: they could discount or purchase notes representing loans made by banks, livestock companies, co-operative marketing companies, or agricultural credit associations; or

[1] See *supra*, pp. 606 ff.

they could make direct loans to co-operative marketing associations in an amount up to 75 per cent of the value of produce or livestock held by these associations. The intermediate credit banks have obtained capital from the federal government and have also raised funds by selling short-term debentures to the public and by reselling notes obtained from borrowers.

b. Reorganization and expansion of farm credit after 1933. The provision of agricultural loans by the government has been reorganized and expanded by action taken in 1933. The Federal Farm Loan Board was abolished and the Farm Credit Administration created to supervise practically all the agricultural credit facilities of the government. The Emergency Farm Mortgage Act of 1933, the Farm Credit Act of 1933, and other acts have enlarged the government program for credit assistance.

The government has maintained the system of federal land banks and intermediate credit banks, but has added to the lending facilities of the land banks by authorizing the Land Bank Commissioner to make direct loans to borrowers in localities in which co-operative associations did not exist or were not functioning properly. The Federal Farm Mortgage Corporation was created in 1934 with government capital of $200,000,000 and power to borrow up to $2,000,000,000 on bonds guaranteed by the government. The proceeds from bond sales and capital resources of the Corporation have been used to allow farmers to purchase their mortgages, to make new mortgages, to repurchase farms lost through foreclosure, and to provide farm working capital. Intermediate credit facilities have been expanded by establishment of special banks for co-operatives in each land bank district and by creation of production credit corporations. The capital of the new intermediate credit agencies is furnished by funds of the Farm Credit Administration, by stock subscriptions of borrowers, by sale of notes in the open market and to the banks, and by floating of bonds.

Before the changes of 1933, the federal land banks had undertaken to obtain favorable interest rates for farm mortgage financing by collectivizing the loans and systematizing the methods of handling them, rather than through subsidies to farm mortgagors. Pressure was brought to bear upon legislators by distressed farmers after 1929 and Congress fixed the interest rate for loans made by land banks under the auspices of the Federal Farm Mortgage Corporation at 4.5 per cent in 1933. Later the rate was reduced to 3.5 per cent and in spite of opposition by many persons, including the former Governor of the Farm Credit Administration, this subsidized rate has been renewed. Starting out as an emergency plan in 1933, the making of loans to farmers for farm mortgages at interest rates below the actual cost promises to become a permanent form of agricultural relief.

The effect of the increase of facilities and liberalization of requirements has been practically to double agricultural credit since 1933. Its extent can be easily seen from Table XV. It indicates that the government has become

agriculture's chief banker. Moreover, the fact that so many farmers have become dependent upon government credit means that the government has an additional lever by which to exert compulsion needed in parts of the program of agricultural control.

TABLE XV. OUTSTANDING LOANS AND DISCOUNTS OF THE FARM CREDIT ADMINISTRATION

	April 30, 1933	December 31, 1939
Farm mortgage credit:		
Federal land banks	$1,105,128,000	$1,904,655,000
Federal Farm Mortgage Corporation		690,880,000
Short-term credit:		
Production credit associations[a]		147,325,000
Loans to co-operatives[b]	160,536,000	163,459,000
Loans to private institutions	78,330,000	33,354,000
Regional agricultural credit corporations[c]	106,540,000	8,005,000
Emergency crop and feed loans	131,250,000	115,575,000
Totals	$1,581,784,000	$3,063,253,000

[a] Although total loans outstanding of production credit associations were $154,496,000 only $147,325,000 was advanced by the federal intermediate credit banks.

[b] This item includes $155,617,000 in 1933 and $87,207,000 in 1939 which was lent to co-operatives by the Federal Farm Board.

[c] These corporations were emergency lending institutions established in 1932 and now in liquidation.

Sources: Data for 1933 from Steiner, W. H., *op. cit.* (supplement, 1935), p. 31. Data for 1939 from 7th *Ann. Rep. Farm Credit Administration* (1939), pp. 143, 167, 173, 192, 206.

3. SPECIAL CREDIT FACILITIES FOR HOME-OWNERS. The government has sought to encourage home-ownership by assisting those who have difficulty in meeting mortgage payments and by aiding persons to build new homes and remodel existing houses. These aids are apparently designed to help home-owners, but an equally important motive of the government has been to assist mortgage banking institutions and the construction industry. Many government planners have believed that stimulation of the construction industry is one of the most effective means to combat depression.

The first legislation to assist home-owners was the Federal Home Loan Bank Act, passed in 1932. This law created a federal home loan bank system, drawn along the lines of the Federal Reserve System and providing credit facilities for member banks and loan associations to use for urban real-estate financing. The Federal Home Loan Bank Board was established to administer this law and has since been charged with administration of other government credit facilities which have been provided for home-owners.

In 1933 the Federal Home Loan Bank Act was supplemented by passage of the Home Owners' Loan Act. This act directed the Federal Home Loan Bank Board to create a new corporation to assist in financing of mortgages upon urban real estate. The Home Owners' Loan Corporation was set up with capital of $200,000,000 from the United States Treasury and with power to borrow many millions more. The Home Owners' Loan Act also provided for

the establishment of federal savings and loan associations, co-operative savings and loan associations which would be members of the federal home loan bank system, and which would have government aid through investment of government funds in the shares of these associations. Insurance of savings accounts in these associations and also in state building and loan associations was provided by the creation of the Federal Savings and Loan Insurance Corporation in 1934. The function of this corporation is analogous to that of the Federal Deposit Insurance Corporation in the commercial banking field.

Further aid to home-owners was provided by the National Housing Administration under the control of an administrator with power to insure lending companies against losses which they might incur on loans to modernize buildings and to construct new farm and urban homes, apartments, and certain other buildings.

The chief agencies furnishing credit facilities for private building are federal home loan banks, the federal savings and loan associations, the Home Owners' Loan Corporation, and the Federal Housing Administration. Their principal activities may be briefly noted.

a. The federal home loan banks. The federal home loan banks are similar to the federal reserve banks. They are located in twelve districts, somewhat different from the federal reserve districts, are financed by stock subscriptions of member savings and loan institutions, and are under strict control of the Federal Home Loan Bank Board. These banks are authorized to borrow funds upon debentures or bonds guaranteed by the United States, and may lend to any member institution on the security of selected real-estate mortgages, obligations of the United States, or obligations guaranteed by the United States. Any savings and loan association, building and loan association, insurance company, co-operative mortgage bank, or savings bank may become a member bank of the federal home loan bank system by subscribing to stock of federal home loan banks and by meeting the requirements and regulations of the system.

The federal home loan banks are authorized to furnish credit facilities for home modernization and building through loans to member lending institutions on the security of real-estate mortgages. These banks can, of course, lend funds to loan institutions which co-operate with other aspects of the housing credit program.

b. Federal savings and loan associations. The federal savings and loan associations are mortgage-lending institutions incorporated by the federal government. They may be entirely new organizations, or they may be state building and loan associations converted into federal organizations with the consent of the state concerned. All federal savings and loan associations are required to be members of the federal home loan bank system. These associations have received capital stock subscriptions from the government, and have obtained other funds by sale of shares to savers and by borrowings from the home loan

banks. The associations are permitted to lend on first mortgages up to 80 per cent of the appraised value of homes and combinations of homes and business properties, in amounts not exceeding $20,000 for each borrower. However, with the insurance of most mortgages placed upon a more liberal basis by the Federal Housing Administration, lending upon insured mortgages allows a much broader extension of credit by such associations.

c. The Home Owners' Loan Corporation. The Home Owners' Loan Corporation was established as an emergency device to relieve home-mortgage difficulties. It was empowered to refinance home mortgages at low interest rates to home-owners in urgent need of funds to save their homes from foreclosure, and to make mortgage loans to home-owners for reconditioning of homes. The Corporation was directed not to make the loans unless the borrower was unable to borrow upon fair and reasonable terms from private lending institutions.

To finance the refinancing and extension of home mortgages, the Corporation received funds amounting to $200,000,000 in capital stock subscriptions from the federal government, and was also authorized to borrow up to $4,750,000,000 by bonds guaranteed as to principal and interest by the government. The lending operations of the Corporation were terminated in 1936 with more than $3,000,000,000 advanced to over a million home-owners. As might be expected, the majority of loans made by the Corporation were for refinancing mortgages. The Corporation often exchanged its bonds for the mortgages held against the home-owners, and in other cases paid off a portion of the mortgages in cash.

The Home Owners' Loan Corporation did succeed in bringing down interest rates to home-owners, and in extending maturity dates on mortgages. Since the Corporation was permitted to make loans for periods up to fifteen years, the loans made included amortization provisions by which it was hoped the borrowers might be able to pay them off. While it is generally agreed that by the time the Corporation is liquidated in 1951 the losses on its loans will be heavy, its service to the unhealthy mortgage situation existing in 1933 can hardly be overestimated. By exchanging its bonds for distressed real-estate mortgages, the Corporation helped a dangerous and unhealthy real-estate mortgage situation which was threatening a large part of the insurance and savings structure of the nation. The least one can say is that the lending operations of the Corporation have given borrowers a chance to repay far more of the mortgages than would have been possible in 1933, and have surely reduced the loss of capital and the human suffering which would otherwise have occurred.

d. The Federal Housing Administration. The Federal Housing Administration, created by legislation passed in 1934, encourages home modernization and construction through providing federal government guarantee of real-estate mortgages issued by private lending agencies to finance home repair and modernization and the building of new homes. The National Housing Act

has provided for two agencies to assist in this program. A Mutual Mortgage Insurance Fund has been established, with the aid of government funds, to make commitments for mortgage insurance, to collect fees for this insurance, to compensate lenders for mortgage losses, and to distribute excess premiums to borrowers on a mutual basis. The act also provided for the chartering of national mortgage associations with power to buy and sell real-estate first mortgages. These associations are privately owned and operated, but are subject to examination and control by the Federal Housing Administrator.

The loan-insurance program of the Federal Housing Administration covers two types of loans, those for repair and modernization, and those for new home-building. The Housing Administration may insure loans for modernizing existing structures up to $10,000. The interest rate is fixed by the Administrator. For the construction of small farm buildings or summer homes, loans up to $2500 may be insured. For residential construction, loans up to $2500 may be insured with only an initial down payment by the borrower of 5 per cent of the cost in cash or land. For residential loans to purchase homes costing $6000 or less, loans up to 90 per cent of the appraised value of the property may be insured. For homes costing more than $6000, loans for purchase may be insured up to 90 per cent of the first $6000 and 80 per cent of the balance up to $10,000.

As a condition for obtaining mortgage insurance, the Federal Housing Administration requires several prerequisites. Loans must be made at low interest rates, varying from maximums of 4½ to 5 per cent. Insurance premiums are fixed at ½ of 1 per cent upon unpaid principal. Maturity dates may be fixed from fifteen to twenty-five years. The Federal Housing Administration is given full discretion in determining whether a loan will be insured, and has the power to turn down applications if the structure does not meet building specifications of the Administration or if the loan does not appear to be economically sound.

The Federal Housing Administration has apparently managed the mortgage-loan business carefully and with restraint. All applications for loans are thoroughly examined, and a mortgage is not insured unless the building meets the rigorous construction requirements set up, unless the location of the residence is desirable, and unless the mortgagor withstands close credit examination. This conservative attitude has caused some criticism by those who would like to see more liberal loans, particularly to low-income persons. The requirements of the administration have also caused many borrowers to find that less restrictive and less costly terms can be had by borrowing from a loan association without mortgage insurance. The principal cause for alarm in the federal mortgage plan is in the high percentage of appraised value or cost which can be mortgaged. If real-estate values should fall materially, this small margin might prove to be inadequate. On the other hand, economic conditions and monetary policies since 1933 indicate that the course of price levels

may be upward, and that except for isolated instances the value of real estate would follow the trend of general prices.

The extent of housing insurance under the Federal Housing Administration is large. The administration had insured loans of more than three billion dollars by 1940, involving nearly three million borrowers.[1] This has not only stimulated the construction industry and the amount of home-ownership, but has also given the government a tremendous stake in the real estate of the nation.

4. AID THROUGH CREDIT FACILITIES: CONCLUSIONS. The government aids to business through extending credit are so broad that almost any business may be affected by them. Some businesses receive the benefits directly and others indirectly. Still others, such as the private lending institutions, find that they have a formidable competitor in the lending field. While the majority of government credit has been extended through private organizations, it is largely backed by the government itself. The part the government has played not only places it in a position of great possible liability but has made it the arbiter of the lending policies of the nation. With the exception of certain agricultural loans, loans to state and local governments for relief, and loans or investments by government agencies to other government agencies, the loan policy of the government, as administered to date, appears to be reasonably conservative. However, there is the danger that the public demand for credit upon easy terms will lead to progressively lower lending requirements and interest rates. If government guarantees of these credit facilities are continued, either by direct statement or by implication, too liberal lending terms will tend to cause a large subsidy element to arise in borrowing. If this should occur, the public would be harmed by being saddled with such subsidy and by encouragement given to uneconomic allocation of the nation's resources.

E. FINANCIAL AIDS — DIRECT SUBSIDIES

As has just been noted, governmental policies not designed to be subsidies may become so by the turn of events. Thus, guaranteeing of home loans may become a subsidy to home-owners if they are made upon an unsound basis or if conditions change and force the government to make good these guarantees. Other government policies which appear on the surface to represent merely loans or to be designed for regulation may in fact represent a program of subsidy to special groups. In the discussion in an earlier chapter, the many subsidy elements in agriculture were pointed out and their extent indicated. Of course, some parts of the government agricultural program are clearly subsidies, but since they have been noted elsewhere they need not be discussed here.

Direct subsidies have been given for business purposes on a number of occa-

[1] 6th *Ann. Rep., Federal Housing Administration* (1940), p. 31.

sions; the more important ones, however, have been granted in the field of transportation. Every kind of transportation agency has at some time received direct subsidies from federal or state governments. These subsidies have often been justifiable as necessary to develop a transportation system adequate for the needs of the nation. In some cases, the subsidies, especially those for inland waterways, have been of questionable economic justification and have followed from pork-barrel tactics of legislators representing local interests. Since the extent of these transportation subsidies has already been treated, we need only mention them here.[1]

F. SPECIAL ENABLING LAWS

Business has received almost indispensable aid from the government through the passage of special legislation which has allowed property rights to be pooled in advantageous organizational forms, which has given business and private individuals means of escaping the burden of crushing debt, and which has allowed business to protect intangible values from appropriation by others. The more important of such laws have been those providing for incorporation, adjustment of debt following failure, and protection of ideas involved in patents, copyrights, and trade-marks. All these laws enable businesses and individuals to do what they otherwise could not so easily accomplish, and, as such, represent valuable government assistance. To be sure, many regulatory measures of the government also assist business. The general laws protecting property have such an effect. The special allowance of resale price maintenance, the regulation of railroad and public-utility rates and service, and the enforcement of standards of fair and adequate competition help many businesses. But the primary purpose of these laws is regulation, while the dominant purpose of the legislation to be discussed in this section is assistance to business.

1. INCORPORATION LAWS. In a sense, all forms of business organization exist because the government tolerates them. The procedures, rights, and restrictions upon forms of business organization are often provided by legislation. But the corporation is a form of business which, in itself, has been created by legislation and which does not exist as a common-law right. As such, incorporation represents a privilege granted by the government through special enabling laws. As yet, in the United States, general incorporation laws are found only in state legislation, although the federal government has incorporated businesses for special purposes.

A corporation is an artificial or fictitious person created by the state for the purpose of owning and using property. Strictly speaking, it is the corporation that owns business property, contracts debts, and makes agreements for sales, purchases, and other matters. The stockholders own the corporation and

[1] See *supra*, pp. 204–08, 227–28, 238n., 245–49, 270–71.

elect directors who supposedly are responsible for the conduct of the business. The corporate form implies, and legislation has granted to the corporation, certain characteristics which business men find to be advantageous. In the first place, ownership of property and the making of contracts in the name of the corporation make possible a continuity and permanence not possible with natural persons, since corporations do not die and need only come to an end when they are dissolved by stockholders or the government. A second advantage is that stockholders are not liable for the debts of the corporation and cannot lose more than the value of their investment (in some cases other possible liabilities exist, but they are relatively unimportant). A third feature advantageous to the stockholders is that shares of stock can ordinarily be transferred freely without affecting the stability of the corporate form. Furthermore, as the corporation has developed, the stockholding owners delegate managerial functions to a board of directors which in turn selects the management, thereby making it possible for the stockholder to become an owner without assuming the responsibilities of management. These features of the corporation make it advantageous for long-term business operations, and also conduce to obtaining large funds of capital through the appeal of the organizational features to investors.

a. State incorporation laws. Every state has enacted a general incorporation law. While these laws differ in details, all follow the same general procedure in allowing natural persons to create a corporation. Three or more natural persons make application to a state official, often the Secretary of State, setting forth in detail certain information about the corporation which they intend to form: the corporate name, location of principal office, purpose of the corporation, capitalization, original stockholders, life of the corporation, and rights and obligations of stockholders. The information is drawn up with regard for the state law and what it allows corporations to do. When the application has been filed, fees paid, and other legal requirements met, the state official customarily approves the application automatically. It then becomes a charter by which the state contracts for the creation of a corporation. There is generally no examination of the character of the incorporators, and the sole ground upon which the charter is issued is whether the application forms comply with the law and the fees are paid.

The amount of information required from incorporators differs as between states, as does the width of power granted to corporations. Since the charter is a contract, the corporation has only the power to do that which the charter confers on it. But most state laws permit such wide powers that a business corporation can ordinarily enter any kind of business, except illegal businesses, and other businesses, such as banking, in which special incorporation procedure is required. As a matter of fact, most states grant such broad powers to corporations, and place so few restrictions upon incorporators, directors, and stockholders, that the choice between states is often made on the basis of taxa-

tion or mere convenience. Some few states are far more restrictive than others, limiting the privilege of owning stock in other corporations, forbidding the issuance of non-voting stock, limiting the power of directors in acting on matters without specific stockholder approval, or forbidding certain questionable financial practices. The real difference in the laws of the great majority of states lies in taxation. Thus, Arizona levies a tax and filing fee of only $60 for any size of corporation, Delaware would charge a $100,000,000 corporation approximately $2700, and Connecticut would levy a charge of $100,000.[1] Annual franchise taxes for such a corporation would be zero in Indiana, about $2500 in Delaware, and $500,000 in Pennsylvania, if all the capital of the corporation were used in that state.

The broad powers granted to corporations, and the few restrictions placed by most states upon those who obtain the privilege of incorporation, have arisen from a competition between the states to encourage incorporations within a state and obtain revenue from them. The very fact that the element of taxation, in the absence of the convenience or necessity of being incorporated in the state where most of the business is done, plays the dominant part in the selection of a state for incorporation is a striking commentary upon state incorporation laws themselves. The states have engaged in an almost unwholesome competition in giving to private individuals an important public privilege.

b. Abuses of the corporation. The lack of control by states over those who would set up a corporation, both at the time of incorporation and following it, has contributed to the development of many abuses of the corporate form. Stockholders may be effectively disenfranchised by the shifting of voting power to a small block of stock held by promoters or insiders. Earnings may be shunted to insiders by unreasonable bonus schemes. Control by directors over corporate policy has made it possible for them to shift funds or make investments to the profit of themselves rather than the corporation. Corporate information has been withheld from outside stockholders while the insiders have used it to their own profit. Finances have been manipulated to give false impressions of adversity or prosperity in order to suit the taste and desires of insiders for profits. Directors have been known to sell property in which they have an interest at terms highly profitable to themselves and unprofitable to the corporation. Many other practices detrimental to corporation investors and to the public interest in the corporation could be mentioned.[2]

The problem of abuse of the corporate privilege has been intensified by the growth of the large corporation, with its separation of ownership and control. Many corporations have thousands of stockholders, most of whom hold relatively few shares. These stockholders are generally unknown to each other

[1] These are based upon 1938 tax rates and are taken from Guthmann, H. G., and Dougall, H. E., *Corporate Financial Policy* (New York: Prentice-Hall, Inc., 1940), pp. 52–55.

[2] See, for example, the discussion in Lyons, L. S., Abramson, V., and others, *op. cit.*, pp. 58–73, and cases and authorities there cited.

and are scattered over the entire nation and many parts of the world. They have a right to vote at stockholders' meetings, to select directors, and to approve certain corporation policies. But the ordinary small stockholder has neither the time, money, nor inclination to attend meetings in faraway cities. The result is that in the large corporations, the stockholder either does not vote or assigns his power to vote to others by a proxy. Since the management of a corporation sends out notices for stockholders' meetings, it is in the position to accompany these notices with proxy forms which give the stockholder's vote to the inside group. If the stockholder assigns his vote, he almost invariably grants it to the management by returning the proxy form (for which no postage is required). In this way, the management group ordinarily has little difficulty in controlling the meeting and in perpetuating itself.

Through the diffusion of ownership in the corporation and the inability of scattered dissenting stockholders to organize, even if they are well enough informed to dissent, the management of the typical large corporation is not under a very serious restraint from the owners, the stockholders. While many of the large corporations, such as the American Telephone and Telegraph Company with its approximately 650,000 stockholders, are clearly in the control of the management, this fact has not led in many cases to abuse. Many managements have an exceptional sense of public duty and interest in the genuine welfare of the stockholders. But the divorce of ownership and control opens the way for abuse of the management of the corporation. When taken in connection with the lax controls of states over the corporations they have created, the resulting freedom has been disturbing to many, and has led to new legislation since 1933, and to demands for additional regulations.

c. Corporate reform. The abuses presented above have been somewhat guarded against by the federal securities and exchange regulations, discussed in a previous chapter.[1] If a business sells new securities in interstate commerce or has securities listed on a national securities exchange, the requirements of full disclosure and the regulations involved place an important restriction upon the abuse of corporate power. Other regulations, such as the detailed control over public-utility holding companies, have materially limited the freedom of unscrupulous individuals in their abuse of the corporate device.

The states, however, have made little attempt to rewrite incorporation laws to provide for elimination of abuses. Since the corporations exist by permission of the state, the power to regulate those established by it appears to be ample. A few states have revised their incorporation laws in the direction of more strictness, but these efforts have been inadequate and are doomed to failure. The competition of states for incorporation business and the relative ease by which a corporation from one state does business in another, as well as the practical difficulties in getting uniform state action on any law, do not presage successful treatment of the problem by the states.

[1] See *supra*, pp. 561–91.

If the problem is to be solved at all, the federal government seems to be the logical agency to do it. Suggestions have been made and bills introduced into Congress providing for federal incorporation or federal licensing of corporations. Although the federal laws could probably reach only those corporations engaged in or affecting interstate commerce, the breadth of interstate commerce arising from recent interpretations of the courts would appear to make it possible for the federal government to reach most business corporations. The more practical plan would seem to be the licensing of corporations, closing the channels of interstate commerce to those businesses which refuse to take a federal license. This measure would avoid the problem of usurpation of state incorporation privileges and the political importance of incorporation taxes to the states. The conditions for licensing could be made broad and strict enough to allow the federal government to make corporation regulation uniform and effective. These regulations should be wisely drawn so as not to impair the effectiveness of the corporation as a social instrument for efficient business operation; but the power to incorporate is a valuable social privilege, and society should make sure that it is used to achieve valuable social objectives.

2. Bankruptcy Procedures. The government has contributed to orderly and efficient business operation by the enactment of legislation and the establishment of judicial process allowing businesses to be released from debt burdens which they no longer can support, or to adjust debt claims so that they may be continued as producing social mechanisms. This orderly liquidation or readjustment of property rights has been provided for by bankruptcy and reorganization laws and procedures. Although these have sometimes been used to allow incompetent or even unscrupulous individuals to escape their obligations, it is nevertheless in the social interest that the burden of insupportable debt be economically and systematically adjusted. A business unable to meet its obligations tends to impair the proper functioning of other businesses. If creditors were simply allowed to sue according to their common-law rights, the result would be delay and confusion in the number of suits, with advantages in obtaining satisfaction of claims lying with creditors who make the first suits. Moreover, if businesses had always to be liquidated upon their inability to meet claims when due, many economic units would be forced to withdraw resources from production and capital would be lost in the process. As a general rule, if an economic organization can be kept as a going concern, the capital sunk in the enterprise can be made to produce far more effectively than if it must be liquidated.

The purpose of bankruptcy and reorganization procedures is to provide for the orderly adjustment of debt in a situation where the debtor is incapable of meeting his obligations. The procedures should allow creditors fair and reasonable protection of their claims, and should enable them to obtain the greatest possible satisfaction of these claims in the salvaging process. These pro-

cedures should be designed for expediting the process of readjustment and for conserving the economic resources of society.

a. Bankruptcy procedures. Bankruptcy procedures derive from long accepted judicial practice, as well as from specific enabling legislation. Both the liquidation and the reorganization of financially embarrassed businesses may be handled by resort to courts of equity. Under this procedure, a judge of a court of equity, upon request of a creditor or the company, may appoint a receiver to manage the business for the court. The judge does not ordinarily appoint the receiver, unless he is convinced that the company is insolvent or in danger of being unable to pay its debts, and unless he believes that an appointment is necessary to preserve the property rights in the interests of all creditors. An equity receivership does not generally arise unless there are many creditors, for otherwise one or two creditors could simply sue for their claim and attach such property as necessary for their satisfaction. But where there are many creditors, as is likely to be the case in the modern business corporation, allowing damage suits to be filed would make it possible for some creditors, those who sue first, to receive full compensation of their claim and other creditors to receive nothing.

The receiver in equity simply acts to conserve the assets of the business until the court is ready to make a judicial sale of the property to satisfy the claims of the creditors. In most business receiverships involving large businesses, the receivership period is used to obtain an agreement between creditors as to the proper share of their claims and to allow for the setting up of a new corporation to take over the assets of the defaulted business. When the judicial sale is made, the assets are sold to a creditor or stockholder group, which turns them over to a new corporation. The business is continued as a going concern and claims are adjusted to satisfy creditors and owners and to enable the new corporation to fulfill its obligations. This process is referred to as reorganization. In some cases the receiver may realize that the business cannot be reorganized. He then liquidates the assets and the court distributes the proceeds to creditors according to the priority and size of their claims. Since liquidation usually involves sacrifices of the assets far below their book values, creditors are generally quite willing to assume a reduction in their claims if the business can be reorganized and continued.

The equity procedure has been modified and supplemented by state and federal legislation. Until 1898, except for laws with temporary effect passed on several occasions during the preceding century, the several states dominated the field of bankruptcy legislation. The federal government was given a specific constitutional grant of power to enact bankruptcy legislation, but such laws as were passed between 1800 and 1898 were either repealed or became ineffective. In 1898 a permanent federal bankruptcy law was passed, and since 1933 the scope of such laws has increased until they supersede the state laws in importance for the treatment of business failure.

There have been several reasons for superseding equity procedures with bankruptcy legislation. The procedure under equity was advantageously flexible, but in many cases this very flexibility led to abuses. Receivers and bankers and lawyers on reorganization committees sometimes took excessive expenses and fees from the bankrupt companies. Occasionally, one group of creditors was able to take unfair advantage of another. Reorganizations were often held up for long periods of time by the power of dissenting creditors to hold out from the plan in the hope of getting a larger share of the proceeds than by accepting reorganization plans. In other cases, the price set for judicial sale was so low as to squeeze out junior creditors and stockholders who had real property rights in the failed company. Difficulties also arose from equity receiverships because of the conflict of jurisdiction between state and federal courts and between federal courts in different districts. Businesses with properties in many localities often faced the complex task of obtaining reorganization through parallel bankruptcy proceedings going on in several judicial districts. Not only did this conflict retard the completion of reorganization, but it increased the expense.

The reasons for having federal laws for bankruptcy rather than state laws are also clear. With businesses operating in several states, the problem of jurisdiction impedes reorganization. Moreover, the courts have held that state bankruptcy laws could not discharge a debtor in one state from his full obligation to a creditor in another state, so that complete bankruptcy proceedings were necessary in every state in which a company did business or had creditors.

For purposes of analysis here, it will be sufficient to note the more important provisions of federal bankruptcy legislation. This legislation has provided for a general bankruptcy law and for laws which enact special procedures for certain types of businesses.

b. General business bankruptcy legislation. The general business bankruptcy law enacted in 1898, and revised in some minor details since that time, defines the procedure and the rights of claimants in case of bankruptcy, but does not work very material changes in previous equity procedure. Petitions for bankruptcy [1] must show that the debtor owes at least $1000, is insolvent, and has committed an "act" of bankruptcy within four months prior to the filing of a petition. These acts include the following: (1) concealing or transferring property with intent to defraud creditors; (2) transferring property to give preference to certain creditors; (3) allowing creditors to obtain liens on property through judicial proceedings without vacating or discharging these liens within thirty days; (4) making a general assignment of property for the benefit of creditors; (5) permitting the appointment of a receiver or trustee while insolvent or un-

[1] Voluntary petitions result when the debtor asks to be adjudged a bankrupt, and involuntary proceedings follow when petitions are filed by three creditors having claims in excess of $500. Voluntary and involuntary procedures are so similar that the distinction need not be noted here.

able to pay debts; or (6) admitting inability to pay debts and willingness to be declared a bankrupt.

With the filing of a petition, the court usually appoints a receiver in bankruptcy to take over the bankrupt's property, and when the debtor is adjudged a bankrupt, a trustee in bankruptcy is appointed to liquidate the business. The trustee may be a member of the management or he may be a disinterested person, but he is charged with full responsibility for settling claims and expenses of the bankruptcy, subject to approval by the court. The general bankruptcy law provides for priority of payment of proceeds, with expenses of bankruptcy, wages, taxes, secured obligations, and claims of general creditors following in that order. Unless the court finds evidence of fraud or concealment in the proceedings, the debtor may be discharged within a short time following the acceptance of the petition, even if the estate is not completely liquidated. The discharge from bankruptcy relieves the debtor of all claims against him except claims for taxes, willful or malicious injuries to persons, fraudulent obtaining of property, or wages due employees for work performed within three months of the filing of the bankruptcy proceeding.

c. Special bankruptcy procedures for railroads, moneyed corporations, and farmers. Federal laws have provided for special bankruptcy and reorganization procedures for interstate railroads, but since these have been discussed previously, they need only be noted here.[1] A bank or insurance company may not be liquidated or reorganized under general bankruptcy or reorganization laws. To protect the investing public, states and the federal government require that liquidation or reorganization of moneyed corporations be under the supervision of the government agency empowered to regulate them. Moreover, where a bank has its deposits guaranteed by the Federal Deposit Insurance Corporation, that agency naturally participates and exerts much control over the bankruptcy process.[2]

Special bankruptcy procedures also apply to farmers who are unable to pay agricultural mortgages. After an earlier mortgage relief law was declared unconstitutional as a deprivation of the creditor's property,[3] Congress passed a farm mortgage relief law in 1934 which has been upheld by the United States Supreme Court.[4] In this law, Congress provided that a farmer unable to pay his mortgage could be adjudged a bankrupt in the federal courts and that the court could stay legal proceedings for three years. At any time during this period, the court could order that the property be appraised, allowing the farmer to obtain clear title to it by paying the appraised value. During the period when the foreclosure proceedings might be stayed, the farmer is obligated to pay fair rental to the mortgage holder. Protection to the creditor is further furnished by the provision that he can insist upon the sale of the mort-

[1] See *supra*, pp. 187–92. [2] See *supra*, pp. 530–33.

[3] *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).

[4] *Wright v. Mountain Trust Bank*, 300 U.S. 440 (1937).

gaged farm at auction, although the law gives the dispossessed farmer the privilege for ninety days to regain ownership by paying the auction price and 5 per cent interest.

d. Special general business corporation procedures. Section 77B, passed as an amendment to the bankruptcy law in 1934, and amendment by the Chandler Act of 1938 have established a special bankruptcy procedure for general business corporations. While business corporations can still have their insolvency difficulties resolved by resort to equity receiverships, the advantages of the new procedure have been such as to encourage businesses to use it. The new special bankruptcy legislation attempts to remove the stigma from bankruptcy, to provide simpler and less expensive procedures, and to provide methods designed to aid in the sound reconstruction of a corporation.

Either voluntary or involuntary proceedings may be initiated under the new law. Upon the approval of a bankruptcy petition, the judge must appoint one or more disinterested trustees in cases where the debtor's indebtedness amounts to $250,000 or more. In the case of smaller indebtedness, he may appoint disinterested trustees, or he may appoint the existing management or others interested in the property. The requirement of disinterested trustees for the larger corporations has been introduced to remove from the control of a bankrupt corporation those who managed it before the insolvency. Of course, if the disinterested trustee desires, he may continue the old management in office for purposes of operating the property.

The provisions of the new law contemplate that generally insolvency will be followed by reorganization; several are aimed at assisting in obtaining a fair and reasonable reorganization. Either the debtor or the trustee is required to compile information as to assets, liabilities, financial position and conduct of the corporation, names of stockholders and creditors, and other pertinent information. This information is filed with the court of jurisdiction and is ordinarily sent to stockholders, bond trustees, creditors, and any other persons designated by the judge.

The trustee is charged with the formulation of a reorganization plan within a time fixed by the court and with the assistance of suggestions by interested parties. Hearings are held on the plan, at which all parties interested may offer suggestions or modifications. If the judge believes a plan to be worthy of consideration, he must submit it to the Securities and Exchange Commission for an advisory report if the corporation has indebtedness in excess of $3,000,000; in other cases, he may or may not submit the plan to the Commission, as he wishes. After an advisory report from the Commission, which is not binding upon the judge, any plan deemed by him to be equitable, fair, and feasible may be submitted to the creditors and stockholders included within the plan. If two thirds in amount of the classes of security-holders included within the plan approve of it, the court may make it effective.

The law lays down numerous provisions which must be included in a reor-

ganization plan. These are partly of a definite regulatory character and partly to protect non-assenting security-holders. The regulatory features insist upon provisions in the new corporate organization for equitable selection of officers and directors compatible with the interests of security-holders and the public, equitable distribution of voting power and prohibition of issuance of non-voting stock, fair distribution of rights and privileges of classes of security-holders, and provisions for periodical issuance of financial statements for companies with an indebtedness of $250,000 or more. The protective features required are the fair and reasonable treatment of dissenting creditors and the just protection of claims of stockholders who are left out of a reorganization plan.

The new law also provides for safeguards against abuses by protective committees and others soliciting proxies or deposits of securities. These provisions are designed to prevent exploitation of the bankrupt corporation's estate by persons who make it a business of interfering in reorganizations and attempting to obtain high fees for services of questionable worth. The law also attempts to stop misrepresentation by interested parties in getting creditors and stockholders to assent to reorganization plans.

e. Bankruptcy proceedings: conclusions. The newer bankruptcy laws represent a curious mixture of government aids and regulation of business. Businesses are assisted by the attempts of government to expedite bankruptcy and reorganization proceedings through forcing early settlement of claims. They receive benefits from the implications of the laws which allow operations to continue without interference. Even where disinterested trustees are appointed, the business generally continues under the same management, and trustees concern themselves only with matters of broad general policy. On the other hand, if a business elects to proceed under the special laws instead of equity receivership, it places itself in the position of having to meet certain financial regulations of the government. However, because the new bankruptcy laws generally give the stockholding group the better chances of participating in a reorganization plan, as well as because of the advantages of expedited reorganization, businesses have taken advantage of it with increasing frequency.

The new bankruptcy laws bring in certain principles which are somewhat foreign to earlier procedures. The jamming through of a reorganization proceeding over numerous dissents is such a departure. The regulatory features are also somewhat new. Furthermore, with the provisions of the law and the way it has been operating, stockholders of corporations have received somewhat greater attention in reorganization than was the case under prior laws. Whether these departures will bring about sounder and speedier reorganizations is difficult yet to tell. If they should — and it is to be expected that they might — the saving of capital from ruin in insolvency will give these laws an eminent social justification.

3. PATENTS. One of the most valuable of government aids to business is the

grant of a temporary monopoly to persons who invent devices. The federal government has allowed inventors to have the exclusive right to their invention since the first general patent law was passed in 1790. This law was based upon the definite power granted to Congress by the Constitution to secure "for limited times to authors and inventors the exclusive right to their respective writings and discoveries." From time to time since 1790, the federal patent law has been revised, but the general principles of granting patents to any person who could prove an invention and the general outline of patent procedure remain essentially the same. The rights of patent-holders have, of course, undergone modification with legislative amendment and judicial interpretation, and the many problems of patents have undergone some changes.

a. Patent requirements. With the single exception of persons employed by the United States Patent Office of the Department of Commerce, any person who has made an original and patentable discovery may apply for a patent. The patent law defines as patentable the invention or discovery of any useful art, manufacture, engine, machine, composition of matter, ornamental design, or botanical plant. Most of these patentable things are self-explanatory, but a few may need some elaboration. A "manufacture" includes those things made by machine or by hand which do not fall within the other classes, and may be illustrated by a special-type glass container or a fastener. A "composition of matter" includes medicines, dyes, plastics, and similar things. The scope of patentable things is so broad that almost any idea which can be put into tangible form [1] can be patented. In addition to the general character of articles which may be patented, the law insists that they be novel and useful.

The requirement of novelty in a patent may be easily illustrated. Articles which have been publicly used may not later be patented. Even if the person applying for the patent were the actual inventor of the device, public sale or use for a period of two years prior to application estops him from obtaining a patent. If an article has been patented in some foreign country, or even is described in a publication in a foreign country, before the date a domestic inventor discovered it, or two years before a patent application, the domestic inventor may not claim patent rights. To be novel, the thing must be something which shows some originality or ingenuity. If a method or device is commonly known or is something which any person skilled in a trade might know about and use, the article is not patentable. However, a novel application of an old idea or a novel modification of a thing already in existence may be patentable. Thus, dress fasteners of various kinds may already be known, but a novel kind of dress fastener may be patentable.

From a social point of view the element of usefulness is important. The social justification of granting patent monopoly privileges is that the invention

[1] Even a design must be expressed in a tangible object. Thus, a dress design or a silverware design is patented, but it must be expressed in the dress or the silverware. However, the thing which is actually patented is the design, and not the object.

will benefit society, and that a temporary monopoly is the compensation an individual receives for making the invention or discovery. A patent would not be issued for a thing which would be clearly detrimental to public morals, health, safety, or welfare. To be useful, a patent must be something which will work or operate, although there is no restriction upon the extent of usefulness, and things of slight use may be patented.

The importance of usefulness in invention carries over into procedure in obtaining a patent. The patent application must completely and adequately describe the invention, so that, at the end of the patent period, information as to the device or article may be readily obtained. This provision insures that after the period of exclusive rights, the public may receive the full benefits of the patent.

b. Patent procedure. The patent law establishes the definite procedure by which patents may be obtained. As might be expected, this procedure is somewhat detailed and complicated and few persons can safely obtain patents without hiring an expert patent lawyer. In applying for a patent, the inventor must file (1) a *petition* giving his name, address, and title of invention; (2) a *specification* describing in detail the exact claims which he makes for his invention; and (3) a *drawing, model,* or *other device* for picturing the exact nature of the invention. Models were required on all patent applications until 1870, but since then they have seldom been demanded.

Applications are then turned over to an examiner of the United States Patent Office. The examiner checks over all the application papers, attempts to check with all previous patents or publications to determine whether the invention is really novel, and looks over the claims made by the inventor to discover whether they are accurate. Since the allowed claims become the real basis for patent rights in most cases, the accuracy of the claims as to what an invention will do is important. Where two or more inventors claim rights to patent the same invention, or where an inventor applies for a patent quite similar to one already issued, an interference action is held. In this action, the examiners of the Patent Office hear the opposing cases and determine the question of priority. Conflicts between inventors can be appealed to the Board of Appeals of the Patent Office, made up of a group of higher officials of the office, and from there to the Court of Customs and Patent Appeals and to the federal courts.

When the application has been thoroughly checked and interference proceedings adjudicated, the Patent Office issues "letters patent" to the inventor. But, because the examination and interference proceedings may take some time, protection of the applicant's rights is provided by the fact that his application gives him priority. During the period a patent is pending, the applicant technically has no patent rights. But since his application serves to warn others of his prior claim to the patent, a notice of "patent applied for" has many of the effects of the patent itself. Moreover, during the period of pend-

ency the inventor may ask to amend his specification of claims, and thereby extend the scope of the patent to fit new devices which have appeared on the market.

The granting of a patent secures, under present law, to the inventor exclusive rights for a period of seventeen years, except in the case of design patents, in which the period ranges from three and one half to fourteen years. By means of various devices, however, the actual period of patent monopoly may be extended, although it takes an act of Congress to extend the basic patent monopoly beyond the stated seventeen-year period. The monopoly period does not begin until the patent is issued, and since patents may be pending for a number of years in which the monopoly is practically effective, the total monopoly period may be much longer than seventeen years. By resort to amendment of patent claims by the inventor and protracted litigation, the period of pendency may be very long. A patent may also be used publicly for two years before the inventor even need make an application. Moreover, where a device depends upon the combination of several patents, by spacing the application or issue of these patents, or by superimposing new and essential patents upon old patents, the period of actual patent monopoly may be extended for a long period of time.

An interesting procedure developed by the Patent Office in 1931 is aimed to give special attention to certain patents. Where the inventor claims that issuance of a patent will induce immediate investment of capital and employment of labor in its commercialization, the office, after investigation, will accord the application a special status and expedite the issuance. To obtain this privilege, the inventor must agree to manufacture the article immediately upon issuance and prove that he has sufficient capital to manufacture in quantity.[1]

c. The volume of patents. One of the interesting features of the United States patent system has been the acceleration in patent application and issuance over the years. From approximately 1000 patents issued per year in 1840, the annual number increased to over 55,000 in 1932, and patent applications amounted to almost 95,000 in 1929.[2] In all, more than 2,000,000 patents have been issued, nearly half of these in the last two decades.

d. Rights of patent-holders. Patent-holders have the exclusive right to the use of their invention during the period of effectiveness. This includes the right for the holder to use it himself, or to license others to use it, or not to use it at all, or to assign full rights for use to other persons. The patent is a property right, and as such can be used in the same way as can any other property right. While corporations cannot apply for patents or have them issued to them, they may have patents assigned to them by inventors immediately upon issuance.

Use of the patent by others without permission of the patent-holder subjects

[1] See testimony of Patent Commissioner C. P. Coe in *Investigation of Concentration of Economic Power*, pt. 3, pp. 858–59 (1939).

[2] *Investigation of Concentration of Economic Power*, pt. 3, pp. 843–45, 1123 (1939).

the user to liability for infringement of the property right. To establish the liability, however, the patent-holder must have marked the patented articles properly and the patent must be valid in every respect. Even though a patent is issued by the Patent Office, it may not be valid, and a person accused of infringement has the right to contest the validity of the patent in the courts. An interesting example of escape from liability for infringement is represented by the famous defense of the Ford Motor Company from a suit for infringement of the so-called Selden patents.[1] These were issued to cover the idea of an automobile as a unit, and for a time were used to require all automobile manufacturers to be licensed by Selden interests and pay royalties for production of automobiles. On appeal to the courts, the Ford Motor Company effectively broke the Selden monopoly by having it restricted to an automobile of a particular design.

The damages which may be claimed for infringement are greater than those which can be obtained under most property-appropriation suits. The patent-holder may claim damages for losses he has suffered as well as profits made by the infringer in the use of the patent. Or a court may enter judgment for damages, in excess of those suffered by the patent-holder and allowed by a jury, up to three times the verdict.

e. Criticisms and proposed reforms of patent laws. The operation of the patent laws has indubitably aided the development of efficiency and progress in American industry. But the laws have not operated without serious criticism.[2] The chief criticisms which have been advanced involve the questions of volume and social merit of patents, of long monopoly periods, of cost and delay in obtaining patents, of suppression of patents, and of patent concentration. Problems which have arisen from patent pooling have already been discussed in connection with the operation of the anti-trust laws.[3]

Most authorities seem to be agreed that a large percentage of patents are issued which have little or no social value and which represent improvements in trifling details that should not be regarded as inventions. There are several causes for the low standard of invention. The Patent Office has neither the staff nor the funds to examine all patent applications and to make a technical judgment of the worth of an invention. Even where the office has refused patents on account of lack of novelty or social value, the courts have occasionally overruled the office. Patent attorneys sometimes encourage the patenting of useless inventions in order to obtain revenue. But even well-meaning attorneys can exercise only a limited restraint upon poor patents, because of the natural enthusiasm of the inventor and his suspicion that a frank attorney is

[1] See *Investigation of Concentration of Economic Power*, pt. 2, pp. 268–71 (1939).

[2] For an interesting discussion of the United States patent system, see the testimony of numerous experts in the hearings before the Temporary National Economic Committee (the Monopoly Inquiry), printed in *Investigation of Concentration of Economic Power*, pts. 2 and 3, pp. 253–1159 (1939).

[3] See *supra*, pp. 456–59.

attempting to "steal" his invention. Moreover, the proper standard of quality for a patentable invention can hardly be defined. If the determination is left to administrative discretion without the right of an inventor to appeal his case to the courts, there may be danger of abuse or error in the administrative judgment. This problem presents such difficulty that probably all a law can do is to set up in unequivocal terms the necessity for patents to possess a positive degree of social utility. Frivolous or inconsequential inventions might be refused the patent right by definite legislation. Such a change in legislation would not necessarily solve the problem, because it would still leave the definition of certain terms to the discretion of administrative and court officials. However, if the new legislative standards were accompanied by appropriations to increase the investigatory work by the Patent Office, they might serve to warn these officials of the proper standards which should apply. As the law has developed, the standard has become one of social disutility, and if an invention promises not to work harm, it will be allowed irrespective of any positive advantages.

Another prominent criticism of the patent laws is the long monopoly periods which are sometimes enjoyed. Examples have been found of monopolies extending far beyond the statutory seventeen years. Because of the possibility of pending applications and other devices, patent-holders have been known to extend such rights for long periods. One patent monopoly extended for forty-four years, the seventeen-year term following upon twenty-seven years of litigation.[1] Pendency of application for five to ten years preceding issuance of patent is not unusual, with such delays more likely to be encountered in the case of patents of high social value, because of the conflict of interests and the desire of the applicant to extend the monopoly.

Since these long periods of monopoly withhold from society the free use of many important discoveries for times not necessary to encourage invention, measures for reform have been urged. A part of the difficulty lies in the inability of the Patent Office to expedite all patents. Some reform has already been introduced by the special-case practice, but more speed could be accomplished by increased appropriations for the office. Some of the difficulty lies in the slowness of the interference process [2] and of the courts. To shorten the time for these proceedings, it has been suggested that the process be modified so that an examiner may grant the patent without appeal. Then, if further proceedings are necessary, they may take the form of suits for infringement and thus the time for litigation will come out of the patent period.

The expense and delay of obtaining patents have been criticized as making it difficult for the small inventor of limited means to obtain benefits under the

[1] *Investigation of Concentration of Economic Power*, pt. 3, pp. 853–55, 1132–37 (1939). Data concerning other instances are found in this investigation.

[2] The interference process is the method of allowing holders of previous patents to contest the validity of a new patent.

patent laws. One small company spent around $300,000 over a period of twelve years to defend a patent application in interference proceedings.[1] The cost of patent lawyers, expert witnesses, and accountants is often too great for an individual inventor to press a case, and even small companies have difficulties. The seriousness of this evil would tend to be reduced if means were found to reduce the period of pendency of patent applications. A single court for patent-appeal suits has also been suggested. If such a court could be made up of lawyers trained in patent technicalities and could have competent assistants, the time and expense of litigating patent questions might be reduced. Litigation might also be reduced by proper publication of all patent applications and by more thorough search of existing patents and knowledge by the Patent Office. Furthermore, the Patent Office or a special patent commission might be empowered to intervene in proceedings involving the litigation of a patent, and aid in the furnishing of expert assistance and advice to inventors without funds to prosecute a worthy case.

The suppression of patents by groups interested in keeping them off the market has been subject to criticism. Many patents are purchased to exclude other persons from developing a product which might compete with an existing good. Patents are also suppressed to keep existing machinery or processes in which a company has a large investment from becoming obsolete. This suppression is made possible by the legal right of a patent-holder to use or not to use a patent, as he sees fit. Some suppression of patents may be socially desirable in order to reduce capital losses and labor displacement from too rapid technological changes, but this retardation of progress can be dangerous in private hands. Some withholding of patents may be desirable to allow a group of producers to build up acceptable standards in a new industry.[2] Suppression of patents which have military significance may also be justifiable in the interests of national defense.

To meet the danger to social progress through undue suppression of patents, various proposals for compulsory licensing have been made. The most usual proposal is to require issuance of a license under a patent if it has not been used by the holder for a certain period of time. Proposals for compulsory licensing raise many questions. In view of the constitutional grant of power to Congress to give "exclusive rights" to inventors, compulsory licensing might not be constitutional. Moreover, it might interfere with the development of an invention. Many inventions must be used in connection with others, and the development of a good employing several patents may require extended research along several lines. Compulsory licensing has also been opposed by many licensing companies on the ground that if they were forced to license competitors at a reasonable fee, they might actually be forced out of business

[1] *Investigation of Concentration of Economic Power*, pt. 3, pp. 940–45 (1939).

[2] This reason has been advanced for withholding some television patents. See *ibid.*, p. 1001.

by the stronger and larger licensee. Compulsory licensing has hence been criticized as tending to remove some of the incentive for invention.

A further important criticism of the American patent system is found in the contention that patents tend to be concentrated in few hands and to promote monopoly. Since so many patents are assigned to corporations and this practice has been growing,[1] many people are led to believe that patents are becoming concentrated in too few hands. The sheer number of patents held by individual corporations does not necessarily show the importance of the patents held, and the fact remains that the increase in patents assigned to corporations is not yet very alarming. Most of the corporations holding patents are small ones, a perfectly understandable phenomenon in view of the risk of patent development. The majority of unexpired patents are also held by small corporations. Moreover, the existence of many cross-licensing agreements have made patents widely available. In a few cases, however, such as in the glass-container industry,[2] patents for the same general product are highly concentrated.

To meet the possible threat of concentration, it has been proposed to limit the number of patents which any person may hold. This proposal seems to be arbitrary and rather unnecessary. For one thing, the problem of patent concentration does not seem to be very great, and using patents in combination for purposes of monopolizing trade might better be dealt with through the anti-trust laws. Consideration should also be given to the economic necessity of the development of patents by corporations and large businesses. Patent development is not only risky, but often requires much research and the expenditure of large sums of money. Individual inventors and small companies cannot always furnish these facilities. Efficient development of patents is almost sure to result in some concentration of them. But until this concentration appears to be abused more than it has at the present, or until the government is unable to deal with abuses through the anti-trust laws, modification of the patent laws to prevent concentration does not seem to be desirable.

4. COPYRIGHTS. The federal Constitution also gives Congress the power to grant authors exclusive rights to their work for a limited period of years. To secure these rights for authors, Congress has enacted copyright laws since 1890. Copyright legislation does not have as much business significance as do patent laws, except, of course, in the case of the publishing business. Hence, it will be necessary here only to note the main provisions of copyright laws and a few of the problems involved.

a. Principal provisions of copyright laws. The copyright laws allow the registration of productions of many more individuals than those usually thought of as authors. Thus, the law provides that any of the following may be copy-

[1] In 1921, approximately 27 per cent of issued patents went to both small and large corporations, while in 1938 over 57 per cent went to them. See *Investigation of Concentration of Economic Power*, p. 1127 (1939).

[2] *Ibid.*, pt. 2, pp. 380–83.

righted: books, periodicals, newspapers, lectures, sermons, public speeches, dramatic compositions, musical compositions, works of art, maps, drawings, photographs, including moving pictures, and other kinds of pictorial works. While any of these articles may be copyrighted, not every expression of an idea included in them may be protected. The expression must represent some artistic or intellectual work. Moreover, the copyright only covers the particular expression of the idea and not the idea itself. The copyright-holder obtains no proprietary interest in the idea, as in the case of patent-holders, and can only claim infringement if the expression itself is copied. In the case of such writings as newspapers, the newspaper cannot copyright the news itself, although it can copyright a way of expressing the news which has artistic merit. And a photographer cannot copyright the subject of his photograph, but can merely be protected against others' copying the photograph itself.

Applications for copyright are made to the Copyright Office, connected with the Library of Congress. For published works, notice of copyright must be included in the work and two copies of the work must be forwarded to the Copyright Office. For unpublished works, copies or photographs, or portions of a motion picture, must be submitted. A small fee must accompany applications, and the Copyright Office issues the copyright as a matter of perfunctory procedure. In case of infringement or duplication of material, the copyright-owner can collect damages through resort to legal suit.[1]

Copyrights give exclusive privileges to the author, his kin upon his death, or an assignee of the copyright, for a period of twenty-eight years. Except for assignees of copyrights, other copyright-owners may renew the privilege for an additional twenty-eight years. The copyright may be assigned to others, although the assignment is void if not registered with the Copyright Office. The copyright gives to the holder the right to print or reprint a work in any language, or to convert it into some other form of artistic expression (a book copyright-owner retains the right to convert the book into a drama), or to perform or present the work to the public for profit. Any interference in this right by other persons constitutes an infringement and may be the cause for damages.

b. Some problems of copyrights. The administration of copyright laws has caused few difficulties because of the perfunctory character of the procedure. Most of the problems have arisen in the definition of infringement. For example, with the advent of the radio, some questions were raised as to whether radio broadcasts of copyrighted music required permission of the copyright-owner. The answer to this question was found in the general principle that any public performance of copyrighted material constituted an infringement, unless given by permission of the copyright-holder.

[1] In case of willful infringement of a copyright for profit, a guilty person may be found criminally liable for a fine up to $1000 and imprisonment up to one year, or both. The criminal aspects of the copyright laws have not been very important in practice, however.

5. TRADE-MARKS. The Constitution gave Congress no special power for the registration of trade-marks, probably because important product differentiation has developed in more recent years. Moreover, even under the common law, misrepresentation and appropriation of trade-names were causes for damage suits by aggrieved parties. Not until 1870 did Congress enact legislation for the registration of trade-marks. This early law was found constitutional as a valid use of the interstate commerce power in 1879,[1] and later trade-mark laws have been presumed to be constitutional. State legislation also provides for registration of trade-marks, and generally covers those which would be used only in intrastate commerce. State laws, however, follow pretty closely the pattern of federal law.

a. Federal registration of trade-marks. The federal government has provided for registration of trade-marks with the United States Patent Office. Any trade-mark can be registered upon application and the payment of a fee, except for marks of certain kinds. Those which cannot be registered are trade-marks which show the flag or symbol of any government agency, or which are immoral or obscene, or which are closely similar to trade-marks previously registered. Registration is obtained by applying to the Patent Office and enclosing several copies of the mark. Examiners of the office search records for duplicates, and if none is found and the mark meets legal specifications and is held to be valid and not infringing upon another mark, the registration is completed. After a trade-mark has been issued, any person believing that it infringes upon a previously registered trade-mark can bring proceedings to have it canceled.

Trade-marks registered before 1920 were limited to a period of twenty years. Since 1920, there has been no limitation upon their duration. The holding of a registered federal trade-mark entitles the holder to sue for damages in the federal courts, under a law which allows the judge to grant damages up to three times the amount incurred and supported by a verdict. Furthermore, the holding of a registered trade-mark establishes a valuable claim for priority in its use, in case a damage suit or a suit to enjoin appropriation by a competitor is sought.

b. The significance of trade-marks. The government's assistance to trade-mark maintenance and protection, provided by the trade-mark registration laws, has been of invaluable aid to business. Product differentiation would be virtually impossible without trade-marks. The general development of monopolistic competition depends to a large extent upon them. The fixing of resale prices by a manufacturer or wholesaler would hardly be feasible without some kind of product distinction. While the common law would protect property rights in trade-names, and the law against unfair competition would also limit unfair use of a trade designation by a competitor, the registration procedure systematizes trade-marks and offers government recognition of the

[1] *The Trade-Mark Cases*, 100 U.S. 82 (1879).

ownership in them. Perhaps it might be said that the government in protecting property in a trade-name has contributed to the breakdown of the freer and more perfect competition.

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CHAPTER

30

GOVERNMENT OWNERSHIP OF BUSINESS

IT IS still true in the United States that private ownership of business is the rule and public ownership the exception. Government ownership of business is nevertheless of great importance, and numerous instances of it can be found in federal, state, and municipal governments, as well as in other subdivisions of the states.

The federal government has long owned and operated the postal service, and has developed such services as parcel post and postal savings which compete directly with privately owned businesses. It has also owned and operated for several decades the Alaska Railroad Company, the Panama Canal, and many enterprises in the Canal Zone, including the Panama Railroad Company. As was noted in the previous chapter, the establishment of federal corporations to assist in the lending of funds to farmers and business men has grown rapidly in the last two decades, and the last decade in particular. During the first World War, the national government entered the business of housing, operated the railways for a time, built ships, and produced war supplies. After the war, it went into the business of furnishing water transportation on the Mississippi and Warrior Rivers through creation of the Inland Waterways Corporation, and thereby supplemented previous construction and maintenance of waterways by operation of equipment on a part of the water transport system. During the same period, the Department of the Interior undertook the furnishing of irrigation and reclamation services, and instituted government ownership of electric power production by the planning of such dams as the Boulder Dam project.

Although it is popularly believed that the real impetus toward government ownership of business has come since 1933, it can be seen that an extensive groundwork for it existed prior to that time. To be sure, the lending agencies of government have been multiplied and their powers broadened. The government has also embarked upon a definite program of power production,

accompanied by navigation, irrigation, and flood-control features, through the establishment of the Tennessee Valley Authority and the Bonneville Administration. The Roosevelt government has further shown its interest in extending this program in the future by the completion of such projects as the St. Lawrence River development.

State, as distinguished from municipal, ownership of business has been relatively limited. Although state governments have in the past constructed canals, turnpikes, and railroads, and gone into banking and other businesses, present state ownership of business is generally confined to the field of distribution of alcoholic beverages, housing, and insurance. A few states still own and operate canals, such as the famous New York Barge Canal. State ownership of bridge and tunnel facilities is also found. In certain states, government ownership of grain elevators exists, and in many states prisons and similar institutions carry on important business activity. Of course, in the field of free services, such as the construction and maintenance of highways and the furnishing of educational facilities, the state governments are still important economic producing units.

The outstanding cases of government in business found in the states are the enterprises operated by municipalities. Many such subdivisions own and operate public markets, dock and wharf facilities, and public-utility services. It is the latter group of services which is particularly significant as a substitute

TABLE XVI. OWNERSHIP AND OPERATION OF UTILITIES AS REPORTED BY 2018 CITIES OVER 5000 BY POPULATION GROUPS, 1940

Types of Utilities	All cities over 5000		over 500,000	200,000 to 500,000	100,000 to 200,000	50,000 to 100,000	10,000 to 50,000	5000 to 10,000
	No.	% of Total						
Auditorium	410	20.2	7	18	17	36	180	152
Bus or trolley bus	22	1.1	2	1	1	3	8	7
Street railway	10	0.5	4	3	0	2	1	0
Electric distribution only	140	6.9	0	1	3	0	53	83
Electric generating and distribution	268	13.2	2	2	4	9	100	151
Gas distribution only	34	1.7	0	1	1	2	9	21
Gas manufacturing and distribution	44	2.2	1	3	2	2	23	13
Port facilities	103	5.1	8	14	13	12	41	15
Sewage treatment	1018	50.1	9	20	21	42	414	512
Slaughterhouse	47	2.3	0	0	3	8	22	14
Water distribution only	127	6.2	1	0	2	9	61	54
Water supply and distribution	1333	65.6	12	25	40	75	576	605
Airport	573	28.2	11	26	30	52	276	178
Cities having none of above	250	12.3	0	1	0	7	93	149
Cities not reporting	15	0.7	0	0	0	0	2	13

Source: Municipal Yearbook (Chicago: International City Managers' Association, 1941), p. 41.

for private ownership. By far the most usual case of municipal ownership of public utilities is found in water plants. In 1940 nearly 66 per cent of the cities of 5000 or more population owned their water-supply system. Far less important, but still rather extensive, is municipal ownership of electric companies, found in 20 per cent of cities of 5000 or more. Gas and street-railway businesses are seldom owned by municipal governments, and no important case of ownership of telephone service exists. An idea of the extent of municipal ownership may be gained from Table XVI.

A. THE BASIS OF GOVERNMENT OWNERSHIP

The basis for government ownership depends to a great extent upon the kind of political and economic system which a society professes to operate. If a society is committed to the tenets of socialism, then government ownership may be justified as a desirable end of that system. But in the United States, although many persons of influence have been motivated by a belief in the "goodness" of collectivism, government ownership has generally had to be justified as being within the framework of a "practical" conception of *laissez-faire* and free private enterprise.

1. Factors Which Explain the Existence of Government Ownership. Perhaps the most important reason for government entrance into productive enterprise is the existence of essential businesses in which private persons cannot or will not engage. Military considerations may lead the government into the production of arms, munitions, and ships, communication and transportation, or such widespread enterprise as is found in the Panama Canal Zone. These businesses may be so important to national defense that private enterprise cannot be relied on, or the returns may be so uncertain that it is unwilling to produce adequate facilities except at costs regarded as excessive. Interest in public health and welfare may lead the government to own and operate water-supply and distribution systems, housing projects, libraries, schools, garbage-collection services, and a host of others. There are also essential services in which the capital outlay is too great or the return too uncertain for private enterprise to undertake them. Such are canals, harbor improvements, wharfs, city markets, power and irrigation dams, bridges and tunnels, forests, and airports.

Closely allied to the production of goods and services in those fields in which private enterprise cannot or will not enter is the entrance of government into business where private enterprise has proved incapable or inefficient. The emergence of government ownership of railroads in most countries of the world has come after the failure or inability of private ownership. For example, the Canadian National Railways emerged as a governmentally owned system of a number of railroads which had failed under private ownership.

Another purpose of government ownership has been to provide a stimulus

to higher efficiency and lower prices in private enterprise. The government has on occasion entered the production and distribution of electric energy to furnish a "yardstick" for private enterprise, thereby stimulating privately owned plants to improve service and lower costs. Instances also exist where the government has gone into other businesses with the same motive, such as street-railway and bus services, grain elevators, gasoline retailing, banking, and insurance.

To be realistic, one should recognize that an important basis for government ownership of business lies in political motives. Irrespective of any other justification, the political value of having government funds spent in a given locality and of having government jobs available for reward may well account for some of the extension of government ownership in the United States.

2. THE LEGAL BASIS OF GOVERNMENT OWNERSHIP. The legal bases of government ownership of business have been noted earlier in Chapter 3.[1] Since the federal government is one of enumerated powers, any ownership of business by it must be justified as necessary or proper for the execution of such powers. But the broad construction which has been given to the interstate commerce and spending powers has given the federal government adequate grounds for many kinds of ownership. The state and municipal governments also have adequate power to enter into business. The attitude of the United States Supreme Court has been that, so far as the national Constitution is concerned, the state may go into practically any business, or allow its municipalities to do so, if the legislature thinks that government ownership is for the benefit of the general public and is willing to make the necessary expenditures.

3. IS THERE AN "APPROPRIATE FIELD" FOR GOVERNMENT OWNERSHIP? From time to time, students of government and business have tried to define the sphere of business which government might appropriately enter;[2] the test is apparently whether the business concerned can be operated effectively and economically by public in contrast to private management. The result of this inquiry is that certain characteristics which indicate whether the public can operate a business successfully have been pointed to by economists from Adam Smith to the present day. It is asserted that a publicly owned and operated business should be one of small capital, so that large losses to taxpayers may be avoided; one of simple and standardized operation, so that non-expert political officials can operate it well; one promising immediate and certain returns, since public enterprise does not have the temper to assume the risks and uncertainties of speculative businesses; one whose service and product are used generally enough to make it of wide public interest and a proper governmental function; and one in an industry which has reached economic maturity, since government is not believed to have the stimulus to ingenuity and alertness to make a success out of a growing or experimental business.

[1] *Supra*, pp. 49–50.

[2] See discussion of this point in Persons, W. M., *Government Experimentation in Business* (New York: Wiley and Sons, Inc., 1934), chap. II.

In view of the actual cases of government ownership, the concept of an "appropriate field" is interesting. Certainly, a moment's reflection will show that government has not, to any great degree, limited itself to such a field. Even if one were to assume that the appropriate sphere of government ownership may be correctly defined from an economic point of view, the motives which lead to government ownership, as has been previously noted, are generally far from purely economic. Hence the question of an appropriate field tends to become rather devoid of meaning. Moreover, it may be that government ownership is assumed because of the failure of private ownership, in which case no alternative may exist. Or governmentally owned and operated businesses, especially when organized under the semi-autonomous government corporation, may have just as much motive for economic efficiency as the large business corporation, owned by private stockholders, but controlled by professional and salaried managers without effective restraint exerted by the mass of uninformed and unorganized stockholders.

B. FEDERAL GOVERNMENT OWNERSHIP: TRANSPORTATION

In describing federal government ownership of business, it is proposed to select certain leading cases in transportation, electric power production and distribution, and finance and housing. The student should realize that these are not exhaustive. Practically every government activity results in some economic production, and many examples of aids to business, discussed in the previous chapter, may be looked upon to some degree as cases of ownership. Although the Post Office Department engages directly in local transportation service only, it is an important instrumentality in the transportation system of the nation, and should be included along with the more obvious cases of government ownership in transportation.

1. THE POST OFFICE. The Constitution authorized the establishment of a postal service, and the first Congress of the United States carried over the organization, already existing in the colonies, by legislation in 1789 and 1794. Although the Post Office did not become a separate executive department until 1872, being responsible to the President and submitting reports to the Treasury Department before that time, the Postmaster General was admitted to the cabinet by President Jackson in 1829.

For the first quarter of a century after 1789, the Post Office was operated along private business principles and a profit was shown practically every year. After 1814, and particularly with the ascendancy of Andrew Jackson to the presidency in 1829, the postal service came to be dominated by purposes of improving service, even at a loss, and of serving as a political and cultural agency. Political control of personnel became established policy under Andrew Jackson's "spoils" principles. Franking privileges to congressmen and

other persons were extended, largely to aid partisan ends. With the introduction of partisan politics and the policy that the postal service should be extended to all persons in the United States, its social and political characteristics early replaced business features.

a. Organization of the postal service. The present Post Office is organized as an administrative department of the federal government, responsible to the President. It operates some 44,300 post offices in the country through which it handles the delivery and collection of mail in practically every part of the United States. Except for some local carrying equipment, the Post Office Department does not own any of the transportation facilities for the distribution of mail, but contracts with railroads, air lines, water carriers, and highway carriers for that service.

The services of the Post Office Department include the handling and insurance of mail, the issuance of money orders, the collection of cash on delivery, the conduct of postal-savings business, and the sale of small-denomination government bonds. Mail service is classified according to the nature of contents, and rates are fixed in each classification, generally in accordance with weight and, in some classifications, according to distance. Expedited service of various kinds is available with the payment of special fees. In addition, certain free services are given. Officials, departments, bureaus, commissions, and other agencies of the federal government are given the privilege of sending mail free; and reading matter for the blind and bulletins and reports from certain agricultural experiment stations and colleges may be mailed without charge. The privilege of free delivery is also granted to newspapers within the limits of the county in which they are published when mailed at or to post offices which have only rural delivery service.

b. The question of policy determination. As compared to many private enterprises such as the railroad, telephone, and automobile-manufacturing companies, the Post Office can hardly be regarded as a very complex business. At the same time, it is a big business and one in which many questions of policy must be determined. In most matters, except those relating to personnel under civil service, prices, and the introduction of new services, discretion is left to the Postmaster General. He may make regulations regarding operation and, in the case of fourth-class mail (parcel post), regarding weight limits, rates, and other matters, subject to approval by the Interstate Commerce Commission.

The Postmaster General also makes all contracts for the transportation of mail, although the Interstate Commerce Commission is given authority to fix reasonable rates for carriage of mail by carriers under its jurisdiction, and the Civil Aeronautics Board may fix them for the handling of air mail. Other matters, such as the extension of urban delivery and the routing of rural delivery, are left to the Postmaster General, subject of course to restrictions laid down by Congress.

Congress has reserved to itself the right to fix rates on all mail except parcel post, and has undertaken to define the general character of services to be undertaken by the Post Office Department.

As a result, one has an interesting case of a business enterprise which has little power to price its service or to expand or restrict it. It cannot enter into contracts for transportation of mail without gaining the approval of charges by an outside agency, and it cannot hire and discharge employees without following the rules and regulations of another government agency. This division of policy-making authority could hardly be tolerated in private business, and may well be a cause for some inefficiency and inflexibility in the postal service. On the other hand, the size of the postal business and its social and economic importance may be so great that too much power should not be allocated to a single agency.

c. Financial results of the postal service. The fiscal record of the Post Office has been one of constantly recurring operating deficits. If any privately owned business had such a record, it would be regarded as a dismal failure. But the Post Office Department is generally regarded as one of the better examples of government in business, even though one may criticize the degree of political control existing and the rather inefficient business practices which have been found.[1] The answer to the apparent dilemma is found in the recognized principal purpose of this department of giving service rather than making a profit.

To understand the recurring deficits of the Post Office Department, one should look to the allocation of revenues and expenses to the various services which the department has made. Table XVII shows these data for the fiscal year ending on June 30, 1940. The table represents an annual cost study by the department The actual revenues and expenses are indicated in the upper part; the adjustments shown in the lower part, by which certain free services are given revenue credit and expenses for some non-postal items also credited, are made pursuant to a law passed in 1930. By the means of the adjustments, an operating loss of many millions of dollars is turned into a "paper" operating profit of a respectable amount.

The table indicates that first-class mail, except for air mail, is the only postal service which is operated at a profit. Substantial losses are incurred on other services, with an especially large loss indicated for second-class mail. This would imply that most of the services are being subsidized. However, since jointly incurred costs have had to be allocated in the cost-ascertainment services of the department, one may well question whether the data prove a case of subsidy or simply a case where the overhead and joint costs have been allocated arbitrarily. If classes of mail other than first class and the special services cannot be handled except at present rates, owing to the elasticity of

[1] See discussion in Lutz, H. L., *Public Finance* (New York: D. Appleton-Century Company, 3d ed., 1936), pp. 246–48.

TABLE XVII. APPORTIONMENT OF POSTAL REVENUES AND EXPENSES TO CLASSES OF MAIL AND SPECIAL SERVICES, YEAR ENDING, JUNE 30, 1940

Class of Mail	Revenues	Expenses	Excess of Expenses
First-class mail			
Other than local	$330,357,753	$208,256,856	$122,100,897*
Local	82,715,355	59,219,595	23,495,760*
Air mail	19,122,905	28,039,249	8,916,344
Total, first-class	$432,196,013	$295,515,700	$136,680,313*
Second-class mail	24,949,510	110,330,537	85,381,027
Third-class mail	75,105,950	101,397,936	26,291,986
Fourth-class mail	133,693,509	155,503,379	21,809,870
Foreign mail	17,831,570	26,225,846	8,394,276
Penalty mail	....	16,986,112	16,986,112
Franked mail	....	746,110	746,110
Free for blind	....	196,023	196,023
Special services †	66,774,495	88,495,185	21,720,690
Unassignable and unrelated	17,464,281	14,843,858	2,620,423*
Total, all operations	$768,015,328	$810,240,686	$42,225,358
Adjustments under the Act of June 9, 1930			
Revenue credits:			
Penalty matter	$41,533,510		
Franked matter	1,217,561		
Other credits	1,177,213		
Expense credits:			
Aircraft and non-postal custodian services		$16,906,110	
Adjusted totals	$811,943,612	$793,334,576	
Net surplus			$18,609,036*

* Excess of revenues over expenses.

† Includes registry, C.O.D., insurance, special delivery, money order, and postal savings.

Source: Ann. Rep. of the Postmaster General (1940), pp. 114–15.

demand, it may very well be that the apparent losses on these services are not a subsidy. They may simply be evidence that such services cannot bear as much of the overhead and joint costs as have been allocated to them. In other words, the Department might be operating in accordance to sound economic principles of what the traffic will bear, and the relatively high rates on first-class mail and low rates on other services may be justified by the factors of cost and elasticity of demand.

Nevertheless, there is probably a real element of subsidy in carrying certain mail, such as the second-class mail. Although this cannot be *proved* by the cost and revenue data published by the Department, the political and social motives behind low rates on second-class mail and certain other services may indicate it.

The adjustments made under the 1930 law are purely for the purpose of showing what the financial results would be if some of the more important free services were charged at rates applicable to the revenue services. As such,

for a clear understanding of postal-service finances, the making of these adjustments is clearly sound. But if this procedure is sound for the free services, it ought also to be sound for other services which do not bear their full share of cost. Although subsidies on these other services may be difficult to ferret out, in view of the necessity of allocating joint and overhead costs, to the extent they can be found they should be shown as an adjustment in arriving at the "paper" loss or surplus.

Even though it may be shown that the Post Office Department earns a surplus after proper adjustments have been made, one cannot conclude that the business is one which has covered all its costs. The expenses reported do not make a full allowance for return upon, or depreciation on, the tremendous investment of the government in post-office buildings and other similar facilities.

d. The postal service: conclusions. From the point of view of financial results, the postal service does not shed much light upon the efficiency of government in business. In all fairness, it can be said that the Post Office Department is not in business primarily to cover its costs or to make a profit. If that were desired, the government monopoly of letter mail and the relatively inelastic demand for that service, as well as the business feasibility of dropping second-class mail, would make a profit possible. But the postal service is a socializing and unifying force in the nation. Cheap transportation of periodicals, newspapers, and other matter may well be justifiable from the point of view of promoting and unifying the culture of the American people.

The very fact that the Post Office has become a means of broadening and unifying culture indicates that when the government takes over a business, social, rather than economic, motives are likely to prevail. The business tends to become an instrument of social policy, rather than a mere producer of goods and services which the consumer desires and can pay for. While the writer has no quarrel with the interjection of such a motive into production, non-economic production gives rise to costs which must be borne by taxation; and the problem arises whether people wish to have their resources spent in that way or in some other.

2. The Alaska Railroad. The Alaska Railroad is one of those business projects in which the government was forced to engage because private enterprise was unwilling to go into it, and because the government regarded the service as desirable for the economic and social development of one of its territories. Although privately owned railroads existed in Alaska before the government constructed the Alaska Railroad, they were not profitable. Some of them went into bankruptcy, and they did not extend their lines to open up the interior of Alaska. As a result, Congress provided in 1914 for the construction and operation of a government railroad under the direction of the President. The act appropriated $35,000,000 for a line not to exceed one thousand miles which was to connect one or more ice-free Pacific coast harbors with navigable

waters and coal mines in the interior. With an additional $17,000,000, a new line was constructed and certain existing lines purchased, until the government had by 1922 a line five hundred miles long reaching from Seward to Fairbanks. In addition, it owned telephone and terminal facilities and other enterprises along the line.

The promise of stimulating the economic development of the territory which the railroad is serving has not been especially well supported by the history of the road. The territory is still sparsely populated, the Alaskan coal fields which the railroad was designed to serve have not produced a grade of coal suitable for export, and other traffic has not been very large. The result is that in spite of low freight rates, the Alaska Railroad never earned its operating expenses until 1940. For example, in the year ending June 30, 1939, the railroad had revenues of $2,354,000 and expenses of $2,371,500, but in 1940 it showed operating revenues of $3,058,000 and operating expenses of $2,712,600.[1]

The Alaska Railroad is not a very significant case of federal ownership of business, and it does not shed much light on the effectiveness of such ownership. Like the Post Office, the railroad was promoted to encourage the economic and social development of a portion of Alaska. The slight increase in population and the unimportant increase in business since it was built indicate that it has not even been very successful in its non-business purposes.

3. THE PANAMA CANAL. One of the larger business enterprises of the federal government is the ownership and operation of the Panama Canal and auxiliary services. Like other government businesses, however, the Panama Canal was probably not built primarily for commercial purposes, but as a means for aiding national defense through increasing the interocean mobility of the nation's fleet. At the same time, the canal is an important business enterprise, opening up steamship lines for the transfer of world shipping between the Pacific and Atlantic Oceans.

Strictly speaking, the ownership of business in the Canal Zone is not limited to the canal proper, but includes certain general business enterprises and the Panama Railroad Company, with its subsidiary, the Panama Steamship Line. There are really two organizations. The Governor of the Panama Canal oversees the operation of the canal and the general business enterprises, while the Panama Railroad Company, a government corporation, owns and operates the railroad and steamship line. The railroad, however, has as its president the Governor of the Canal Zone, but has a board of thirteen directors appointed by the Secretary of War.

a. History of the canal. The Panama Canal was constructed by the federal government and placed in operation in 1914, after years of difficult work and an original expenditure of nearly $400,000,000. With additional construction expenditures after 1914, the capital cost had increased to more than $543,000,000 before depreciation reserves, and $508,000,000 after depreciation, by June

[1] *Ann. Rep. Secretary of the Interior* (1939), p. 346 and *ibid.* (1940), p. 411.

30, 1939.[1] With major enlargement of the canal for national defense purposes being planned in 1940 and 1941, this capital investment may be expected to increase materially.

When one realizes the importance of the canal to defense, and the difficulties and expense in its construction, its history is one to give encouragement to believers in government ownership of business. Since 1921, expenditures for construction of canal facilities have been capitalized and interest at 3 per cent per year has been charged against net revenues to arrive at a statistical surplus. In spite of the fact that this capitalization is not reduced by an amount properly allocable to defense, the canal has not suffered very large deficits after interest is charged against net revenues. As a matter of fact, the total deficit since the opening has only been a little over $26,000,000. Even though it be admitted that perhaps inadequate depreciation has been taken into account and the canal has had no taxes to pay, the deficits after return are certainly not large for a business which is so valuable for defense. The financial picture of operations is given in Table XVIII.

b. Canal Zone businesses. The entire Canal Zone is publicly owned, and no privately owned businesses can be found in it. Partly because of limitations of space and the need for facilities to care for operating personnel, and largely because of the defense importance of the canal, private parties are not allowed to own any land in the Zone and private businesses do not operate there. Besides the Panama Railroad Company with its railroad and steamship line, there are many other business enterprises in the Zone. These businesses are owned and operated under a curious joint arrangement of the canal administration and the railroad.[2] Nearly all the ordinary businesses are owned by the Panama Railroad Company, but practically all are operated by the Panama Canal employees. Thus, the railroad owns dock facilities and coal plants, commissaries, houses, apartments, hotels, telephone and electric clock systems, farms, and cattle. The canal administration owns and operates the ordinary public-service enterprises, such as electricity and water supply, and handles the postal system, the Panama Canal Press, sales of oil, and ship chandlery.

Although all these enterprises cannot be discussed, it is interesting to note that they have been carried on in a highly creditable manner.[3] Dimock held that the quality of goods and service was superior in general to that of private business, that the prices even after allowing for tax and other differentials were reasonable, that the operation of the enterprises was efficient, and that employees appeared to be exceptionally well treated. On the other hand, the operating units were not given enough independence, the executives were not

[1] *Ann. Rep. of the Governor of the Panama Canal* (1939), pp. 124, 130.

[2] Much of the material here, as elsewhere in this section, is drawn from Dimock, M. E., *Government-Operated Enterprises in the Panama Canal Zone* (Chicago: University of Chicago Press, 1934).

[3] *Ibid.*, pp. 128–30.

Table XVIII. Financial History of the Panama Canal

(000's omitted)

Fiscal Year	Tolls	Civil Revenues	Business Profits	Total Revenues	Net Appropriated Expenses	Net Revenues	3% Return on Capital	Computed Surplus
1914–1920	$33,304	$1,206	$536	$35,046	$36,658	$1,612 *	....	$1,612 *
1921	11,262	214	564	12,040	9,578	2,462	$14,675	12,213 *
1922	11,193	192	323	11,708	8,469	3,239	15,253	12,014 *
1923	17,508	184	1,140	18,832	8,241	10,591	15,202	4,611 *
1924	24,290	392	902	25,584	8,924	16,660	15,151	1,509
1925	21,375	208	766	22,349	8,667	13,682	15,100	1,418 *
1926	22,927	218	841	23,986	8,543	15,443	15,086	357
1927	24,217	392	876	25,485	9,548	15,937	15,068	869
1928	26,943	233	737	27,913	9,501	18,412	15,035	3,377
1929	27,124	243	738	28,105	10,187	17,918	15,014	2,904
1930	27,077	349	761	28,187	9,894	18,293	14,987	3,306
1931	24,645	346	563	25,554	10,693	14,861	14,987	126 *
1932	20,707	327	557	21,591	10,239	11,352	14,944	3,592 *
1933	19,621	310	1,136	21,067	9,556	11,511	14,908	3,397 *
1934	24,065	97	1,367	25,529	7,751	17,778	15,039	2,739
1935	23,339	82	1,021	24,442	9,301	15,141	15,124	17
1936	23,507	120	920	24,547	9,495	15,052	15,160	108 *
1937	23,147	99	917	24,163	10,110	14,053	15,205	1,152 *
1938	23,215	90	825	24,130	9,396	14,734	15,230	496 *
1939	23,699	107	682	24,488	9,965	14,523	15,251	728 *
Total	$453,165	$5,409	$16,172	$474,746	$214,716	$260,030	$286,419	$26,389 *

* Deficit.

Source: Ann. Rep. of the Governor of the Panama Canal (1939), p. 131.

picked with a view to their ability but according to somewhat unsuitable civil-service requirements, and the enterprises did not use to advantage the psychological techniques which the business world employs in keeping customers satisfied.

c. The Panama Railroad Company. The Panama Railroad Company was first incorporated in 1849 as a private venture to furnish trans-isthmian transportation during the California gold rush. The railroad was completed in 1855 at an expense of $8,000,000, and for nearly four decades enjoyed prosperity. But following a period of mismanagement and the depression of 1893, it fell into financial difficulties. When the federal government negotiated for the purchase of the canal building rights and equipment, it also purchased the railroad, which came into its hands in 1904 at a cost of $7,000,000. In buying the railroad, the government also bought control of the Panama Steamship Line, owned by it. In spite of some misgivings of President Taft, who disliked the idea of government in business, the steamship line was retained and sailings from Panama to New York maintained.

The financial history of the Panama Railroad Company under government ownership has been rather commendable. In addition to paying regular dividends to the United States Treasury, holder of the $7,000,000 of common stock, the railroad has built its investment considerably by plowing in earnings. Most of the years since 1923 have brought a 10 per cent dividend to the Treasury, and in 1932 Congress forced the paying of a 40 per cent dividend from reserves to build a dam in the Canal Zone. The railroad has paid nearly $14,000,000 of dividends since 1924 and has earned on all operations a net income of approximately 3 per cent of average depreciated investment.[1] In addition, it has accumulated depreciation reserves of $9,900,000, and has reinvested $42,000,000 of earnings up to June 30, 1940.[2] Although the railroad has made some of its earnings from its miscellaneous business services, and has had the advantages of a monopoly in the Zone and of freedom from taxes, the prices charged appear to have been reasonable and the operation of the road efficient. In fact, the history of the Panama Railroad Company is a bright spot in the experience of government in business.

d. The Panama Steamship Line. The Panama Steamship Line is managed from New York and is under the supervision of one of the vice-presidents of the railroad company. The line is small, operating only three steamships in 1941, and has not attempted to compete vigorously with the privately owned lines. It has restricted its service to weekly sailings between New York and Haiti and the Canal Zone. The restriction in service has apparently been due largely to the opposition of privately owned lines.

In spite of efficient and highly capable management,[3] the steamship opera-

[1] *Annual Reports of the Panama Railroad Company* and Federal Co-ordinator of Transportation, *Public Aids to Transportation* (1940), vol. III, p. 319.

[2] *Annual Report Panama Railroad Company* (1940), p. 17.

[3] Dimock, M. E., *op. cit.*, pp. 83–84.

tions have not generally been profitable. Although the line made profits during the years of the first World War and in 1928 and 1929, until 1940 other years have shown operating deficits. From 1930 to 1939 deficits averaged approximately $250,000 annually and aggregated $2,529,000. In 1940, however, owing to defense preparations at the canal, the steamship line yielded a profit of $115,000.[1]

The poor financial record of the steamship operations until 1940 is not without an explanation. Besides the opposition of private enterprise, and the unwillingness of Congress and the administration to allow the line to go after business aggressively, it is forced to give Canal Zone employees very large reductions in rates and to give the government itself extremely favorable rates. The former Federal Co-ordinator of Transportation found that, if no reductions in tariffs had been made for the government, the $4,000,000 deficit between 1922 and 1936 would have been replaced by a $3,000,000 operating profit.[2]

e. The Panama Canal and enterprises: conclusions. For a business operated not for profit or for commercial reasons primarily, but to a great extent for the needs of national defense, the Panama Canal and associated enterprises present an encouraging picture of the federal government in business. Much of the favorable history is due to the strategic economic position of the canal and the government monopoly of enterprises there. It is also due to the fact that Congress has, as a matter of fact, given the Canal Zone authorities a surprisingly free hand. Moreover, the executive personnel has been drawn largely from the army corps of engineers with experience in the canal, and practically all the other employees not attached to the army have been placed under the protection of the civil service. Dimock found the canal enterprises to represent the highest kind of governmental enterprise and one which "should be viewed with pride by American citizens." [3]

Besides the need to readjust steamship tariffs, probably the most important need for the canal enterprises is an administrative reorganization. The separation of the Panama Canal and the Panama Railroad Company is unnecessary. What would appear to be wise is to establish a single government corporation and place all the canal enterprises under it. The possibilities for unifying administration, for flexibility and freedom from the red tape of government departments, and for developing semi-independent business policies on a long-range plan make this the logical means of handling government ownership in the Canal Zone.

4. The Inland Waterways Corporation. During the first World War, the federal government through the United States Railroad Administration

[1] *Annual Reports Panama Railroad Company*, for years mentioned.

[2] Federal Co-ordinator of Transportation, *Public Aids to Transportation* (1940), vol. III, p. 317.

[3] Dimock, M. E., *op. cit.*, p. 212.

undertook the operation of a barge line on the Mississippi and Warrior Rivers. Because much money had been spent on the line and on improving the rivers for navigation, and because inadequate private barge service existed, the government after the war turned the barge line over to the War Department for operation. It desired to prove that private operation of the line would be feasible, and it was assumed that the government would sell the line to a private operator as soon as a suitable one was available. Because of the burdensome regulations of the War Department, Congress created the Inland Waterways Corporation in 1924 to take over and operate the barge line.

When the Corporation was set up in 1924, the committee of Congress reporting the bill favorably believed that the government could dispose of the property in five years at a profit after having established the feasibility of water transport on the Mississippi and Warrior Rivers; but the committee also advised that, if the experiment should not turn out well, it should be abandoned and expenditures for navigation improvement halted.[1] This idea was lost sight of in the amendments of 1928, which encouraged further operation of the barge line and improvement of navigation until such time as a suitable purchaser, which would not be a railroad or anyone interested in railways, could be found. Such a buyer had not been secured by 1941.

The results of the experiment with the Inland Waterways Corporation have not been very encouraging. In spite of a showing of some profits for certain of the years since 1924, question exists whether the Corporation has really covered its costs. Very large expenditures have been made by the government for the improvement of waterway facilities over which the Corporation operates. While it would not be fair to charge all these expenses to it, a fair appraisal of costs cannot be made by overlooking them entirely. Moreover, the Corporation has probably not had to pay, at least until recently, as much in taxes as private transport agencies have paid. The Corporation has also had the advantage of not having to pay for the president's salary, postage, or for all the government facilities, such as office space, which it has used, and it has not had to pay a return upon the $22,000,000 which the federal government has invested in its fixed and floating equipment.[2]

In making a study of the extent of public aids to transportation, the Federal Co-ordinator of Transportation analyzed the costs of the Inland Waterways Corporation. He held that if the Corporation was to be used to illustrate the feasibility of private ownership of the barge line, in computing profits certain costs should be considered beyond those accounted for by it; these included more ample depreciation allowances, the cost of capital, taxes, the cost of postage and special government allowance on telegrams and purchases, and certain other costs. When these were considered, the co-ordinator found that

[1] *Report of the Special Committee to Investigate Government Competition with Private Enterprise*, H.R. 1985, 72d Cong., 2d Sess. (1924).

[2] *Ann. Rep. of the Inland Waterways Corporation* (1938), p. 7.

in the years from 1924 to 1936, instead of the net income of $687,000 shown on the Corporation's books, it actually sustained losses totaling more than $15,500,000.[1] Even if the Corporation was conceived of as a government business entitled to low capital costs and advantages of other low government costs, the co-ordinator computed that it had really lost $9,400,000 between 1924 and 1936.

Transportation economists who have studied the history of the Inland Waterways Corporation generally agree that it has not been an economic success.[2] They point to the subsidy elements in its business, to the meager earnings, and to the fact that the Corporation has never paid a dividend to the federal government as return on the investment. Supporters of the Corporation, on the other hand, point to the savings to shippers caused by the lowering of railroad rates in response to barge-line competition. Without doubt, the federal barge line has served to lower railroad rates on competing services, although it is extremely doubtful if shippers save enough to make up losses to taxpayers. Moreover, one might raise the question as to whether the original purpose of the line is consistent with the justification of rate-reduction now claimed. The original purpose was to show private enterprise that water transportation would pay, and not to force private enterprise to charge unremunerative rates on traffic it had previously carried.

5. The United States Merchant Marine. During the first World War, Congress authorized the establishment of the United States Shipping Board Emergency Fleet Corporation in 1917 to engage in the construction, maintenance, and operation of merchant vessels. The activities of this corporation were continued after the war and its name was changed to the Merchant Fleet Corporation. Later its activities were transferred to the United States Shipping Board Bureau and in 1936 to the Maritime Commission.

The basis for the financing of merchant vessels by the federal government, both during the war and since, has been primarily national defense, although there has naturally been some desire to increase the amount of commerce carried in American ships. Merchant vessels are often easily convertible to wartime use, either as armed raiders or as supply ships, and the part a large merchant fleet would play in defense has aided in getting Congress to vote large sums for the merchant marine.

The policy of the merchant marine since 1917 has shown a wavering between federal ownership and operation, and federal subsidies for the building of ships to be owned and operated by private companies. During the first World War, the government embarked on an ownership plan and leased ships to operators or operated them through the Fleet Corporation. After

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation*, vol. I, p. 23.

[2] See Moulton, H. G., and others, *The American Transportation Problem* (Washington: Brookings Institution, 1933), pp. 498–503; Miller, S. L., *Inland Transportation* (New York: McGraw-Hill Book Company, Inc., 1933), pp. 679–80; Daniels, W. M., *American Railroads: Four Phases in Their History* (Princeton: Princeton University Press, 1932), pp. 117–18.

the war it operated a large part of the merchant fleet, but began immediately to dispose of the ships on the best possible terms. In spite of liberal prices, and the sale of 1522 ships between 1921 and 1932, the Shipping Board still had on hand 357 vessels in 1932, of which 99 were being operated under special management contracts.[1] As late as 1940, the government still owned 104 ships, of which 41 were being operated by management agents and the remainder were laid up and kept in minimum condition for emergency operation.[2]

The policy respecting government ownership of the merchant marine has not undergone much change since 1921. But in addition to liquidation of the large fleet obtained during the World War, the federal government has followed the policy of making liberal construction loans to operators for the building of ships. Under legislation passed in 1920, 1928, and 1936, the Maritime Commission and its predecessor the Shipping Board have had a revolving fund of $250,000,000 for the construction and financing of new ships for the merchant marine; these are constructed and sold at prices advantageous to private operators. In the case of ships for the foreign trade, a subsidy for construction in shipyards of the United States is given to make up for the higher costs of domestic over foreign construction. These subsidies in 1939 amounted to 51 to 56 per cent of total construction costs of ships.[3]

The costs of encouraging a merchant marine have been extremely large. Between 1917 and 1933, the operations of the Shipping Board cost more than three and one half billion dollars, of which approximately $250,000,000 represented losses incurred in the operation of ships remaining under government ownership, the remainder being due to the difference between the acquisition and sale prices of ships.[4] As late as 1940 the Maritime Commission showed losses of $878,000 incurred in the operation of 41 government-owned ships.[5] Moreover, in the renewed desire to increase American merchant-marine tonnage, the Commission reported in the latter part of 1940 that it had underwritten the cost of constructing 177 new ships at a cost of $438,000,000.[6] Although these ships had been contracted for by private operators in advance, when it is remembered that ships for the foreign trade will be subject to the domestic-foreign cost differential, it is clear that a large part of the construction cost will fall on the government. In addition to the subsidy elements in construction, ships of the American merchant marine receive handsome subsidies through the operation of mail contracts and operating-differential agreements.

6. Wartime Operation of the Railroads. For a period from December, 1917, to March, 1920, during and immediately after the first World War, the federal government took over and operated the railroads of the United

[1] Wooddy, C. H., *The Growth of the Federal Government* (New York: McGraw-Hill Book Company, Inc., 1934), pp. 231–32.

[2] *Ann. Rep. U.S. Maritime Commission* (1940), pp. 27, 34.

[3] *Ann. Rep. U.S. Maritime Commission* (1939), p. 45.

[4] Wooddy, C. H., *op. cit.*, pp. 231–34.

[5] *Ann. Rep. U.S. Maritime Commission* (1940), p. 34.

[6] *Ibid.*, pp. 8, 35–43.

States. Although private operation has continued since 1920, the experience with the government wartime operation is of more than historical significance, since both opponents and proponents of government ownership of railroads make reference to this experience in supporting their cases.

a. Events leading to government operation. The assumption of control over the railroads by the federal government late in 1917 came as the result of the obstacles to unified operation under private management and the inability of the railroads to handle traffic as expeditiously as war needs seemed to warrant. Before the United States entered the war in 1917, the demand for goods for shipment to Europe had, as early as the middle of 1916, caused a heavy increase in traffic. In spite of measures taken by the railroads through the Car Service Commission, the Committee on National Defense, and the Railroads' War Board, traffic congestion on the Eastern railroads grew until President Wilson took over the roads in 1917 under emergency powers granted to him in 1916.

One of the principal causes of the congestion was the disruption of ocean shipping from ports on the eastern seaboard, caused by the heavy war business and the German submarine campaign. Cars could not be unloaded, with the result that terminal facilities became crowded and sidings filled with unloaded cars. This situation not only impeded the movement of freight but kept railroad equipment from being used for the hauling of freight.

Despite excellent work by the Railroads' War Board, organized by railroad management in 1917, the traffic congestion problem could not be solved. The Board issued orders providing for pooling of equipment, for heavier loading of cars, for curtailing of unnecessary service, and for rerouting of traffic. But these orders depended upon voluntary acceptance by the railroads concerned, since the War Board had no governmental authority. Moreover, many railroads feared possible difficulty under the anti-trust laws for combining and following the authority of a central organization. Furthermore, railroad managements, who were nevertheless patriotic, had the interests of their own lines to think about, and often hesitated to take a course which might expedite traffic, but which would cause financial loss.

Another important cause of assumption of control over the railroads by the federal government was the financial position of the railroads themselves. With rising prices after 1914 they tried to obtain higher rates, but were not very successful and railroad earnings lagged. This restricted railroad credit, and the credit demands of the government for wartime financing created serious competition in the capital markets. The result was that the railroads were unable to obtain adequate capital for expansion of their facilities to meet the wartime traffic.

b. Organization of federal control. When President Wilson took over the railroads by proclamation late in 1917, he created the Federal Railroad Administration and placed Secretary of the Treasury McAdoo at the head in the posi-

tion of Director-General of Railroads.[1] The Railroad Administration was organized with a number of staff divisions [2] and with the railroads organized for operating purposes in seven geographic regions. The positions were filled with experienced railroad men, and former executives of railroads became federal managers under the plan.

To compensate the railroads for the use of their lines and equipment, a standard contract was provided for by the President. By this contract, each railroad was guaranteed an annual compensation equal to the average net railway operating income for the three years preceding June 30, 1917. The government agreed to pay all operating expenses, including taxes on physical property, and to pay for maintenance on the basis of the three-year period used in calculating income. It was allowed to make any capital expenditures desired, but the railroad was to reimburse it for these expenditures, unless it could be shown that they had served only a war purpose.

c. Operation under federal control. The Railroad Administration did succeed in one very important matter — the movement of traffic. Through pooling equipment, through limiting the use of priorities to traffic which could be unloaded on delivery, by joint and unified use of terminals, and by shipping traffic over lines which promised the quickest handling, the Railroad Administration made a remarkable record in moving traffic. The government also helped solve the labor problem by some increases in pay and by appealing to the patriotism of employees. Needed equipment and supplies were obtained under the pressure and prestige of government priorities. Savings were effected through increased standardization of equipment, the pooling of passenger service, the elimination of many duplicating services, and the cutting down of salaries of high railroad executives.

d. Results of federal operation.[3] From the point of view of traffic movement, one can say that the job of the Railroad Administration was to help win the war by movement of traffic and that this job was exceedingly well done. In 1918, the movement of traffic was 59 per cent over pre-war levels. Troops were moved efficiently, as many as 1,100,000 having been transported in one month. New high records in coal transportation were made, and the car shortage was materially reduced by 1918.

In respect to operating efficiency, gains were not so notable. What gains may have been present over private operation were probably due to the unification possible under government control and the motives of patriotism which led to unusual co-operation by employees and executives.

[1] After a year's service Mr. McAdoo resigned and the President appointed Walker D. Hines, former counsel of one of the largest railroad systems and a generally recognized able railroad executive.

[2] Divisions of law, operation, public service, accounts, labor, capital expenditures, traffic, finance, waterways, and wages and working conditions.

[3] Data in this section are drawn largely from Hines, Walker D., *War History of American Railroads* (New Haven: Yale University Press, 1928), and reports of the Interstate Commerce Commission.

The costs of federal operation were decidedly higher than had been the pre-war cost under private management. As compared to net railway operating income in the test period (June 30, 1914, to June 30, 1917), the operating income during federal control was some $642,000,000 less than under private management. These higher operating costs are even more clearly indicated when one notes that the total operating cost during federal control was 83 per cent above that during private operation, and that costs per freight-revenue-ton-mile were 49 per cent above the test period in 1918 and 81 per cent above in 1919. However, as illustrative of rising costs generally, it is interesting that the United States Steel Corporation showed a 62 per cent increase in unit costs in 1918 above 1914, and an 83 per cent increase in 1919.

The total costs of federal operation must take into account other items. The railroads collected $204,000,000 for undermaintenance of their lines. Excess compensation above the standard return was allowed to many railroads and involved an additional outlay of $105,000,000, and other claims and costs amounted to almost $175,000,000. The result was that the cost of operating the inland transportation system during the war was around $1,125,000,000. To this should be added another $550,000,000 appropriated in 1920 to aid the railroads to return to normal private ownership, thus bringing the total cost to the government of the twenty-six months of federal control to approximately $1,675,000,000.

Although these costs seem large, they may be somewhat understood by noting the maintenance, labor, and rate policy of the government during the war. While the Railroad Administration spent more for maintenance than the railroads had before the federal operation, the higher costs during the war and the traffic burdens resulted in actual deferment of maintenance. Capital expenditures of the government were only three fourths of previous railroad budgets, a very low amount when the higher war costs are considered.

Wages were materially increased by the Railroad Administration, and accounted for increases in costs of nearly a billion dollars annually. Even with these wage increases, the Administration did not keep pace with the rise of wages in other industries, and when the railroads returned to private ownership, they found a serious labor problem on their hands.

Despite rapid rises in costs during the war, the Railroad Administration made only one increase in rates, in June, 1918. While this increase brought almost a billion dollars a year, it was far below the increase in costs, and not consistent with the rise in prices generally. The Railroad Administration hesitated to raise railroad rates, because it disliked to contribute to already rising costs of living; but it is doubtful whether the higher rates would have brought any real hardship during the war when they could have been collected, and it is certain that a much better financial showing could have been made.

e. Federal railroad operation: conclusions. The experience of the government in operating the railroads during the first World War sheds no conclusive light

upon the effectiveness of government ownership under normal circumstances. The purpose of the Administration was to help win the war at any costs. It did the job of moving goods, and probably accomplished this task better than could have been possible under private management. Even though it is true that the job was done at great cost, there is no evidence that the wartime Administration attempted to operate the railroads as a paying business. Consequently, in a period so abnormal one can hardly come to any very definite conclusions about the federal government's engaging in the railroad business. The most that can be said is that the experiment may indicate how political motives can supersede economic ones when the government engages in business. The unwillingness of the government to raise rates while all private businesses were doing so is interesting evidence on this point.

C. FEDERAL GOVERNMENT OWNERSHIP: ELECTRIC POWER

The entry of the federal government into the field of production and sale of electric power, now becoming so important a case of government in business, may be traced to the conservation program of President Theodore Roosevelt and to the first World War. As early as 1902, the United States embarked upon a program of reclamation which not only put it into the business of peddling water to settlers in arid regions of the Southwest, but led ultimately to electric power production in the great Boulder Dam project, launched in 1929. The search for a source of nitrate production in the first World War led to the development of a hydro-electric nitrate plant at Muscles Shoals in northern Alabama, and to the creation of the Tennessee Valley Authority in 1933. Although the electric power aspects of Boulder Dam and other reclamation projects, and of the Tennessee Valley Authority, have not been inevitable results of reclamation and the wartime search for nitrates, they are logical developments. Moreover, even though the purposes of these projects include irrigation, navigation, flood control, and prevention of soil erosion, as well as the generation of electric power, it is generally recognized that the power aspects have perhaps the most significance for the future of government ownership of business. The other purposes of these projects have seldom been looked upon as within the scope of private enterprise, while power production has customarily been undertaken by private business.

1. THE RECLAMATION POWER PROGRAM. In undertaking its reclamation work, the federal government has for some time constructed irrigation dams and ditches. Since 1920, it has indirectly engaged in the power business through granting licenses to power companies to produce hydro-electric power at many of the irrigation dams; and in a few cases it has owned and operated its own hydro-electric plants.[1] But the real entrance of the government into the

[1] The net revenue from government owned hydro-electric plants was only $400,000 in 1932. See Wooddy, C. H., *op. cit.*, p. 539.

electric-power business, along with irrigation and reclamation, came with the Boulder Dam project. This project will be discussed presently.

The reclamation program of power production has been increasing rapidly in recent years. Ultimate power installation at twenty reclamation projects, including Boulder Dam, will equal 5,600,000 horsepower. In addition, two other projects, although not strictly reclamation ones, are related to the reclamation program and under the responsibility of the Secretary of the Interior. These projects, the Bonneville Administration and the Fort Peck Dam, will ultimately add 900,000 horsepower, and make the total power installations at federal dams equal to 6,500,000 horsepower, an amount equivalent to 40 per cent of all the hydro-electric power installations in the nation in 1939.[1]

Except for the Grand Coulee project, which may reach an ultimate installation of 2,700,000 horsepower when it is completed, the Boulder Dam installation is the largest of the power plants under the jurisdiction of the Secretary of the Interior. Moreover, Boulder Dam is virtually completed and in 1940 accounted for $4,460,000 of the $7,870,000 gross revenues taken in by all power projects under the federal Bureau of Reclamation.[2]

a. The Boulder Dam project. The Boulder Dam project was introduced into Congress in 1922 by legislation calling for the turning of flood dangers of the Colorado River into valuable irrigation water for the Imperial Valley of California and into electric power. After long debate the bill was finally approved, and became law by the signature of President Coolidge in 1928. The project, expected to be self-liquidating and self-supporting, was financed by the government at a cost to 1940 of approximately $142,000,000.[3] Contracts for construction were let in 1931 and the dam was completed in 1936. It provided for the storage of 30,000,000 acre-feet of water for flood control, power production, and irrigation purposes. The initial power installation was to be 1,835,000 horsepower, with possibilities for increasing this power capacity in the future. By 1940, the actual installation was 975,000 horsepower.[4]

The organization and financing of the Boulder Dam project is rather interesting. The law approving it really provided for an interstate compact between the seven states in the area, although Congress agreed to furnish the funds. But the law stated that it should not be effective unless six of the states ratified the project, and that the funds would not be advanced unless power-

[1] Lineweaver, G. W., "Will the Reclamation Power Program be Continued?" 25 *Public Utilities Fortnightly*, pp. 13–25 (January 4, 1940). The projects listed, all in the Mountain and Pacific states, are: Boulder Canyon (Arizona-Nevada); Grand Coulee (Washington); Central Valley (California); Kendrick (Wyoming); Rio Grande-Elephant Butte (New Mexico-Texas); Shoshone (Wyoming); Riverton (Wyoming); Newlands (Nevada); Grand Valley (Colorado); Minidoka (Idaho); Parker Dam (Arizona-California); Yuma (Arizona-California); All American Canal (California); Strawberry Valley (Utah); Colorado-Big Thompson (Colorado); Salt River (Arizona); Boise (Idaho); Yakima (Washington); North Platte (Nebraska-Wyoming); Uncompaghre (Colorado); Provo River (Utah); Owyhee (Oregon). In the case of two of these power dams, ultimate installation is not known. See *ibid.*, p. 17. The Bonneville project is in Washington-Oregon and the Fort Peck project is in Minnesota.

[2] *Ann. Rep. of the Secretary of the Interior* (1940), p. 95. [3] *Ibid.*, p. 123. [4] *Ibid.*, p. 92.

sale contracts were made which would provide revenues sufficient to return the cost of the project with interest within fifty years. Both conditions were met and legal difficulties cleared in time for letting the contract for construction in 1931.

Furthermore, the government does not really operate the Boulder Dam project, but leases the generating equipment to other parties. The largest operator is the city of Los Angeles, which produces electric energy for itself and the Metropolitan Water District, both public enterprises. A small part of the production is leased to a private company, the Southern California Edison Company.

Although the Boulder Dam project represents a significant incursion of the federal government into business, it is a rather halting one. The government, as stated, did not enter the project until the states in the Colorado basin had signed an interstate compact and until power contracts had been made which promised to cover the costs. Moreover, it did not even go into the business of producing electric energy, having leased its facilities, and at no time did the government plan to distribute power of Boulder Dam to customers. Yet it did encourage public enterprise by giving preference in leasing the power output of the project to publicly owned distributing systems.

b. The Bonneville Administration. Closely related to the reclamation program, although technically not a part of it, is the newcomer to federal power generation and distribution, the Bonneville Administration. The project, created by Congress by legislation in 1937, provides for the construction of a power, navigation, and flood-control dam on the Columbia River with an ultimate electric power installation of 518,400 horsepower. The Bonneville Administration was created as an administrative organization to manage the power production and other facilities of the Bonneville Dam on the Columbia River, and to connect its transmission lines with the larger Grand Coulee Dam, farther up the river.

The Bonneville Administration is not a corporation, as is the Tennessee Valley Authority, but is a semi-independent agency reporting to the Secretary of the Interior. For purposes of effective business administration, a single administrator is placed at the head. The purposes of the project are similar to those of the Tennessee Valley, although far more emphasis was placed on the electric-power aspects by the legislation creating the Administration. Besides navigation and flood control, the law specifically provides that the project is to encourage the widest possible use of electric energy and to bring about uniform rates throughout its transmission area.

The Bonneville project in 1940 [1] had an installed capacity of 86,400 kilowatts, or about one fifth of its ultimate capacity. It has actively begun to serve wholesale customers in southern Washington and northern Oregon.

[1] *Ann. Rep. of the Secretary of the Interior* (1940), p. 128. By 1941, installed capacity was scheduled to be 194,000 kilowatts.

Although it has favored publicly owned enterprises, it does serve one important private company and several large industrial customers near the dam. Profiting from the experience of the Tennessee Valley Authority and from the clarified legal standing of such projects, the Bonneville Administration has entered upon a vigorous policy of building transmission lines to reach customers who might otherwise be unable to use power from the dam.

Although it is too early to discuss results from the operations of the Bonneville Administration, the project bears watching. With the completion of the Grand Coulee Dam, the Administration will have an interconnection with that dam which will make it the largest power project in the world. If the Columbia River is further developed by federal dams, as is now proposed, the Bonneville Administration will surely far overshadow any other hydro-electric development.

2. THE TENNESSEE VALLEY AUTHORITY. A project of the federal government which has caused much consternation among supporters of private enterprise is the Tennessee Valley Authority. Formed in 1933 with the forthright intention of furnishing a public yardstick for private enterprise in the electric power industry, the Tennessee Valley Authority represents the culmination of the struggle to dispose of a World War nitrate plant and the apparent beginning of definite entry of the federal government into the business of producing and distributing electric power.

Under the National Defense Act of 1916, the government undertook the construction of a power dam in the Tennessee River Valley for the purpose of supplying electricity to two of its nitrate plants. The dam and power plants were not completed until 1925 and cost the government $45,000,000. With nitrate plants, auxiliary steam-generating plant, a limestone quarry, and a connecting railroad, the cost of the entire project in 1925 was approximately $80,000,000.[1]

For years, dispute existed over the disposition of the Muscles Shoals properties. Lease of the facilities to private operators was blocked by advocates of public ownership in the Senate, and bills to provide government operation were vetoed by President Coolidge and President Hoover. Not until the inauguration of President F. D. Roosevelt was the issue decided in favor of public operation. One of the first New Deal measures was to create the Tennessee Valley Authority, a government corporation with three directors appointed by the President, to take over and operate the property and to oversee the expansion of the facilities.

a. Purposes of the Tennessee Valley Authority. The legislation under which the Tennessee Valley Authority has been created emphasizes that the principal purpose of the agency is to conserve the resources of the Tennessee Valley, especially by means of flood control and the promotion of navigation. Ac-

[1] Wilson, G. L., Herring, J. M., and Eutsler, R. B., *Public Utility Regulation* (New York: McGraw-Hill Book Company, Inc., 1938), p. 417.

cording to the law, the generation and distribution of electric energy is a subsidiary function of the Authority for the purpose of avoiding wastage of water power and for aid in meeting the cost of the project. The law further provides for unified agricultural and industrial development of the valley through fertilizer production, reforestation, national-defense preparations, experimentation, and other means for the economic promotion of the area. Although the law appears to make production and distribution of electric energy a subsidiary feature of the whole plan, its framers realized that power production would probably be the most important feature. The minor place given to power production was probably due to the believed need for constitutional "window dressing."

b. Development of the program. When the Tennessee Valley Authority was set up in 1933, it took over the dam and nitrate plants and other assets at Muscles Shoals, the value of these properties then being placed at $33,800,000.[1] In 1933, an additional $50,000,000 was put at the disposal of the Authority by congressional appropriation. Other additional appropriations have been made by Congress until, in 1940, such appropriations amounted to more than $270,000,000. In addition, the Authority was given power to issue a limited amount of bonds on the credit of the United States, and in 1940 [2] these had been issued to an amount of over $60,500,000.

The physical plant of the Tennessee Valley Authority has been continually growing. Starting with the Wilson Dam properties in 1933, the Authority has planned for the construction or acquisition of eleven additional dams, of which by late 1940 six were completed, one had been acquired, and four were under construction.[3] All these dams are on the waters of the Tennessee River or its tributaries, and when completed are expected to furnish navigation facilities from the Ohio River to Knoxville, to reduce flood crests on the Ohio, Mississippi, and Tennessee Rivers, and to furnish hydro-electric generating capacity of more than a million horsepower. Even with the proportion of the planned work done, the power sales of the Authority are large. In the fiscal year ending June 30, 1940, it sold 3,629,677,000 kilowatt hours of electricity and took in revenues from electric power of $15,125,000. This volume of business was well over twice that of 1939, and nearly ten times that of 1936.[4]

Under the law the Authority must give preference in the sales of power to publicly owned distributing systems. As the result of government encouragement under Public Works Administration allotments and the inducement of obtaining low-priced power in the Tennessee valley, many publicly owned enterprises have developed there. The Authority has undertaken to furnish these enterprises with power and to build transmission lines from the dams.

[1] *Ann. Rep. T.V.A.* (1940), p. 55. [2] *Ibid.*, pp. 54–55.

[3] In addition, four additional tributary dams were acquired from the Tennessee Electric Power Company in 1939. *Ibid.*, p. 18.

[4] *Ibid.*, p. 19.

In the case of some transmission lines and of most local distributing systems, the Authority and the distributing public enterprises often found themselves in competition with a privately owned company. The policy of the Authority in these cases has been to bargain with the private company for the sales of facilities at prudent investment costs less depreciation. The facilities so purchased are divided between those belonging to the distributing municipality or county and those which the Authority takes over. As the result of such purchases, by August, 1940, the Authority and its wholesale contractors (the publicly owned enterprises) had bought $116,711,000 worth of private electric facilities, of which the Authority's share was $54,000,000.[1]

In addition to the purchase of transmission lines from private companies, the Authority has embarked upon an extensive program of building its own distribution facilities, although it does not, except for a few industrial customers and some temporary rural service, distribute power to the public directly. The Authority often transmits the power to the substation of the wholesale purchaser, however, and usually fixes the terms upon which this power will be sold to the local customers. In 1940, the Authority was serving 75 municipalities, 3 counties, 35 co-operatives, 12 temporary rural districts, 7 large industrial plants, and 17 privately owned public utilities. To do this has naturally required a large investment in transmission lines and other distribution equipment.

c. Legality of the program. The United States Supreme Court has upheld the legality of the Tennessee Valley Authority program in general. In a major case handed down in 1936, it held that the Wilson Dam and its power plant must be taken to have been constructed constitutionally through the power of the federal government for national defense and promotion of navigation; and that with power to construct the properties determined, the disposal of electric energy from the dam was clearly given by the constitutional grant to Congress of plenary power for disposal of properties of the United States.[2]

When some of the private companies in the territory of the Tennessee Valley Authority undertook to stop the purchase of private plants and distribution lines, the Supreme Court again held in favor of the Authority in 1939.[3] It did not decide the issue as to whether the Authority could constitutionally purchase private plant facilities to facilitate the disposal of "surplus" power from its dams. Instead, it held that the private utilities did not hold exclusive franchises for their operations, and hence, not being damaged by the purchases, had no legal standing to maintain the suit.

d. Financial aspects of the program. The Tennessee Valley Authority has become a large governmental enterprise with more than a third of a billion dollars of assets. But it is a multiple-purpose enterprise with its fixed assets devoted to navigation, flood control, power production and distribution,

[1] *Ann. Rep. T.V.A.* (1940), pp. 86–87.
[2] *Ashwander v. T.V.A.*, 297 U.S. 288 (1936).
[3] *Tennessee Electric Power Co. v. T.V.A.*, 306 U.S. 118 (1939).

fertilizer production, and economic planning in the Tennessee Valley. The character of the assets and the investment in each, along with the financial results to June 30, 1940, are shown in the Authority's balance sheet in Table XIX. The net expense is shown as a deficit item under the liabilities and indicates a profit on the power business, but losses on all the other activities. Except for fertilizer production, which might be expected to show a profit at some time in the future, the losses on most of the Authority's activities are not surprising. Flood control and developmental operations are almost invariably carried on at a loss by government to be charged to taxpayers. Even though the navigation program will not be in full operation until all projects are completed, it is not purposed to charge tolls on the waterway resulting, and these costs will naturally be charged to taxpayers.

TABLE XIX. BALANCE SHEET OF THE TENNESSEE VALLEY AUTHORITY
JUNE 30, 1940
(000's omitted)

Assets:			
Current Assets			
Cash and cash funds			$17,563
Receivables			7,426
Inventories			2,381
	Cost	Accrued Depreciation	Depreciated Investment
Fixed Assets			
Dams, locks, etc.	$205,758	$11,774	$193,984
Transmission and other electric plant	85,948	5,750	80,198
Fertilizer plant	4,682	947	3,735
General plant	10,170	2,985	7,185
Construction in progress	35,112	....	35,112
Investigations	263	....	263
Total Fixed Assets	$341,933	$21,456	$320,477
Total Assets			$347,847
Liabilities:			
Current Liabilities			$ 7,253
Funded Debt			60,573
Appropriations from Congress			270,069
Property Transferred from War Dept.			33,812
Net Expense (or *Net Income**) *of Programs*			
	Year ended June 30, 1940	June 16, 1933 to June 30, 1940	
Navigation	$ 856	$ 2,847	
Flood control	444	2,025	
Power	4,299*	5,194*	
Fertilizer	2,473	11,043	
Related property	847	3,997	
Developmental activities	1,409	9,142	
Total Expense (deficit)	$1,730	$ 23,860	
Total Liabilities			$347,847

Source: Ann. Rep. T.V.A. (1940), pp. 54–55.

Where much division of opinion has come is in the allocation of costs of electric-power generation and transmission, and the question of whether these operations are being carried on at a loss. Obviously, the proportion of fixed investment allocated to power will have a great effect upon the total costs of producing electric energy. Although the allocation of investment made, and the costs based on it, have been both approved and disapproved by members of a congressional investigating committee and others,[1] any student of economics must realize that the principles of joint cost involved make any allocation arbitrary. Dams constructed for more purposes than power production involve costs the allocation of which cannot be accurately or logically made.

The accounting for costs has also been attacked on the grounds that depreciation charges are too small, that the Authority does not pay for the use of most of its capital, and that taxes are not the equivalent of those paid by private companies. Although the depreciation rates vary from 1.15 per cent per year on some dams to 2.5 and 3.75 per cent on electrical turbines, generators, and other equipment, and do seem rather low, they are not far out of line with rates used in private industry and have been approved as reasonable by the congressional investigating committee.[2] Taxes have been paid on the basis of 5 per cent of gross revenues from electric production, in comparison with much higher rates paid by private companies, although Congress provided in 1940 for temporarily increasing them to 10 per cent.[3] While this higher percentage is still lower than that of private companies, the increase does indicate a disposition on the part of Congress to deal fairly with local and state governments on the score of taxation.

The Tennessee Valley Authority has not paid the federal government any returns on the investment made, but the profits from the electric business would make such a return possible. However, any such profits have been, and are likely to be, reinvested or absorbed in the costs of non-revenue-producing projects. Even so, the return made on the electric generating and distributing business has been rather modest, although it has shown marked improvement in the last year. In 1940, the Tennessee Valley Authority claimed that it had made an annual return of approximately 3 per cent on the investment in completed plant facilities.[4] But since this computation is not based on

[1] See majority report supporting the allocation and minority report attacking it, in *Report of the Joint Committee Investigating the T.V.A.*, Sen. Doc. 56, 76th Cong., 1st Sess. (1939). The periodicals have included a large number of articles attacking the allocation.

[2] *Ibid.*, pp. 153–61. The committee also approved the tax costs.

[3] *Ann. Rep. T.V.A.* (1940), p. 402. As passed in 1940, the law provided that the 10 per cent figure should apply to the first year (ending June 30, 1941), and should thereafter be reduced annually until in 1948 the tax should be 5 per cent of gross revenues.

[4] *Ibid.*, p. 45. The Authority based its calculation on an investment figure which allocated 40 per cent of joint-purpose facility investment to power, 36 per cent to navigation, 24 per cent to flood control, and none to fertilizer production or national defense. With this allocation plus single-purpose facilities attributable to power, approximately 52 per cent of the total investment has been allocated to power. This was approved by President Roosevelt in December, 1940. See *ibid.*, p. 414.

total investment in power facilities, and since question exists as to the adequacy of certain depreciation allowances, the tax costs, and the allocation of assets to power production, the return is not particularly large.

e. Is the T.V.A. an accurate yardstick? The question which persons interested in the Tennessee Valley experiment are asking is whether the project furnishes an accurate yardstick of public-utility rates by which private power company rates can be measured. There can be no doubt that electric rates in the Tennessee Valley are low and that electricity consumption is high in comparison with the national average.[1] But not only are rates of customers of Tennessee Valley Authority distributors low, and their consumption high, but the private companies in the area also serve at low rates and obtain large consumption. Although the private companies deny that government competition has forced them to embark on low-rate policies, which in many cases have proved to be profitable, the low rates of the Tennessee Valley Authority have probably accounted for them.

Granting that the Tennessee Valley Authority has caused rates to fall in the geographical area it serves, and to some extent throughout the United States, do the cost and rate aspects of its power program prove that government can produce power more cheaply than private companies? In other words, is the Tennessee Valley Authority an accurate yardstick? As one writer has pointed out, the question of the accuracy of rates as a yardstick can hardly be settled when agreement cannot be obtained upon the question of the proper cost of facilities to be allocated to power production.[2] The question of accuracy of cost certainly does depend upon the allocation of costs between projects, and these joint costs can only be apportioned arbitrarily.

Furthermore, the yardstick comparison is spoiled somewhat by the investment of government funds at little or no cost to producers and distributors of Tennessee Valley Authority energy. The appropriations and lack of return on government investment in the case of the Authority's properties have already been noted. In addition, many of the municipalities and rural cooperatives which purchase power from the Authority for ultimate distribution received liberal Public Works Administration grants in financing their publicly owned distribution systems.

f. The Tennessee Valley Authority: conclusions. The Tennessee Valley Authority has weathered the storm of court suits, internal dissension of directors, a congressional investigation, and continuous public scrutiny by private power interests and others, many of whom are prejudiced against its program. In the face of such difficulty, one might wonder that the program has survived. But, in the view of this writer, the Authority has come through its difficulties

[1] Customers of T.V.A. distributing agencies used an average of 1353 kilowatt-hours in 1940, against the national average of 925, and paid an average rate of 2.11 cents per kilowatt-hour, against the national average of 3.91 cents. See *Ann. Rep. T.V.A.* (1940), p. 25.

[2] See comments of Professor B. W. Lewis in Lyon, L. S., Abramson, V., and others, *Government and Economic Life* (Washington: Brookings Institution, 1940), vol. II, p. 742.

with exceedingly high credit. Tales of political corruption and inefficiency seem to be blasted by the facts turned up in the congressional investigation.[1] The record of the directors and the responsible employees appears to be a credit to the public service.

The primary difficulty in assessing the Tennessee Valley Authority lies in its multiple-purpose program. It combines governmental services in the interests of conservation and navigation with business enterprise. The directors are forced to administer a part of the program as a business enterprise and the rest as an economic planning and social rehabilitation program. In any such project, one is likely to find difficulty in weighing the merits of each. Thus, it is extremely difficult to tell, if possible at all, whether the electric production proves either the efficiency or the inefficiency of government in business.

In many respects, the Tennessee Valley Authority has been an outstanding success. The social and economic rehabilitation of the areas in and about the Tennessee Valley has proceeded with remarkable success. The experiments in fertilizer production appear also to be valuable, although more time is needed for any very definite conclusions on this score. The power policy of the Authority has very clearly stimulated the use of power, and has aided in showing to private public-utility companies that the demand for electric energy may be so elastic as to make low rates more profitable than high rates. In this very connection the project furnishes an interesting and valuable addition to regulation. As may be recalled, regulatory authorities cannot usually force private utilities to charge lower rates to stimulate consumption unless they can prove that these will yield operating expenses plus a fair return on utility investment. Often, regulatory authorities have their hands tied in forcing mass-production and mass-consumption policies on private utilities. But an experimental program like that of the Tennessee Valley Authority cannot only show that these policies may succeed, but can put the pressure of potential competition on private companies to get them to adopt such policies.

D. FEDERAL GOVERNMENT OWNERSHIP: FINANCE, HOUSING, AND OTHER CASES

In addition to the Post Office, transportation undertakings, and power projects, the federal government owns and operates many other businesses, most of which have traditionally been regarded as within the sphere of private enterprise. Of particular importance are banking and housing, although several other interesting cases might be mentioned.

1. FEDERAL GOVERNMENT OWNERSHIP: FINANCE. In following out its program of control of and assistance to business groups, the federal government has set up many financial institutions in which it has partial or entire

[1] For the evidence adduced in this investigation, see *Hearings before the Joint Committee on the Investigation of the T.V.A.*, Pursuant to Pub. Res. 83, 75th Cong., 3d Sess. (1939).

ownership interest. The Federal Deposit Insurance Corporation is partially owned by the government and operates a system of bank-deposit insurance. The many agricultural credit agencies and the credit agencies for home-owners represent cases of governmental assistance and also government ownership. The Reconstruction Finance Corporation is, of course, a governmentally owned super-bank with powers to lend widely to a variety of businesses and for other causes.

Other lending activities of the government have been devoted to the encouragement of the use of electric power. The Rural Electrification Administration has made loans to promote the extension of electric power lines into rural areas, largely by financing rural co-operative groups.[1] The Public Works Administration has made loans and grants to local governments to enable them to construct or purchase publicly owned generating or distributing facilities, and has also included rural distribution systems within its program. Financial assistance has also been given to consumers for the purchase of electrical appliances. The Electric Farm and Home Authority was incorporated in 1934 with power to purchase conditional sales contracts arising from purchase of appliances through regular retail channels. The Authority has insisted on special terms, such as low down payments and financing charges, and has done much to reduce the prices of appliances in areas in which it operates.

Other government corporations or agencies which are really in some aspect of banking might be noted. However, these cases of government ownership have already been dealt with in connection with the program of regulation and control, and further comment here is unnecessary.[2]

2. GOVERNMENT OWNERSHIP: HOUSING. In addition to assistance to private builders of houses and other buildings, the federal government has gone into the business of constructing and operating housing projects. In order to stimulate low-cost housing developments, it supplemented its favorable loan policy by actual construction of many housing projects.

The government first entered the housing business in 1917 during the first World War. At that time, two agencies were concerned with the work. The United States Housing Corporation in the Department of Labor carried on 40 housing projects in 26 localities, and owned and operated accommodations for 6000 families and 8000 single men and women.[3] The United States Shipping Board also constructed houses for 28,000 individuals. At the end of the war, the government withdrew from its low-cost housing operations.

In 1932, the Reconstruction Finance Corporation was empowered to make loans to self-liquidating building projects undertaken by limited-dividend

[1] For an analysis of the loans and program of the Rural Electrification Administration, see *Ann. Rep. of the R.E.A.* (1939).

[2] See *supra*, especially Chapters 21, 24, and 29.

[3] Schoenfeld, M. H., "Progress of Public Housing in the United States," 51 *Monthly Labor Review*, pp. 267–82, at p. 269 (August, 1940). Most of the data in this section have been drawn from this source.

corporations under state and municipal control. In 1933, the Public Works Administration was authorized to promote low-cost housing. At first, the Administration undertook to stimulate construction by loans to limited-dividend housing corporations set up under state law, but the failure of the loan policy led to direct construction of low-cost housing by the Administration. When the United States Housing Authority was created in 1937, the 50 projects in 35 cities undertaken by the Public Works Administration were taken over by the former agency.[1]

The United States Housing Authority was directed by law to sell or lease the Public Works Administration projects as soon as possible. By 1940, all the projects, except 17 operated temporarily by the Housing Authority, had been leased to publicly owned housing agencies. In addition to its function to sell or lease the Public Works Administration projects, the Authority was given power to make loans to public housing agencies in the states to enable the latter to erect and operate low-cost housing. The law authorized loans to be made up to 90 per cent of the developmental cost, and also provided for an annual subsidy to permit rentals consistent with incomes. By June, 1940, the Housing Authority had negotiated contracts for loans amounting to $638,000,000 with 171 local authorities for the construction of 413 public housing projects.[2]

The federal government has hardly entered the field of housing construction and operation as a business. The dominant motive has been to provide needed low-cost housing for social betterment, and at the same time to give employment to workers in the construction and allied industries. The housing program thus represents another type of governmental economic activity which is dominated by non-economic motives. The government has made no attempt to cover its costs. The Public Works Administration made outright grants of 45 per cent of the construction cost, and the Federal Housing Authority makes annual allowances to public housing agencies to enable them to charge low rents and still cover costs. The average annual Federal Housing Authority subsidy so resulting has been estimated at $72 per family per year, and with housing projects provided in 1940 for 160,000 families, the direct subsidy at that time was at the rate of $11,500,000 annually.[3]

3. Other Cases of Federal Government Ownership. Cases of federal government ownership of business, other than those discussed, might be mentioned. Some of the executive departments compete with private manufacturers by producing firearms, ammunition, uniforms, ship stores, stationery, and innumerable other goods.[4] The Virgin Islands Company was established

[1] The Public Works Administration projects were located in twenty states, the District of Columbia, Puerto Rico, and the Virgin Islands, and involved a cost of approximately $127,000,000. See Schoenfeld, M. H., "Progress of Public Housing in the United States," 51 *Monthly Labor Review*, pp. 271–72 (August, 1940).

[2] *Ibid.*, p. 274. On that date only thirty of these projects had been constructed or occupied.

[3] Derived from data in *ibid.*, pp. 274–75.

[4] A congressional investigating committee found in 1933 that the federal government was competing with private enterprise in some two hundred and twenty-five lines of industrial activity. See *Government Competition with Private Enterprise*, H.R. 1985, 72d Cong., 2d Sess. (1933).

in 1934 through a grant of $2,000,000 from the Public Works Administration for the purpose of promoting economic rehabilitation in the Virgin Islands by assistance in raising and processing sugar and the manufacture of rum. The Federal Prison Industries, Incorporated, was created in 1934 to operate shops and factories in federal correctional and penal institutions and to sell the products to government agencies.

E. STATE GOVERNMENT OWNERSHIP

Although at present the state governments are not widely engaged in business, there have been many notable incursions into state businesses in the past. State banks were common and many states constructed turnpikes and canals in the early nineteenth century. State governments also contributed to or constructed railroads. But the depression of 1837–1842 brought most of these enterprises to a halt, and involved the states in tremendous losses from operations by which it had been hoped to make profits capable of supplementing, or making unnecessary, tax revenues. The lack of business administrative techniques and of an appreciation of business methods and judgment made these state enterprises doomed from their beginning.

Of the present instances of state ownership of business, perhaps the most important are the ownership and operation of special transport facilities, the operation of state liquor stores, housing activities, and state-owned insurance funds. Although a number of states operate canals and provide harbor facilities, toll bridges, and ferries, perhaps the most representative and largest of such enterprises are the New York Barge Canal and the Port of New York Authority. In a sense, the New York Barge Canal is not a business enterprise, since it charges no tolls, but its predecessor, the Erie Canal, was a toll-charging project and the present canal does shed some light upon the character of governmentally owned businesses.

1. THE NEW YORK BARGE CANAL. The New York Barge Canal is perhaps the most important of the purely artificial waterways in the United States, and owes its beginnings to the once profitable Erie Canal, constructed between 1817 and 1836. The present canal is really the result of extensive reconstruction of the Erie Canal and other New York canals between Buffalo and Oswego and Albany. This reconstruction followed upon authorization of $101,000,000 by New York in 1903 for the project. Further funds were appropriated until the total construction costs by 1936 aggregated $177,000,000, of which $26,000,000 had been expended for terminal facilities.[1]

The New York Barge Canal provides a canal system five hundred and twenty-five miles long, with a minimum bottom width of seventy-five feet and a minimum depth of twelve feet. No tolls are charged, and although the state obtains some revenues from facilities along the canal and at its terminals, they are

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation* (1940), vol. III, p. 48.

rather insignificant in view of the maintenance cost. From 1931 through 1936, the maintenance and operation cost averaged $2,850,000 per year, and revenues averaged only $650,000 per year.[1]

The New York Barge Canal has not been operated, however, as a business venture, and the question of operating losses would appear not to be very important. Nevertheless, the canal is justified as a transportation facility which brings business to New York State and performs socially desirable service at low cost. Studies made of the costs of maintaining and operating it indicate that it has been an investment of rather questionable value for the state. Moulton found in 1933 that the inclusive cost of transportation for the traffic handled was nearly double that of privately owned railroad companies; that the taxpayers of the state contributed 10 mills per ton-mile to effect at most a reduction of 1 or 2 mills in transportation rates to shippers; and that the abandonment of the canal would make possible a reduction in railroad rates and increased tax contributions to government, as well as a saving in the annual maintenance charge.[2] Moulton's conclusions were later substantiated by the study of the Federal Co-ordinator of Transportation.[3]

2. THE PORT OF NEW YORK AUTHORITY. Few cases of government ownership of business have elicited more praise and less criticism than have the operations of the Port of New York Authority. This agency was created jointly by New York and New Jersey in 1921 as a government corporation with power to prepare plans for port development and to construct and operate toll bridges and tunnels leading into New York City. The two states concerned provided capital funds of $17,500,000, with the provision that the Authority should repay this investment with interest. All other funds have been obtained by borrowing in the open market. While the states do not guarantee the bonds of the Authority, the law establishing it provides that the annual payment of 4 per cent interest and 2 per cent amortization charges to the states need only be made if the corporation has a surplus above operating expenses, interest on its bonds, and amortization and reserve funds, and that the payments shall not be cumulative.[4] Hence, the lien of the states is subordinated to the claims of the bondholders. This provision, along with the success of the Authority, has enabled it to borrow needed funds easily and at low rates of interest.

Since its formation, the Port of New York Authority has built the Holland Tunnel, the George Washington Bridge, the Bayonne Bridge, the Goethals Bridge, the Outer Bridge, and the Lincoln Tunnel, at a cost of more than $200,000,000. In addition, it has constructed and operated the Union Inland Freight Terminal in New York City. In spite of the fact that deficits have

[1] Federal Co-ordinator of Transportation, *Public Aids to Transportation* (1940), vol. III, p. 48.

[2] Moulton, H. G., and others, *The American Transportation Problem*, p. 476.

[3] Federal Co-ordinator of Transportation, *loc. cit.*

[4] Thurston, John, *Government Proprietary Corporations* (Cambridge: Harvard University Press, 1937), pp. 124–25.

been suffered on all facilities except the Holland Tunnel, the George Washington Bridge, and the freight warehouse, the Authority has made net profits each year, over and above operating expenses, interest, and other charges. These profits were equal to $4,345,000 in 1938 and $5,450,000 in 1939.[1] They have been used largely to amortize investments and to accrue reserves.

The success of the Port of New York Authority may be traced to some extent to the high degree of autonomy bestowed by the states creating it. Also the directors have insisted that their position is one of public trust and that their duty is to follow a course of action which will enable them to pay interest on bonds and to amortize the cost of the tunnels and bridges which they operate.[2] Without doubt, it has been this attitude, and the capacity to make it prevail over the popular demand for low tolls and enlarged facilities, that has accounted in very large part for the Authority's success.

3. STATE LIQUOR STORES. Following the repeal of the Eighteenth Amendment and the legalization of sale of intoxicating beverages, many states entered the business of dispensing liquor to customers. The establishment of state-owned liquor stores has been justified as a measure to supplement regulation of manufacture and use, to avoid the perplexing problems arising in connection with sale of liquor, and to provide revenues to the states. Seventeen states have set up stores and, while most of these have a monopoly on package liquor, the great majority allow sales by the glass by any licensed vendor.[3] In addition to the primary purposes mentioned state operation has sometimes been justified as a means of getting the good to customers at low cost, and prices are generally lower in the states having a monopoly on the retailing of packaged intoxicants.

State operation of liquor stores has been uniformly profitable and has probably meant lower distribution costs than is the case in states in which private stores operate. Although states with private enterprise in retailing liquor get large income from license fees, and in a few this return may be as high as or higher than profits which would be obtained from state stores, the operation of the latter usually means that retail outlets are fewer and that savings can be obtained from volume purchases. Moreover, state stores have not been bound by resale price maintenance contracts and hence have not been forced to charge the high markups prevalent on many nationally advertised brands.

Although state operation of retail liquor stores opens the way for political influence to lead to inefficiency, the retailing of intoxicants is a kind of business in which a state may profitably engage. The state need not bother with manufacture or the building up of confidence in a trade-name. Moreover, the

[1] 19th *Ann. Rep. Port of New York Authority* (1940), pp. 67–70.

[2] See excerpts of a speech of one of the directors, 146 *Financial and Commercial Chronicle*, p. 1113 (February 12, 1938).

[3] Hall, F. P., *Government and Business* (New York: McGraw-Hill Book Company, Inc., 1939), pp. 423–24. For a discussion of the state stores and their operation, see Shipman, G. A., "State Administrative Machinery for Liquor Control," 7 *Law and Contemporary Problems*, pp. 600–20 (October, 1940).

demand for intoxicating beverages is relatively inelastic and fairly stable, so that price policies and inventory problems are relatively unimportant. From a business management point of view, the retailing of liquors, especially with a state monopoly, is not particularly complex.

4. INSURANCE. In analyzing workmen's compensation insurance and unemployment insurance, the existence of state-owned insurance systems was discussed.[1] With the advent of unemployment insurance on a national scale, such systems have in reality become so much a part of the national government program that they can hardly be regarded as examples of the state government in business. The state does its own accounting for the unemployment insurance scheme, but the plan is under close supervision of the Social Security Board and the funds are kept in the federal treasury. But for the handling of compensation insurance, many of the states requiring it operate funds which virtually put them in business. Experience indicates that they have generally administered these plans effectively and efficiently.

Occasionally other kinds of insurance are handled by the state governments. Wisconsin has a state life insurance system, and North Dakota, South Dakota, and Oklahoma have had state hail insurance for crops. Moreover, in certain states, such as Massachusetts, systems have developed under state guidance for the insurance of deposits in savings banks. Beyond compensation insurance, however, the entry of states into the insurance business has not been great enough to warrant much attention.

5. HOUSING. To an increasing extent, especially with encouragement by the federal government, the state governments have been going into low-cost housing. They have done so through authorizing the formation of housing authorities, state corporations with power to investigate housing conditions, to construct projects, and operate them. In a few states, a housing authority is given a wide jurisdiction and most of the low-cost developments are handled by it. In most cases, however, the state authorizes localities desiring a low-cost development to set up housing authorities.

These local and state housing authorities are the agencies referred to in the discussion above on the federal government and housing. They receive the construction funds, up to 90 per cent of the cost, from the Federal Housing Administration, and also obtain subsidies to allow rentals to be low enough for the low-income classes. Since the program has been treated above,[2] further attention need not be paid to these subsidies here.

F. MUNICIPAL OWNERSHIP: PUBLIC UTILITIES

As was noted in the first part of this chapter, the municipal governments have entered into a wide array of business enterprises, most of which fit into the category of public utilities. Of 2018 representative cities, it was shown

[1] See *supra*, pp. 722–23. [2] *Supra*, pp. 879–80.

that only 12.3 per cent had no publicly owned enterprises, and virtually all of these were municipalities with 50,000 or less population.[1] Of those enterprises which are more likely to be regarded as businesses and in which private enterprise is believed to have a proper field, the most important in which the municipalities have entered are those furnishing water supply and electric service. With encouragement by the federal government to municipal ownership of electric light and power plants and generating systems, through Public Works Administration loans and federal power installations, the question of municipal ownership of this public utility, at least, is likely to assume increasing importance in the future. As a matter of fact, municipal ownership of electric light and power may well become the principal battleground in the struggle between public and private ownership of business.

1. THE TREND OF MUNICIPAL OWNERSHIP. The trend of municipal ownership of public utilities is particularly interesting in the cases of water supply, gas, street transportation, and electric power, since these utilities are generally operated as businesses, as distinct from public service, and are clearly open to the alternative of private ownership. The supplying of water service by municipal enterprise has shown a consistent increase since the opening of the nineteenth century, when most of the existing waterworks were privately owned.[2] Municipal ownership of gas generation and distribution facilities has, on the other hand, shown an opposite trend. In 1899, there were 12 municipal gas utilities, or 1.1 per cent of the total number of gas plants, and this number increased to 132, or 6.5 per cent of the total, in 1914, after which time the number has declined so that by 1940 there were only 78, or 3.9 per cent of the total.[3] Municipal ownership of street-railway and bus lines has shown some tendency to increase, although such cases have never been very important. The number of street-railway enterprises operated by municipalities increased from 1 in 1907 to 20 in 1927, and declined to 10 in 1940, but the number of bus operations had increased to 22 in 1940, thereby making the total of street-transportation enterprises owned by municipalities 32 in 1940.[4]

The trend in municipal ownership of electric power facilities has been rather mixed. From a beginning of four municipal plants in 1882, the number increased to 3066 in 1923.[5] But after 1923, the number declined until in 1932 there were only 1849 plants. Since 1932, however, the number has increased so that in 1939 there were 2102 municipally owned and operated

[1] See *supra*, p. 850.

[2] Wilson, G. L., Herring, J. M., and Eutsler, R. B., *Public Utility Regulation*, p. 522, and *Municipal Yearbook* (1941), p. 41.

[3] Jones, E., and Bigham, T. C., *Principles of Public Utilities* (New York: The Macmillan Company, 1932), p. 733, and *Municipal Yearbook* (1941), p. 41. Of the 78 plants in 1940, only 44 were engaged in both generation and distribution, the remaining plants distributing gas only.

[4] Jones, E., and Bigham, T. C., *op. cit.*, p. 736, and *Municipal Yearbook* (1941), p. 41.

[5] Dorau, H. B., *Changing Character and Extent of Municipal Ownership* (Chicago: Institute for Research in Land Economics and Public Utilities, 1929), p. 12.

utility establishments.[1] Of course, the number of establishments does not give a true picture of the importance of municipal ownership. At the time in which the number of plants was decreasing the horsepower installations showed a very large increase. Thus, although the number of municipal generating plants was only a few more in 1930 than in 1903, their horsepower capacity had increased tenfold.[2] Technological changes had resulted in the improvement of interconnection and the increase in efficiency of large generating plants, with the result that many small plants became obsolete, and a number of municipalities with small plants purchased their power from large public or private generating systems. Even though the capacity of municipal plants increased during the period in which their number decreased, this increase was not as large as that in the industry. This indicates that the relative position of municipal plants was declining, and may be traced to the development of large privately owned power systems under the impetus of holding companies. These systems often purchased municipal plants at high prices during the 1920's in order to expand their influence, and also offered municipalities such favorable wholesale power rates that the public enterprises gave up their generating business and merely maintained their operation of distribution systems.

The reversal of the downward trend of municipal ownership of electric utilities since 1932 has been interesting. Not only have the number of municipal enterprises and generating plants increased, but the production of electric energy has increased faster than has that of privately owned utilities.[3] The explanation is found largely in the policy of the federal government to encourage municipal ownership by Public Works Administration grants and loans, and by the generation of hydro-electric power by such agencies as the Tennessee Valley Authority, which give preference to publicly owned distribution enterprises. The importance of the hydro-electric program has already been discussed. The influence of the Public Works Administration can be noted from the fact that by 1939 it had allocated $205,000,000 to help finance local public ownership, of which $98,000,000 represented outright grants.[4] In addition to the encouragement of the federal government, state governments have removed some of the legal barriers to effective municipal ownership, by allowing municipalities to finance public-utility enterprises through revenue bonds, outside the municipal debt limit and supported by revenues

[1] The reader should note that the data on electric utilities are not comparable with information previously cited from the *Municipal Yearbook*, since that publication does not take into account municipalities of less than 5000 population, and the data used here for electric power ownership include smaller localities. In the case of other utility services, the exclusion of smaller municipalities is not significant, since such services are not likely to be so prevalent in such places.

[2] Lyon, L. S., Abramson, V., and others, *Government and Economic Life*, vol. II, p. 729.

[3] *Ibid.*, p. 731.

[4] P.W.A., *America Builds: The Record of P.W.A.* (1939), p. 278. These expenditures were for 117 new systems and 223 additions to existing systems.

from electric operations, and by allowing municipalities to serve customers living beyond their boundaries.

2. Some Problems of Municipal Ownership. In addition to the drawbacks which face any government industry, which will be summarized presently,[1] municipal public-utility enterprises have faced certain special problems which have hampered them in serving adequately and efficiently. One of these is the practice of furnishing services free to the municipality; water service may be given without cost to the fire department and the city departments, and electric power may be made available for street lighting and other services without charge. The result of such practices is often to make the municipal enterprise appear to be less profitable than it is. Or if the rates to customers are made high enough to cover these services, some of the cost of government is levied on the users of utilities rather than upon the general taxpayers. In this connection, it is pertinent to note that financing of government costs by high rates to users of utilities is not necessarily consistent with the best application of the tax principle of ability to pay.

Closely related to the problem of free services is that of a successful municipal enterprise charging its customers too much and using the profits to replace tax costs of government. Profitable operation is often not difficult, especially with such services as gas, water, and electricity, the domestic demand for which may be relatively inelastic in the upper price ranges. The making of an excess profit is subject to the same objections on the score of sound tax principles as is the granting of free utility services to municipal government departments. However, it would seem reasonable to allow the municipality to charge rates which would cover operating expenses, a payment equivalent to taxes which a private company would pay, and a fair return on the investment. If these items were allowed in calculating rates, the user of municipal utility service could hardly feel injured, the rates charged would present a fairer yardstick for measuring results under private ownership, and the taxpayers could obtain a reasonable benefit from business revenues of the municipality.

Another difficulty which has thwarted many municipalities in the entry or expansion of utility service is the practice of most states of placing debt limitations on their local subdivisions. While one cannot deny that limitation of municipal debts contracted for non-revenue-producing services is highly desirable, this has sometimes meant that a municipality cannot enter the business of furnishing utility service, or, if already engaged in it, has been unable to finance extensions and betterments. Since expenditures may be necessary to make a municipal enterprise efficient and to enable it to serve adequately, debt limitation may not be wise in all cases. If a municipal utility is well operated, the addition to a locality's debt for purchase of utility assets may be a sound reason for increasing debts. To ease the burden of debt limitations, some states in recent years have been allowing bonds for utility enterprises to

[1] *Infra*, pp. 892–94.

be floated outside these limitations, if the indentures bind the municipality to payment of interest and principal from income of the utility services only.

Until the development of publicly owned power districts or power areas receiving energy from some large public power-production plant, and the growth of interconnection between municipal utilities and private utilities, one of the greatest obstacles facing municipal utilities was to have a plant large enough to be efficient. With technological changes in the industry making large plants most efficient, many small systems found that they could not generate and distribute power as cheaply as a private company with its far-flung connections could. The inefficiencies of small size, particularly in generation of electricity, had much to do with the decline of municipal ownership in the 1920's, and is still a serious drawback to its institution in many smaller localities. The development of Diesel-powered electric generation plants has served to modify this disadvantage to some extent, however.

3. State Regulation of Municipally Owned Utilities. As a general rule, operations of municipally owned utilities are not subject to regulation by the state public service commission. By the middle of 1940, only thirteen states placed municipalities under the jurisdiction of their commissions, and in a few cases this jurisdiction was limited.[1] A few additional states impose jurisdiction only upon municipal utility operations outside of corporate limits.

The wide lack of public regulation of municipally owned utilities is explained by the general belief that a city owning its utility services is subject to direct control of the customers through the polls, and that these customers do not need state intervention to protect them. Although this may be true in very many cases, the writer questions whether such control is adequate to allow municipalities to be free of regulation. With political control existent in many municipalities and with very little real power in the hands of unorganized individuals, there are often as great possibilities for abuse as exist in privately owned enterprises. Perhaps the possibilities are even larger, since the operators of a publicly owned enterprise need not fear the competition of private ownership, as the privately owned company often fears public ownership. If for no other reason than to prod public officials to adopt accurate and modern accounting methods and to take an aggressive interest in promotion of service through experimentation with rates, state regulation would seem to be advisable. And when it is realized that it may remove abuses which can creep into municipal business enterprises, there appears to be reason to believe that it might do good, and certainly should cause no harm.

4. Municipal Ownership: Conclusions. Most of the questions regarding the advantages and disadvantages of municipal ownership of public utilities

[1] Welch, F. X., *Cases on Public Utility Regulation* (Washington: Public Utilities Reports, Inc., 1936), supplement no. 4 (1940), p. 120. The states so regulating municipal utilities were Indiana, Maine, Maryland, Massachusetts, Missouri, Montana, Nevada, New York, Rhode Island, Virginia, West Virginia, Wisconsin, and Wyoming. Jurisdiction was limited in Massachusetts and Missouri.

are also applicable to government ownership generally, and they will be discussed as aspects of the wider problem. Perhaps the most significant question is that having to do with charges under public ownership as compared to private ownership. Except for such cases as public markets and auditoriums, municipalities have generally entered the public service business to make total costs and perhaps a profit, at the same time furnishing adequate service at reasonable rates to customers.

On the question of reasonable rates under municipal ownership, the only rather comprehensive data available are concerned with electric utilities. In the last few years, the Federal Power Commission has collected information pertaining to rates charged by publicly owned electric-power companies in comparison to rates of privately owned companies. Data on average electric bills in several size groups have indicated that the rates of publicly owned utilities are generally lower than those of privately owned.[1] This was true for all size groups of communities above 2500 population. In communities of less than 2500 population, the privately owned companies indicated lower rates.

In order to meet the criticism of private companies that public enterprises pay no taxes and hence do not have as high costs, the Federal Power Commission also made a study of taxes and tax equivalents. It found that in 1936 the privately owned plants paid on the average 13.2 per cent of their gross revenues in taxes. Publicly owned enterprises, on the other hand, paid through taxes and net cash contributions an average of 17.3 per cent of their revenues. In addition, publicly owned utilities were paying the equivalent of 8.5 per cent of their revenues in free services, while the corresponding payments by privately owned utilities were negligible.

Consequently, the studies of the Federal Power Commission indicate that, on the average, municipally owned electric utilities furnish service at as low cost as privately owned companies, if, indeed, they are not doing so at a lower cost, especially when the extra burden of free services is considered. However, the averages of the Commission leave much to be desired. Study of individual companies and public enterprises show results widely diverse from the average. The average rates and results of municipally owned enterprises tend to be brought down by some of the outstanding cases where the municipality is furnished with low-cost hydro-electric service from federal projects. Furthermore, the Federal Power Commission study does not take into account the assistance which has been rendered to municipal enterprises by advantageous federal government loans and grants, nor does it give a basis for accurately weighting the quality of service involved. Nevertheless, the light cast by the detailed data which the Commission has published makes it far more difficult for proponents of private enterprise in the electric utility business to flout

[1] See Federal Power Commission, *Rates, Taxes, and Consumer Savings — Publicly and Privately Owned Electric Utilities — 1935–1937* (1939); *idem, Average Electric Bills, 1939* (1939); and *idem, 19th Ann. Rep.* (1939), pp. 12–14. The average bill groups are for sales of 25 k.w.h. per month, 100 k.w.h., and 250 k.w.h.

public ownership on grounds of excessive rates, high costs, inefficiency, or the advantages of lower taxation.

G. GOVERNMENT OWNERSHIP OF BUSINESS: CONCLUSIONS

In drawing conclusions respecting government ownership of business, the student should distinguish the motives which have prompted it. Most government production is undertaken as a means of performing a public service with certain broad social or economic gains to be made, and not as a means to sell goods or services at a profit, or even at cost. In such enterprises, one cannot be too concerned with the relative efficiency of government ownership in relation to private ownership, since the chances are that private enterprise could hardly be induced to take over the business and operate it on the same basis upon which the government operates. Thus, a private enterprise could hardly be expected to enter low-cost housing without government subsidies and charge the same rents that the government now charges. But in the case of those services which the government furnishes free or below cost, and hence finances partially or wholly out of taxation, a person should ask whether the service is worth the tax cost. Conclusions on such matters are not subject to objective determination, but must be left to individual opinion in special cases.

But where the government enters into business in competition with private enterprise, or takes over a business which could be operated as efficiently under private enterprise, or goes into business with the avowed purpose of making it pay, then the taxpayer, worker, or consumer has a right to know whether public or private enterprise is the proper course of action. Moreover, even if the government believes that a service should be given to the people at a price below the full economic cost, one may question whether in every case it is wise to have it enter the business, or whether it would do better to subsidize private industry to undertake the task.

Answers to such questions of public policy can be determined sometimes in the light of the usual advantages and disadvantages of government ownership of business. But to obtain informed judgment, the advantageous and disadvantageous aspects of government ownership of business must be modified by the particular project in mind. The motives which lead to government ownership, the results to be obtained, and the costs to be incurred are matters the validity of which must be judged by reference to special cases of public enterprise.

1. Advantages of Government Ownership. Governmentally owned enterprises often have certain advantages in cost over private businesses. As a general rule, not only has the government ready access to the capital market to obtain funds adequate to any enterprise, but interest rates on government borrowings are lower than the cost of capital for private enterprise. The

lower capital cost results from lower interest rates on government bonds, as well as from the fact that private enterprise must obtain some of its funds by share capital in which the investors have the hope, if not the promise, of materially higher returns than those available on bonds. The difference between the low interest rates on government bonds or even bonds of governmental corporations, whether such securities are fully quaranteed by the government or not, and the lowest rate of return allowed by the courts to regulated private companies is ample evidence of the lower cost of government capital. On the other hand, it can be stated that sometimes government enterprises are not constructed and financed with as low investment costs as are private enterprises, and that the savings in interest costs may be dissipated in the larger amount of capital required.

The governmentally owned enterprise may also obtain some economies through being able to unify operations and to make larger producing organizations than may be possible or feasible under private ownership. In certain cases, the government might be able to avoid the duplication of facilities and effort which competitive private enterprises entail. For example, many of the problems of wasteful duplication could be eliminated by government ownership of the railroads or all transportation facilities. Moreover, the unification of operations may result in larger-scale producing plants, with resultant economies, and in larger organizations with economies of large-scale management. The unified ownership and operation of electric plants under some kind of government ownership broader than the ordinary municipality could, for example, result in the adoption of the most efficient size of plant, and could also give rise to economies from pooling purchases, research, and expert assistance.

A third possible economy from governmentally owned business might come from the use by the enterprise of existing government services. Virtually every government needs corps of engineers, architects, construction experts, lawyers, financial experts, and numerous other individuals of special training and ability. A government enterprise having only occasional need for such services could obtain them from other government departments at little or no additional cost. A private business, on the other hand, would have to maintain staffs for such purposes, or hire, usually at high fees, the assistance when needed.

Another advantage of government ownership of business arises from the reduced cost of regulation. If the government takes over a business on which it has previously had to expend much effort and money in regulating, the lessening or discontinuance of regulation would result in material savings. However, it should be recognized that government ownership may not denote the complete lack of need for regulation. Regulation may be made easier through the control over the business being more direct, but the necessity for checking upon possible abuses of power, dishonesty or incompetence in personnel, and

policies not conducive with the purposes of the government business means that some part of the funds now spent on regulation would have to be used for control even of a government business. The fact that funds are spent for financial audits, civil-service techniques, or legislative investigations should not conceal the real nature of the regulatory function. And, in many cases of government ownership, full protection of the public interest would appear to justify setting up an independent regulatory commission with many of the duties such an agency now has toward privately owned companies.

The government would also perhaps enjoy some advantages in labor costs and a less difficult labor problem. Although many individuals in the government receive wages or salaries higher than would be paid to them in private industries, other individuals, especially those in the middle and upper pay brackets, often work for less pay from a government agency than they would obtain in private business. The security of government employment, the advantageous pension systems, and the favorable working conditions, especially when the employment is covered by an effective civil-service system, are inducements which private employment has not always offered. But it is in the lesser labor problem that government enterprise would probably enjoy its more important advantage. The tradition and legal principle that workers may not strike against the government have led to fewer labor disturbances in government employment than in private employment, and such disturbances are causes for great expense in many private industries.

2. Disadvantages of Government Ownership. Most of the disadvantages associated with government ownership of business arise from the lack of profit motive and the natural tendency for political influences to play too large a part in functions which are predominantly economic. In too few cases is government enterprise judged by its ability to make a profit. As a result, the lack of motivation from profit-seeking may cause inefficiency and sluggishness to impede the progress of an activity which should be dominated by imagination, vision, and aggressiveness. In this connection, however, two rather pertinent observations can be raised. Perhaps the public pressure to make an enterprise pay and to accomplish results efficiently is greater in certain cases of government ownership than has been realized; and it is a well-known fact that there are many capable individuals in government enterprise who are motivated to such an extent by the desire to serve that the profit motive could add little or no stimulus to their efforts. In the second place, the modern large corporation with its thousands of unorganized stockholders and its management responsible only to itself can hardly be regarded as dominated by a very strong profit motive, at least by the persons who would be expected to gain most by the making of handsome profits.

A second drawback to government ownership may be mentioned. In the zeal to develop controls in government, legislators and administrators have sometimes built up systems of red tape which hamper the efficient operation

of business enterprise. A business which under federal ownership must seek appropriations from Congress each year before it can spend anything, which must deposit its funds in the national Treasury, which must have every pay voucher approved by the office of the Comptroller-General, which must select personnel through channels of the civil service, and which must have specific legislative authorization for changes or extensions in policy, is an enterprise which must necessarily lose much of its efficiency. To meet this difficulty, the wider use of the government corporation is a hopeful sign. If adequate checks are placed upon the actions of directors or managers, with definite lines of responsibility mapped out, and yet with a high degree of autonomy allowed, government operation of business may become as free of administrative inefficiencies as large private business.

Perhaps the greatest disadvantage in government ownership of business is the tendency for political considerations to impair the securing of economic results. The application of the spoils system to the selection of government personnel, with its resultant uncertain tenure and filling of positions with incompetent individuals, is one of the principal causes for inefficiency in government enterprise. The extension of civil-service qualification for positions will help rid the government of this fault, but the existence of these requirements is not an insurance of competent personnel. Civil-service examinations are often too much concerned with technical skills and not enough adapted to the selection of personal qualities of leadership and capability to guarantee high-grade personnel. Furthermore, civil-service employees are not easily removed from their positions, in the absence of proof of dishonesty or great incompetency, so that a government enterprise under civil service might not be able to keep the most capable persons in responsible positions.

Political influences make themselves felt in government enterprises in other ways than through the spoils system. In the making of contracts for the purchase of materials and supplies and for the sale of goods, political pressure and considerations do on occasion cause uneconomic transactions to be made. In some cases, the law may be adequate to guard against these influences, and in others the fear of unfavorable publicity may act as a deterrent. But to expect that political considerations can be eliminated from the transaction of business in a government enterprise is to expect the inconceivable.

Political influences of pressure groups of one kind or another may undermine the efficiency of public ownership in business. Organized labor may inflate costs by pressing for high wages and exceptional working conditions, not by means of a strike threat but through the offices of legislators. Local pressure groups may demand that the government business expand its services or lower its prices, or increase its construction in that locality. Users of the government service may band together to bring about a reduction of prices, on the curious theory that, somehow, if the government pays for it individuals will not have to. In the long run, perhaps this sort of tampering

with the economic operation of a government business, on the ground that departure from serving at cost is in the "public interest," is the chief danger of public ownership.

3. GOVERNMENT OWNERSHIP AND THE FUTURE. At the present time, government ownership of business appears to be getting its greatest stimulus from the desire to supplement regulation and from the idea that such ownership is necessary or desirable to promote the public welfare. Other motives are still important, and will continue to be so, but these two influences seem to have the upper hand.

The costs and delays of regulation, the tendency of rates to be too fixed over a period of time, the inability of regulatory commissions to force a vigorous mass-production and mass-consumption program on private businesses, and the complexities resulting when courts have ultimately to decide economic problems are a few of the more important weaknesses of regulation which competitive public enterprise hopes to mitigate. But unless government ownership can be justified on other grounds as well, and unless it can prove to be profitable, in the sense of covering all economically necessary costs by revenues, is the supplement to regulation worth the cost? While an answer to this question is not easy, it does seem to the writer that regulation is not so imperfect as to justify blind expansion into government ownership, irrespective of costs, duplication of private investment, or the destruction of free private enterprise.

As for the tendency to expand government businesses on grounds of public welfare, those persons clamoring for the beneficence of government should realize that costs must be covered by someone. If a person can purchase a governmentally produced good at a price below its total economic cost, he has received a contribution from someone, either a general taxpayer or a person the value of whose property or income may be diminished by the price-disturbing effects of government borrowing. Society has a scarcity of natural resources, capital, and economically employable labor. Every government expenditure without a similar income must mean a reduction in these scarce resources. If cheap postal service, or low-cost housing, or public auditoriums, are desired more than other economic goods which consumers would have to give up in order to obtain them, then there can be no question about the social justification for such services. But when the government enters business to give people low-cost or free services, these economic implications should be understood.

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CHAPTER

31

GOVERNMENT CONTROL OF BUSINESS: *Conclusions*

ALTHOUGH it is impracticable to summarize all the various actions of the government in controlling business in the United States, certain concluding observations can be made. These controls present a complicated mass of regulations, aids, and cases of government in business. From this maze, one may expect to obtain some important implications as to the meaning of government control of business to those who are trying to decide the course of future social, economic, and political policies. Since the ability of the economic system to function efficiently and to improve the economic position of individuals is closely related to the happiness and welfare of every member of American society, the significance of government controls of business is of the most vital importance. Individual economic well-being is virtually a prerequisite for effective freedom, and economic liberty is closely related to political liberty. If democracy is to succeed, it must solve problems of economic welfare, and, at the same time, preserve a governmental framework which leaves the maximum of individual freedom consistent with that welfare. It may even be more important to leave some economic problems untreated by the government than to give up too much individual freedom in solving them.

The examination of government control of business undertaken in this book presents many questions. What, in general, have been the programs and patterns of control? What have been the real motives leading to control, and are these motives sound social reasons for control? In instituting controls, what problems have been created? What can be said of the results of control, the effects upon economic activity and upon the institutions of capitalism and liberty? Furthermore, what can be said of the future of government control of business? What effect does the disturbance created by war and by the inevitable readjustment to follow have upon the probable future of government control of business? These are some of the fundamental questions upon which light should be shed by understanding the policies of government in its control of business.

A. THE PROGRAMS AND PATTERNS OF CONTROL

Out of the complex of government controls of business, a few principal patterns of control seem to emerge. These patterns do not account for all kinds of government controls, and they do not apply the same in every one of the large segments of economic activity government intervention in which has been discussed in this book. But it does appear that the major programs have been aimed at one or more of the following: control to determine the degree of competition, control of price, control of output, control of business conduct, and control to reduce economic risks. As can readily be appreciated, these controls are not independent of each other but are often related in any given program of government intervention.

1. Control to Determine the Degree of Competition. A great many government-control measures are designed to establish a certain kind or degree of competition between sellers. In some fields monopoly has been encouraged, in others competition has been restrained but not eliminated, and in still others the government has attempted to maintain effective competition. In the transportation industry, the federal government has restricted competition by requiring certificates or permits before entry into service and has encouraged the lessening of competition by permitting or favoring competition; at the same time, it has not allowed carriers to gain a position which would "unduly" suppress competition. In the public utility industry, state governments have encouraged the growth of local monopolies to a much greater extent than they have been promoted elsewhere, although recent incursions of government ownership in the electric power field have tended to restore some of the respectability of potential or actual competition.

The attitude of the government toward private businesses — those not "affected with a public interest" — has been one of insisting upon competition. The anti-trust laws and the fair competition laws have been passed by the federal and state governments with such an end in view. But, as the anti-trust laws have been interpreted, they do not restore competitive conditions. Large producers or sellers, even formed as the result of combination, may still lead a lawful existence. Sellers may retain the monopolistic advantages of trade-marked and advertised merchandise, or of goods produced under a patent. In such cases, with resultant price leadership, product differentiation, and reluctance to engage in price competition, the vigor of competition is necessarily reduced. Fair-competition laws both encourage and discourage competition. Removal of deception, misrepresentation, or other restraints upon trade may sharpen competition, while insistence upon equal treatment of buyers irrespective of economic advantages — as found in the Robinson-Patman Act — and application of state "fair-trade" laws — that selling at a uniform price fixed by manufacturers or at a markup fixed by the state is fair — may dull it.

In the extractive industries, competition is also reduced by market agreements, control of output, fixed-price commodity loans, outright price-fixing, and other means to insure farm, coal, and oil producers a certain share of the national income. Competition between workers for jobs and between employers for labor is diminished by legislation fixing working conditions and wages and protecting labor unions which speak for the majority in bargaining for the entire group of workers in a craft or industry. Government aids to business tend both to increase and to decrease competition. Promotion of standards and dissemination of information, for example, encourage more effective competition, but protective tariffs, subsidy policies, and provision of patents and trade-marks retard its operation.

Often overlooked is the fact that protection of society demands either the restraining hand of competition or the restrictions of government control against abuses of monopolistic power. If the government allows or encourages monopoly or the moderation of effective competition, government control of price and service is a natural result. Sellers who seek refuge from competition should realize that the public has never long permitted monopolistic power to continue unregulated. On the other hand, the governmental policy should take into account the extent to which competition exists, and should not impose restrictions on private businesses where competition can do the regulating.

2. Control of Price. For many years government control of price was restricted by the interpretation of the national Constitution and by generally accepted policy to those businesses clothed with a special public interest, such as transportation agencies and local public utilities. In addition there had been some price control involved in regulation of interest rates which financial organizations might charge borrowers and scattered, though largely ineffective, regulation of minimum wages of certain classes of workers. More recently, however, the scope of price control has been extended to include minimum wages of workers generally, the price of bituminous coal, and the price of agricultural products. In the case of most agricultural products and of crude oil, these controls have been indirect, with regulation coming through marketing agreements, proration and production controls, and other plans for maintaining price through influencing supply. Moreover, the resale price maintenance laws, the laws providing for minimum retail markups, and the Robinson-Patman price-discrimination law tend to result in fixing of price under government auspices. Furthermore, government ownership and promotion of such facilities as waterways and electric power plants have been used as means for reducing prices charged by private enterprise.

Where price controls are well developed, as they are in the transportation and public-utility industries, they involve the administrative problems of fixing reasonable rate levels and reasonable and nondiscriminatory individual rates or prices. Commissions have followed the principles, largely as dictated by legal and economic necessity, that the level of prices should cover total

costs, including reasonable operating expenses and a fair return on the capital used in the business, and that individual prices should cover out-of-pocket costs plus a contribution toward overhead or joint costs. The determination of such reasonable prices by administrative action has been shown to be an extremely difficult and complicated task. Similar difficulties are likely to be encountered in any field to which price regulation may be extended.

The difficulties of price control have led to additional regulations. Thus, accounting regulation has been found necessary, largely as an incident of fixing reasonable prices. Strict regulation of security issuance by carriers and public utilities has been held to be essential for protection of rates and service, because of the destructive results of overcapitalization and of deterioration of credit standing. The regulation of other financial practices, reorganization procedures, and combination also has a definite relationship to the need for reasonable rates and adequate service. Indeed, once the government undertakes to regulate price, the way is open, through the sheer necessity of making price regulation effective, to bring under control many practices of management and labor.

3. Control of Output. Output controls of various kinds have generally been found along with price controls. The quantity of output may be regulated as a means of obtaining price control, as is the case in agriculture, or as a means of securing adequate service under monopolistic conditions, as is the practice with the public utilities. Interesting, too, is the control of quantity of output involved in maximum hours for labor; often such hours laws have been justified as a method of reducing the supply of labor and hence increasing the value of workers employed. The quality of output may also be subject to government regulation. Thus, the usual public-utility and transportation laws require that service be of a certain minimum standard and be rendered without unreasonable discrimination between customers.

To be effective, output controls necessarily require strict and detailed supervision of business operation. They not only cause a heavy burden on government administration, but are likely to be irritating to enterprisers. As the scope of output control increases, the questions of what to produce, how much to produce, and by whom it should be produced naturally mean the replacement of profit-seeking initiative of individual enterprisers by government economic planning.

4. Control of Business Conduct. Although all government controls entail intervention into the character of business conduct, other controls are instituted by society, or at least by organized groups within society, to place business operations on a plane which is regarded as ethically correct. The requirement that competition be fair, the regulations to prevent fraud and deception, and the controls to protect labor against maltreatment fall into this class. These regulations are based generally upon the feeling that certain courses of conduct are inimical to the well-being of society, and that other

courses are "fair" or "good." Because these controls rest upon ethical considerations, and such grounds depend upon group attitudes of right and wrong, or good and bad, the substance of control of business conduct is likely to undergo change. For example, the fixing of resale prices and placing of other restrictions on price competition between ordinary businesses are now regarded as necessary for price competition to be "fair," although a decade or two ago they would have been thought of as unfair. And the establishment of the company-dominated unions in the 1920's was viewed as sound and just business practice, but such domination of union organization a decade later became an unfair labor practice.

5. CONTROL TO REDUCE ECONOMIC RISKS. Many programs of control have as their primary motive the reduction of economic risks with which persons may be faced. Controls to insure economic security have been assuming greater importance in recent years. The wave of labor legislation to provide minimum wages, maximum hours, and social insurance against risks of accident, disease, unemployment, and indigent old age began many years ago, but gained real momentum in the last decade. The renewed vigor with which financial institutions have been regulated, security issuance supervised, and holding companies controlled represents a program to protect investors. Most of the agricultural program of aids and controls has constituted a broad plan for insuring an economic status for the farmer which is thought to be desirable. Fair-trade laws and chain-store taxes have been used as devices to protect the small independent seller against the danger of crushing competition from mass distributors. Government assistance programs, such as a protective tariff, a transportation subsidy, or a program of credit aids, may be means whereby groups are protected from the rigorous effects of competition and the danger of economic failure.

If, in reducing economic risks, the government succeeds in eliminating fraud, misrepresentation, or the exploitation which comes from superior bargaining power, the control may improve the efficiency of the economic system. However, as has been pointed out in the discussion of labor regulation, agricultural controls, and certain cases of government promotion and ownership, the sympathy felt for certain groups of society may well be justified, but a policy giving effect to that concern must not overlook the consequences upon the ability of the economic system to function efficiently. Regulation to reduce economic risks should take care lest the vigor of individual initiative be undermined or people come to believe that security can be guaranteed for society by restraints upon production.

B. THE MOTIVES OF CONTROL

As a general rule, government policies do not materialize unless they are supported by the public. This does not mean that the public generally must

actively support every policy adopted by the government, but it does mean that either a large segment of the public believes the policies to be wise, or a small segment presses for a program which is not strongly opposed by the larger group. Such a latter possibility is of real importance. For, with the tendency of pressure groups to influence legislators, programs may be adopted largely because the general public is indifferent or uninformed.

1. Broad Social Objectives. If one were to read the preamble of most important control measures passed by federal or state legislatures, he would be impressed with the broad social objectives there expressed. He would find there that a transportation law was passed to encourage a transportation system adequate to meet the needs of the country. He would find that a resale price maintenance law, which can hardly be regarded as a means of encouraging price competition, is justified as a law to prevent destruction of competition. Or he would note that the purpose of an agricultural production and price-fixing law is to remove an economic emergency arising from the disparity between prices of agricultural and other commodities, with consequent destruction of farmers' purchasing power and a breakdown in orderly exchange; and that a law leading to fixing of bituminous coal prices is justified as a means of conserving natural resources, while a punitive chain-store tax is excused as an innocent revenue measure. In fact, it is difficult to find a regulatory law, a government aid measure, or an instance of government ownership which is not put forth in large part as a means of protecting the public health, morals, safety, or welfare, or of contributing to national defense, or of collecting revenue.

In most cases of government-control laws, broad social objectives do actually exist and the desire to fulfill them is the predominating motive behind the institution of control. There can be no doubt that the public desire to remove abuses which interfered with equal, adequate, and reasonably priced services motivated and justified regulation of railroads. The honest insistence upon competition and the belief in the social value of competition did surely account very largely for the Sherman Anti-Trust Act, the Clayton Act, and the Federal Trade Commission Act. The desire to protect labor from the harm of too long hours and too low wages was the principal reason for the state and federal wage and hours laws. Likewise, one must admit that the belief that free collective bargaining would aid orderly manufacture and commerce had much to do with the passage of the Wagner Labor Relations Act. And public interest in reasonably priced and adequately furnished public-utility services explains why legislation has been adopted to regulate public-utility operating companies and to place holding companies under strict control. Nor can it be denied that the needs of national defense and the promotion of flood control and navigation had something to do with the creation of the Tennessee Valley Authority. One could go over the entire field of regulation and find a broad social objective apparently acting as the principal motive for control, if not constituting the entire motive.

The primary reason for having to bring government controls into play for protecting the welfare of society is the abuse of individual freedom by persons responsible for business policy. While the abuses which often give rise to government regulation have sometimes had a degree of justification from the point of view of individual property rights, the destructive influence of certain practices upon the welfare of many persons has made regulation necessary or desirable. The railroad managements of the nineteenth century who took a "public be damned" attitude might have sincerely believed that their principal duty was to their stockholders, rather than to the public which depended so much upon fair and adequate transportation service. The promoters of large combinations in the latter part of the same century may have honestly thought that they had a right to combine businesses for profit and for preservation of property rights against destructive competition, but they did not reckon with the broader public interest in the maintenance of free competition and fair opportunity for other individuals to do business. Many of the promoters of the public-utility holding companies of the 1920's may well have felt that they were within their rights to increase profits, to protect their interest in construction companies or investment banks, and to enlarge their sphere of influence and power by combining control over many public-utility operating companies. But these promoters either did not consider how their actions affected investors and users, or did not realize that the device they had built up could be used by the unscrupulous to defraud customers and investors through questionable, if not unlawful, practices.

The abuses which have called forth control have been the thoughtless or dishonest practices of persons in positions of business responsibility. Had these individuals been more careful to see and promote the public interest, as opposed to narrow private interests, or had they been able to rid themselves of the dishonest or otherwise unethical element in their midst, many of the government controls would not have come. Although the honest and public-spirited business man must chafe under regulation along with the dishonest and selfish, business men must realize that certain members of their own group have necessitated many of the controls.

Nevertheless, it must be recognized that such concepts as public welfare, health, morals, safety, conservation, and national defense are so broad that virtually any policy might be justified as promoting their betterment. While one must grant that these social interests have been real and important in bringing about control, there have seemed to be some far more definite motives which have strongly influenced the legislative course of government control of business.

2. Protection of Business Groups Against Competition. One of these more definite motives is the desire by certain producing groups to be protected from competition. Manufacturers of products competing with foreign imports struggle to obtain passage of tariff laws and other legislation designed to

place a foreign competitor at a disadvantage in the local market. Railroad managements encourage more regulation of water carriers and motor carriers so that their competitors may be held in check. Farmers support legislation giving the government power to enforce marketing agreements so that competitors in a market will not drive prices down. Independent retailers promote legislation to require their competitors to abide by resale prices fixed under manufacturers' contracts or to charge prices equal to some formula of cost. Independent retailers aim also to hinder the advantages of chain distributors by pressing for punitive chain-store taxes and for laws limiting discounts to large purchasers. Other business men in many fields support legislation to limit size and curtail monopoly, with a hope of reducing the competitive advantages of a large producer. Or, business men may encourage the government to legalize codes of competitive behavior which may reduce the vigor of competition which they face, even though such codes mean greater business controls. Likewise, labor may wish to eliminate competition of unorganized workers or workers in certain unions by insisting that the government pass legislation outlawing company-influenced unions and allowing organized labor to speak for majorities in collective bargaining.

The interesting thing about the desire on the part of producers themselves to have legislation passed to protect them against competition is that government control is invited by the very parties which have traditionally resisted it. A business group asking for legislation to protect itself against competition does not, of course, wish the government to enlarge its field of control very much. But these groups forget that if a precedent is made for protecting one group against competition, another group may find a way of soliciting government aid in its behalf. The manufacturers who have so strongly supported a protective tariff have given the farmers a good case for having their prices protected by legislation. Or, the retailers who wish prices controlled by or through the government may not see that they are creating a basis for other sellers to push for legislation to fix their prices at profitable levels. What has happened in many cases is that organized groups of producers and sellers have gone independently to the government for legislative assistance, not realizing that the combination of efforts of many such groups can result in a large extension of government control over business.

Moreover, the business man or farmer who asks for legislation which may protect his competitive position often brings down upon himself a program of government control which may be more complete and irritating than he had ever realized. The farmers who saw in the Agricultural Adjustment Act of 1933 a means for improving their lot apparently did not realize that they were assuming the burden of having government inspectors check their planting; and the support of marketing agreements meant that many farmers lost the traditional freedom of planting what they desired and marketing the quantity of goods they wished. Moreover, retailers and manufacturers who supported

the resale price maintenance laws and the Robinson-Patman Act may not have realized that the operation of these laws would mean increased governmental supervision of their businesses, with an enlarged list of government rules to observe, and a multiplied volume of reports to make. Whenever government assumes a field of control, not only does it have to put in many irksome rules and enforcement procedures, but the government control tends to become broader and more intensive. As the problems of control become more understood, gaps in laws and procedures are discovered, and additional legislation involving added control ordinarily results.

3. PRESERVATION OF SMALL BUSINESS. Back of many of the government controls of business may be found the very real, yet not often recognized, desire to protect and preserve the small business man. Although the desire to maintain competition was perhaps the principal motive for the anti-trust laws and the many trade-regulation laws which have followed, a motive of almost equal importance has been the wish to protect the small business man from extermination. This motive has become stronger during the development of the laws against combination and unfair competition. The curious twists taken by the Clayton Act through the Robinson-Patman Amendment and by the resale price maintenance and sales-below-cost laws indicate that the program to maintain a certain plane of competitive activity has become more and more a program to keep the small seller from being destroyed by the efficiency and power of the mass distributors. Similar in purpose and import, of course, are the anti-chain-store taxes.

Other policies of control can be pointed to as illustrating this motive. The refusal of the federal government to take over the banking field and the reluctance with which such a policy as branch banking has been permitted indicate an unwillingness on the part of government to allow the smaller business unit to be edged out of banking. The agricultural program, both as respects control and assistance, also apparently aims to maintain farm-ownership with small units by protecting the profit margin of the average producer and by aiding farmers to improve production methods and rehabilitate themselves. The various "grandfather" clauses in the new federal regulations of carriers are another indication of the desire to protect the small business man.

The preservation of small business units has something to be said for it. The experience of ownership and control of business not only encourages individuals to put forth their best productive efforts, but, by maintaining economic democracy, aids in conserving political democracy. Effective competition, with its merits of price and quality control, is also more easily realized the smaller the business unit. On the other hand, government-control policies should be careful not to give up too much by the way of efficiency and costs in order to protect the smaller businesses. Intelligent policy should carefully weigh the relative advantages to be obtained against the possible losses to be incurred.

4. Protection of Consumers. Many governmental-control programs put into effect to promote the social welfare may well be for the protection of the consumer. The regulation of railroad and other public-utility rates and services, the regulation of banks and banking, the controls over insurance, and the conservation of natural resources through such devices as oil proration have decidedly protective results for the consumer. But the latter has seldom been thought of as a class, and has even more rarely been given much consideration in the framing of governmental control policies. Yet, in spite of the fact that the protection of consumers has not been a very important motive leading to government control of business, it appears to be gaining somewhat in importance.

The work of the Federal Trade Commission has been especially noteworthy in illustrating a desire to protect consumers. Through opposing price-fixing schemes as methods of unfair competition and outlawing various deceptive devices in selling, the Federal Trade Commission has contributed handsomely to consumer protection in the United States. Also worthy of note is the administration of pure food and drug laws by the Food and Drug Administration, and the influence of the Department of Agriculture to have uniform standards of measurement and grading adopted. The increasing rôle of consumer protection is illustrated by the passage of legislation in 1938 to extend the jurisdiction of the Federal Trade Commission over deceptive and harmful practices as well as unfair methods of competition. The Food, Drug, and Cosmetic Act of 1938 also enlarged the scope of consumer protection by giving the Food and Drug Administration much more power to protect the public against dangerous drugs, devices, and cosmetics.

However, it may well be emphasized that the desire to protect the consumer has not been as strong a motive behind government control of business as the importance of the consumer class should justify. The fact that consumers have not been organized and that other groups have been well organized to press their cases before legislatures accounts for this apparent inconsistency in government policies. The desire to protect shippers, laborers, independent retailers, agricultural producers, and other producing groups has had a greater part in determining government policies, simply because they have been better organized than consumers in presenting their cases.

5. The Desire for Economic Security. One of the strongest motives behind government control of business, particularly in recent years, is the desire of certain groups in society for economic security. In a sense, this motive is not altogether one separate from those already mentioned. The business men who have pressed for tariff laws, protection from monopoly, protection from too vigorous competition, or financial and other assistance from the government desire to preserve their income, investment, or position. Farmers have demanded an agricultural program which would protect their "fair share" of the national income. Investors have desired security from incompetent,

dishonest, or unfortunate managers of financial organizations and from sales of fraudulent or misrepresented securities. The desire of workers for security has led them to insist upon laws guaranteeing collective bargaining, fair minimum wages and maximum hours, unemployment compensation, and retirement benefits.

The desire for security is a human motive which is easily understood. Most of the struggle of mankind throughout history has been dominated by a desire for economic and political security. With the complications introduced by a wage system and by industrialization, the maintenance of individual security has been increasingly more difficult. And when the world-wide depression occurred after 1929, with its decline in employment, business profits, wages, and production, the impairment of security led inevitably to a demand for government action. In response to this demand the government has instituted programs of social security, regulation, and business aids which have accounted for much of the expansion of government control over economic activity.

C. SOME BASIC PROBLEMS OF CONTROL

In dealing with the fields of government control of business, much attention has been given to the problems encountered therein. Some of the more important problems were briefly noted earlier in this chapter in the summary of programs of control. There seem, however, to be a few problems which are characteristic of government control generally. Among the more important of these basic problems are those having to do with encouragement to competition or monopoly, encouragement to economic inefficiency, interstate trade barriers, conflicting interests in control, and the effectiveness of administration.

1. SHALL GOVERNMENT ENCOURAGE COMPETITION OR MONOPOLY? One might ordinarily expect that in certain fields of regulation, the government would either support the maintenance of competitive conditions or encourage monopoly. The theory behind regulation of railroads and public utilities is that they have monopoly power, that monopoly is most efficient, and that regulation is to furnish the safeguards which competition would otherwise provide. The theory back of regulation of other business has been that competition is desirable, and that if the law will maintain competitive conditions, fair prices and adequate services will follow.

Much can be said for the theories of regulation dividing businesses between those which are monopolistic and in which monopoly is the most efficient, and those businesses which are competitive and in which the best output at the lowest costs can be obtained under competition. But what has happened to these theories in their application to government regulatory policy? In the transportation field businesses are regulated as monopolies, but competition is al-

lowed to flourish and is even encouraged. In the public-utility industries, a much higher degree of monopoly is found, with the pre-eminent position of one telephone system throughout the nation and the usual local monopolies in electricity, street railways, water, and gas. But even in these industries, the concentration of power by the American Telephone and Telegraph Company has been questioned and the local, state, and federal governments have begun to support the idea of competition, actual or potential, in electric-power production and distribution.

In other businesses, one finds a curious mixture of competitive and monopolistic governmental-control policy. The anti-trust laws have the purpose of enforcing competition, but they do not cause businesses to be broken down into small enough units or outlaw loose combinations — such as those furnished by trade associations, co-operatives, and joint selling agencies — so that competition may in fact be secured. The laws regulating competitive practices encourage competition to a great extent, but in recent years, many obstructions to its free operation have resulted from the strange interpretation given to fairness under resale price maintenance legislation, restrictions on mass distributors, and other fair-trade legislation. Moreover, along with laws to enforce competition may be found more laws giving strong protection to patent rights and trade-marks.

In the agricultural industry, the traditional freedom of competition has given way in part to various kinds of price and production controls. In the coal and oil industries, monopoly is fought at one moment and price and production controls supported in the next. Competition in the labor market is made to diminish or disappear through encouragement to monopolistic labor organizations and partial removal of wages, hours, and conditions of work from the field of competitive bargaining. Furthermore, by aiding and entering business on an ever-increasing scale, the government has tended to reduce the effectiveness of competition between private parties.

Not only has the government policy of control appeared to be inconsistent in regard to the support of competition and monopoly, but the mixture of policies has tended to introduce an unnecessary element of confusion in the operation of the economic system. What is needed is a canvass of the entire field of economic activity, with a view to determining where monopoly should be permitted to prevail, where competition should be enforced, and where oligopoly or monopolistic competition might yield desirable results. After such a determination, regulatory policy should be designed to promote the ends sought. If it is believed that social and economic advantages lie in making an industry monopolistic, then government policy should encourage monopoly and regulate the prices, services, and conduct of the business in great enough detail to protect the public interest. If competition appears to be the best policy in another industry, then government policy should be designed to promote effective competition on a plane of socially desirable be-

havior. If other industries may better be operated with monopolistic elements, but a degree of competition, then the control policy should be created to safeguard the public against the abuses of monopoly which the existing competition cannot eliminate.

2. The Problem of Encouragement to Inefficiency. In previous chapters, a number of cases have been pointed to in which the government has encouraged inefficiency. The tendency to place an "umbrella" over the costs of inefficient producers, whether in transportation, retailing, agriculture, bituminous coal, or elsewhere, means that society is deprived of the advantages of getting goods at their lowest cost and that the efficient producer may be handicapped by regulations to protect his inefficient competitor. Such policies are obviously not in the interests of the efficient operation of the economic system and the improvement of the material welfare of society. They have been introduced at the behest of politically vocal groups who wish to be guaranteed their costs and their "share" of the national income, irrespective of whether they may justify such returns by their value to the economic system. The requests of these groups have been aided by the rather naïve belief, apparently so widely entertained, that somehow all can become richer by giving everyone a stable or increasing proportion of a national income which he does not help to augment.

There may be cases where it is in the social interest to protect inefficiency. If society may ultimately be harmed by the rise of monopolistic businesses and the destruction of the small-business man, government controls to protect the small businesses may well be justified. Or, if farmers and coal miners might become impoverished with unhampered operation of a competitive system, the importance of these groups to social and economic stability might justify legislation which may reduce material output. And, if tariffs or subsidies are necessary for national defense, the costs may be warranted. Nevertheless, any governmental policy which tends to impair economic efficiency should be closely scrutinized to ascertain whether the advantages are worth the costs.

3. The Problem of Interstate Trade Barriers. Under the influence of certain industries hampered by variance in state and local controls and as the result of research in recent years, the deleterious effects of interstate trade barriers have been given much publicity. The problem of such barriers is certainly not new and has existed to some extent throughout the history of the United States. For the tendency of state governments to place regulations on businesses means inevitably that these regulations will impede the free flow of trade between states. The existence of forty-eight states and thousands of local governments with power to police and to tax naturally results in variance in regulatory and tax provisions, and this variation causes inconvenience to businesses operating over political boundaries. And when regulations or tax measures discriminate against out-of-state goods, these barriers are greatly magnified.

The interstate commerce clause was included in the federal Constitution for the principal purpose of breaking down interstate trade barriers. The administration of legislation passed pursuant to the clause has done much to make for free interstate trade untrammeled by local regulations and taxes. But the clause has not been employed to remove all the more burdensome of these barriers, and it is quite true that, despite the oldness of the problem, interstate trade barriers have been increasing in number. Congress has refused on many occasions to interfere with state regulation; the carefulness with which Congress left motor-carrier control so much to the states is an interesting case at point. In its interpretation of the interstate commerce clause, the United States Supreme Court has taken the attitude that a burden placed by a state or local government on interstate commerce must be direct and real to be unlawful in the absence of action by Congress.

The state and local governments in searching for new objects of taxation have placed many taxes on motor vehicles passing through the state, and have supplemented their sales taxes with "use" taxes on goods imported from other states, whether or not the buyer paid a sales tax in the state of purchase. These governments have also set up complicated laws regarding weights, proper lighting, lengths, insurance requirements, and capacities of motor vehicles. Operating under their police powers, states also inspect and embargo plants, fruits, and vegetables, and fix rigid requirements for importation of out-of-state dairy, livestock, and other agricultural products. Other regulations require proper labeling of goods shipped from other states, and importation of wines or liquors may be subject to special requirements.

The purpose of state regulations which protect the safety and health of residents and the use of taxes for revenue purposes cannot be criticized, even though variations in state laws would inevitably hamper the free flow of trade. But, when, under the guise of the police power or the tax power, states impose discriminatory restrictions on businesses of other states, the hindrance to free trade impairs the efficient operation of the economic system in the United States. The imposition of higher taxes on production of wine made out of a state than that made within a state, or the requirement of higher inspection standards than necessary for protection of public health and safety, but for the purpose of discriminating against out-of-state businesses, are examples of the kind of trade barriers which can have no sound economic or political justification in the United States.

Interstate trade barriers are a natural result of the system of government in the United States. With police and tax powers in the hands of so many governmental agencies, one can hardly be surprised at the variation and discrimination which have followed and which have interfered with the free flow of trade. Since a wide economic area is conducive to efficient production, and since the prosperity of the United States has been in large part due to the fact that a large area of free trade has existed, the tendency of state and local gov-

ernments to place walls around their political boundaries should be sharply restricted.

The refusal of the United States Supreme Court to interpret the interstate commerce clause of the Constitution as forbidding many of the restrictions and discriminations involved in interstate trade barriers leaves the problem to be solved either by some kind of congressional action or by co-operation of the state and local governments. While the latter solution is possible, the likelihood of forty-eight states agreeing to a policy of freedom and equal treatment, and curtailing their local subdivisions in the imposing of barriers, does not appear to be particularly great. But, if Congress will do so, it surely has ample power under the interstate commerce clause to pass legislation providing for the removal of interstate trade barriers. While such a policy is fraught with the dangers of provincial politics, the way should be clear, and Congress should act. Such federal legislation need not impair the ability of states to pass necessary police regulations for protection of their residents nor to levy taxes needed for government support. All that such legislation would have to do is to provide for uniformity and equality in these regulations and taxes.

4. The Problem of Conflicting Interests. Since the very nature of representative government in America means that regulations are usually passed piecemeal in response to the demands of organized groups, and the problem is seldom seen as a whole, it is not surprising that government controls produce many conflicting policies. The inconsistency of measures dealing with competition and monopoly has been discussed. The conflict between the desire to protect certain groups and yet to make for efficiency in production has been noted. Throughout the programs of government control, one finds conflicting interests. In order to give the farmers better prices, consumers are called upon to pay higher prices for their goods. For the milk market in New York City alone during 1940, it has been estimated that the marketing agreement in effect took $25,000,000 from consumers for the benefit of milk producers.[1] Users of transportation and public-utility services find their interests in lower rates in conflict with the need of management for higher revenue. Coal and oil consumers wish greater production at lower prices, but producers press for prices fixed at a level to cover their costs.

Conflicts of interest also exist between producers. Industries producing goods for export are harmed by protective tariffs on imports which impair the ability of foreign buyers to make purchases in the United States. Railroad companies feel themselves harmed by government subsidies to waterways and air lines, but manufacturers and other producers using transport services find benefits in the lower rates resulting. Power companies find their interests damaged by strict regulation and by government hydro-electric production, but industrial users of electricity are helped by the low rates made possible. Labor regulations and security programs bring improvement in the status of

[1] *New York Times*, February 1, 1941, p. 19.

labor groups which are employed, but may raise costs to consumers and other producers, and may tend to limit the volume of employment available to other workers. Fair-trade laws and chain store taxes may yield benefits to a large class of retailers but may take away advantages of mass distributors.

Many more conflicts of interest could be found in the present program of government control. But perhaps the most prevalent conflict is between the interests of producers and of consumers. Since producing groups are much better organized than consumers, and since individual groups of producers feel that they have more to gain by getting regulations favorable to them as producers, rather than as consumers, the tendency for government controls is to reflect their needs. While conflicts may be inevitable in government and there may be no means of eliminating conflicting interests in control policies, the problem should be recognized and attempts should be made to see government controls from the point of view of their effects on the broader social interest in heightened production, lower costs, and wider participation in economic security.

5. The Problem of Administration. The extension of government controls over economic activity gives rise to difficult problems of administering these controls intelligently, fairly, and with the public interest in mind. As government controls have been broadened and regulation has become more specialized, commissions and other administrative agencies have multiplied and have received more discretion in applying the laws. At first, the legislatures defined the scope of administration discretion narrowly; but later the number of such cases increased. Definite legislative rate-fixing gave way to discretionary requirements of reasonableness. Vast discretion came to be given in matters of entry and abandonment of service, accounting, finance, adequate service, investigation, wages, hours, fair competition, and other objects of regulation, and government administrative agencies were bound only by the requirements that their actions be "reasonable," "just," or "in the public interest."

The broad field of discretion left to administrative agencies and the complications of applying an ever-enlarging field of regulation have raised critical problems of administration. If commissions or other administrative agencies are inexpert, biased, or arbitrary in the application of their authority, the public purpose behind many regulations can be thwarted, economic liberty can be curtailed unwisely, and government controls can become greater burdens on the effective operation of the economic system than was ever conceived by legislators.

In many fields of administration, a "right" or "correct" application of the law cannot be expected. The concepts of "reasonableness," "fairness," "justness," or "public interest" are so indefinite that it is virtually impossible to give them a meaning in practice which is beyond criticism. But because these concepts are indefinite and their application may be colored by the prej-

udices or incompetency of administrators, safeguards must be placed about the administration of regulation. These may come from several directions. The legislature may define the jurisdiction and duties of administrative agencies more closely. It may broaden the basis for appeal to the courts, or the courts themselves in interpreting the requirements of due process of law may widen the grounds upon which appeals may be accepted. And the legislative and administrative branches of government may undertake measures to insure greater competence and impartiality of administrative personnel, and may enlarge administrative staffs so that adequate findings may be made before laws are applied.

One of the most thorough studies of the problem of administration in federal government agencies was made by the Attorney General's Committee on Administrative Procedure, a group of eminent lawyers, which investigated the problem in 1940 and made a final report in 1941.[1] The recommendations of the committee were designed to make for speedier and more independent adjudication of disputes arising between federal administrative agencies and private interests. The committee did not recommend that the scope of judicial review of administrative action be broadened, claiming that further safeguards of this kind were unnecessary. The recommendations of the majority of the committee may be summarized as follows:

(1) A new office of Federal Administrative Procedure should be created with a duty of reviewing administrative practices, studying problems of administration, receiving complaints from the public, and recommending improvements in procedures.

(2) A new corps of independent officers should be set up in each administrative agency with the duty of hearing and deciding disputes between the agency and the private interests, thereby leaving the heads of the agency free to act as quasi-judicial appellate officers.

(3) Further separation of judicial and prosecuting functions should be made by the agencies so that persons investigating and prosecuting cases should have no part in deciding them.

(4) Rules and regulations of the many agencies should be regularized, the public should be given a greater share in the formulation of rules, and greater publicity should be given to the existence and meaning of rules set up by administrative agencies.

(5) Informal procedures, whereby conflicts can be resolved without resort to formal hearings and expensive proceedings, should be extended and simplified. So that private parties can have their rights defined quickly and definitely, the committee recommended that authority be delegated more widely to lower officials of agencies, in order that these officials might have the power to resolve the issues in dispute.

(6) Agencies should be empowered to issue advance or "declaratory" judgments in order to reduce uncertainty and delay. These rulings would have the force of final orders and would be reviewable by the courts much as formal final orders are at the present.

[1] The monographs of the committee appeared as *Administrative Procedure in Government Agencies*, Sen. Doc. No. 186, 76th Cong., 3d Sess. (1940). The final report and recommendations of the committee were announced in January, 1941. See *New York Times*, January 25, 1941, p. 1.

The recommendations of the Attorney General's Committee on Administrative Procedure, if enacted into law, would clearly remove many of the criticisms advanced against federal administrative agencies. These recommendations have the merit of not limiting the effectiveness of administrative action as a broadening of the scope of judicial review would tend to do. While the recommendations would make for far more definiteness in regulations of administrative agencies, they would not — and probably no measure could do so — reduce the broad field open to administrative discretion. Such a broad sphere of discretion is probably unavoidable in the administrative process, and its abuse can be circumvented only by the development of such safeguards and elimination of uncertainties as suggested by the committee, as well as by closer legislative definition of duties and by the growth of an intelligent and public spirited personnel in regulatory commissions and boards.

D. SOME EFFECTS OF CONTROL

The effects of government controls of business are numerous and widespread. They have influenced the very form and importance of government. They have reached out into every branch of economic activity and have modified the production and distribution of economic goods. They have forced changes in the concept and philosophy of capitalism and have had significant effects upon individual freedom. Moreover, this very development has tended to cause the further expansion of control. While other effects of government intervention into economic activity may be pointed out, these effects seem to be the most noteworthy from the point of view of social interest.

1. THE ASCENDANCY OF THE FEDERAL GOVERNMENT. The expansion of government control of business has not only been accompanied by the ascendancy of the federal government over state and local governments, but has also contributed to its rising importance as the chief regulatory agency. In broadening the sphere of regulation and in attempting to make it more effective, it has been found that the federal government is the agency which can best accomplish the task. Railroad regulation started with state and local government controls but was soon brought under the fold of the federal government. Regulation of highway carriers likewise has been placed in part under the federal government, although state and local controls are still predominant. State regulation to prevent monopoly and to enforce a level of fair competitive practice has been to a great extent superseded by federal regulation. Failure of state governments to solve the interstate aspects of communication, electric-power, and gas-industry regulation has meant the shift of many phases of control of these industries to the federal government. State and local governments hardly dared attempt the regulation of agriculture and bituminous coal production, because of the difficulties encountered in the fact that economic boundaries transcend political boundaries; and the federal government has

been called upon to assist states in the control of oil production. Moreover, in the fields of government assistance to business and government ownership of business, the federal government has emerged as the dominant agency.

This ascendancy is not at all difficult to understand. As economic activities cease being local in nature and become interstate and national, the limited political boundaries of the state and local governments and the practical impossibility of co-operation between so many governments have made the federal government the logical authority to create and administer controls. This tendency has certainly not reached its limit in practice. The rise of increasingly bothersome interstate trade barriers in recent years will probably call forth federal action. The relationship of many transportation agencies, now regarded as local, to the national system of transportation is likely to result in eventual enlargement of federal control over highway operations. The importance of interconnected and co-ordinated electric-power production and distribution to national welfare and national defense seems to presage the further growth of federal government influence in this field. Moreover, there is no reason to believe that the tendency for the federal government to increase its regulatory powers over labor has reached a stopping point. As a matter of fact, the growth of national trade and the awakened interest of government in national welfare indicate that its rôle will continue to increase.

2. Economic Effects of Control. The economic effects of government control over business are difficult to trace and to evaluate. Those of many individual government policies have been noted in the discussion of separate regulations, aids, and cases of government ownership. But to attempt to assess the entire program of government control as it affects the level of economic activity is fraught with difficulties. For one thing, economic results in any industry or for the whole economic system are subject to many other forces than the actions of government. Industrial managements determine the course of economic activity by the decisions they make, as do trade unions, trade associations, co-operatives, and other non-governmental elements in society. Furthermore, government controls may tend both to increase economic efficiency and to reduce it, so that the balance of effects on material welfare may be hard to strike.

The question of economic results of control revolve around the influence of the government policies on maximum production at lowest cost. Has the government enacted legislation which increases costs without proportionately increasing output? Has it put programs of control into effect which have reduced society's supply of natural and capital resources? Have the government controls restricted the full utilization of resources and manpower? In surveying the field of control, many cases of increased cost, decreased output, impairment of capital, and operation at less than capacity can be found in which these controls have caused or contributed to such economic effects. The wasteful duplication of transportation facilities encouraged by the gov-

ernment, the reduction of price competition in retailing made possible, the obstructions to international and national trade through tariffs and regulations, the arbitrary limitation of agricultural production and price-fixing to guarantee income, the limitation of hours of work, the tolerance or encouragement of business and labor monopolies, and the sometimes spendthrift allocation of resources to questionable government aids and public works, are some of the examples of government policies which appear to bring about negative economic results.

On the other hand, many of the government control policies have indubitably added to the ability of the economic system to produce at low costs. The curbs placed upon private selfishness and incompetency not only may lower costs to buyers, but may aid in the preservation of economic resources. The enforcement of order in such fields as transportation and public utilities, and elsewhere, may bring economic saving through not permitting the competitive squandering of resources and through not allowing private persons to gain positions of unregulated economic power. The insistence on publicity, fair dealing, or competition may have the effect of allowing consumers and investors to make choices which will yield them greater satisfaction at lower costs.

Moreover, it must be recognized that human values may be more important than the improvement of material standards of living. The limitation of working hours, the betterment of wages and working conditions, or the reduction of labor's risks may involve costs to society, but the results in human happiness and health may more than justify these costs. The preservation of independent business men or farmers from the destructive effects of too strong competition may cost society some loss of efficiency, but the existence of an independent middle class of owners may be of greater value than the cost. Military or defense considerations, improved housing for submerged classes, or other policies for social or political betterment may mean economic costs and losses, but may still be good public policy. However, when government controls are considered, their economic effects should be studied along with their other advantages, and a decision should be made as to whether the benefits accruing to society are worth the costs.

3. Effects on Capitalism. It can hardly be open to doubt that the vigor engendered by the desire for profits found in the capitalistic system has been in large part responsible for the economic prosperity of the United States, although the abundance of natural resources and the large area of free trade should not be overlooked. Moreover, in spite of the tendency of many persons to look with disdain on capitalism or free private enterprise as representing codes of the jungle, the fact remains that the American people still predominantly believes in a system which is fundamentally capitalistic, a system which allows freedom to individual enterprise, profits to business owners, and competitively determined prices.

To say that government control of business has modified the essence of cap-

italism is to put the effect lightly. Virtually every government control restricts the private property rights upon which capitalism has been based. But many of these controls contribute to the more effective operation of capitalism. If competition is encouraged by government action, the effectiveness of the system of private enterprise to produce at lowest cost and in the greatest quantities tends to be improved. If the government controls result in the reduction of dishonesty, deception, or incompetence in business, they encourage the efficient use of private property. If government requirements increase the fund of information available to consumers and producers, the government may aid in the operation of intelligent competition and economic business policies.

While many of the government controls may help free private enterprise in business, the very restrictions involved tend to diminish the freedom which has characterized capitalism. Private property becomes far less private. Business policies must consider government regulations, and business practices may be modified by the aids and ownership of government. But in spite of these restrictions on business, the owner of property in the United States still has a large area of freedom. In fact, it may be that the government program of controls, by eliminating the more glaring abuses and shortcomings of capitalism, will serve to insure a high degree of business freedom, and to protect private capitalism from the complete destruction which has occurred in many parts of the world.

4. The Self-Generative Tendency to Expansion of Government Control. One of the interesting results of government control of business is that programs of control have a tendency to expand. Even if no new fields are opened, government control in existing ones tends to enlarge. One program of regulation discloses gaps in control and leads to further regulation. This extension may also generate more control by bringing to the light the need for additional regulation to make the control more effective. For example, the regulation of railroads proposed by the Interstate Commerce Act of 1887 planned primarily the maintenance of fair and reasonable rates and rate practices. But experience showed that maximum and minimum rate powers, accounting control, supervision of security issuance, regulation of combinations, control over service, and other restrictions were necessary to effect the purposes which the framers of the act had in mind. Then, to make railroad regulation fair and equitable, and to bring substitute transportation services under government supervision, it has not been difficult to prove the wisdom of extending railroad controls to other transportation agencies.

The ever-increasing control of electric-power companies has extended to regulation of holding companies and interstate operations of the power industry, primarily to make possible government supervision of rates and services to consumers. The regulations against monopoly were supplemented by measures restricting practices conducive to monopoly. The rather innocuous assistance to farmers by credit aids and tariffs led to stricter control of production

and marketing because the earlier measures could not solve the problem. The failure of state blue-sky laws to protect investors has given rise to controls by the federal government.

Many other examples of this self-generative tendency in government control of business could be mentioned. The significant thing about this tendency is that a minor and rather harmless policy of control may develop into a major and highly restrictive program, through the natural desire of the public and legislators to stop the gaps in government control policy and to accomplish the ends sought by it. Such a tendency means that the government seldom reverses the direction of its policies. The disposition to maintain extensions of control is well illustrated by the experience in the last decade with the National Industrial Recovery Act. It will be recalled that this legislation provided for government supervision of wages, hours, collective bargaining for labor, and for measures of fair competition which reduced competition for businesses. When this law was invalidated by the United States Supreme Court, the government replaced almost all its controls, bit by bit, with other legislation. The Wagner Act guaranteed collective bargaining rights. The Wage and Hour Act provided for regulation of wages and hours. The various state fair-trade laws received the blessing and support of the federal government, which also passed the Robinson-Patman Act limiting competition between mass distributors and small retailers. In addition, the coal industry was brought under price control and the federal government lent its aid to enforcement of state oil production control laws.

E. GOVERNMENT CONTROL AND THE FUTURE

One finds no indication that government controls of business will be relaxed in the near future. The national defense program has placed business practically on a war footing, and the mobilization of economic resources involved necessarily means the increase of government controls over business. The indications are that stricter controls may be imposed on foreign and domestic trade; industrial production is due for tighter restrictions of output, and, if too high prices are threatened, the scope of price regulation may be widened. These probable objectives of controls will be likely to follow patterns which have been laid down in previous regulations. The trade and production restrictions will probably incur the sort of planning by central authority which had been employed in the fixing of estimated "normal" agricultural or petroleum needs under existing controls. The regulation of prices may be expected to follow the cost-plus-fair-return doctrines used in public utility rate regulation.

Even after the European war has ended, there is little probability that government controls will be diminished or cease their tendency toward expansion. The desire to effect an orderly transition from a war economy to a peace

economy will probably demand "emergency" measures, such as those which followed the first World War and the 1929–1932 depression. These may include a new wave of government spending and an additional batch of public works, as well as more strict control of capital, management, and labor. Whether the controls come as the result of outright regulation, through the inducement of government aids, or by the threat or institution of government ownership, the present indications are that businesses of all kinds will be placed to an ever-increasing extent under the thumb of a strong central government.

Even if such increases in government control should not come, one can see few instances of present controls which are likely to be lessened. In view of the importance of government controls of business and the likelihood of their increase toward a form of national collectivism, the citizen of today must be prepared to analyze their nature and effects so that economic efficiency may not be hampered and personal liberty may not be traded for the promise of security. For even if government controls are to grow in scope and intensity, it is still possible for the citizen to retain for himself, through intelligent voting and enlightened leadership, the ability to guide these policies into desirable channels and to obtain safeguards against the arbitrary usurpation of liberty by an authoritarian government.

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