Letters

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

Has Reagan Dropped the Ball?

TO THE EDITOR:

Bob Crandall's article makes some valid observations ("Has Reagan Dropped the Ball?" *Regulation*, September/October), for we in the administration have not been able to provide as much regulatory relief as quickly as we would have liked. But I question his view that we have somehow fumbled an opportunity that has now passed us by. Deregulation is a time-consuming process, one that will take at least four years to complete and that must survive on its merits rather than on what may seem momentarily fashionable. I think the administration has established a solid record of accomplishments in its first year that will grow very substantially over the next three years.

If the administration's program came out sounding too pro-industry in tone, it was unintentional. It is also regrettable, because "relief" for big business was never and is not now the principal focus. In fact, the very first major problem that we addressed was handicapped transit retrofitting, an enormously expensive regulation that chiefly affected the older cities of the Northeast. Most of the thirty-nine regulatory programs whose review was announced in August affected city and state governments. The administration has also given considerable attention to academic institutions, and has directly helped consumers through marketing order changes that were opposed by agribusiness interests. If we have made mistakes with regard to industry, it has been in moving too slowly, especially on relief for small business (scheduled to be announced early this year) and in not giving enough emphasis to our goals of increasing job opportunities and slowing consumer price increases.

With respect to legislation, the hundred major program reviews completed so far indicate that much relief can be provided without statutory change—and that in most cases statutory change is premature until we have better data on where it is needed and why. To say this, of course, is not to excuse the lack of progress in revising the Clean Air Act, where the necessary changes are known. Although we may have been mistaken in not proposing a bill this summer, a comprehensive and responsible bipartisan proposal (H.R. 5252) did finally emerge in Congress, as we had hoped when we announced our eleven principles in August. In any event, I now think that neither the public nor Congress was sufficiently informed about the arcane complexities of the act to make rapid change possible in 1981, given other budget and tax priorities. Thanks to the fine contributions to the subject this fall by AEI, Brookings, and many others—partly in response to the eleven principles—the needed improvements are now more readily achievable, and the administration has made their enactment a very high priority for the first half of 1982.

As for the independent agencies, again time should tell a different story, especially as appointments are filled out at the Interstate Commerce Commission. But despite the President's appointment power, the ICC remains "independent"; and until the administration is granted executive oversight authority of the kind contained in S. 1080 over the independent agencies, it is difficult for us to take any "credit" or "blame" for what those agencies do administratively. I trust that Crandall's concern that we are relying too much on executive oversight does not mean that he opposes its extension in S. 1080.

I think we will be able to make great improvements in the regulatory system in four years. But it is going to take at least that long. Any effort to push substantive change too far too fast will be counterproductive legally, technically, and politically. I only hope that critics like Crandall do not get so impatient that they stop providing constructive criticism when we need it, as we most certainly will from time to time.

C. Boyden Gray,
Counsel to the Vice President

TO THE EDITOR:

I agree with Crandall that the administration's early regulatory improvements have been portrayed too much as pro-business rather than pro-consumer actions. That stems from the fact that regulatory relief, along with tax and spending cuts, was a major element in the President's overall program to turn the economy around. Naturally the early regulatory changes have been announced in that context. But Crandall is correct that continued public support will depend on the recognition that regulatory relief means not only a better business climate, but also lower prices, lower taxes, and more jobs.

Crandall is mistaken, however, when he criticizes the administration for single-mindedly pursuing centralized review of regulations instead of seeking statutory change. Perhaps he was commenting too early to see the fruits of either our regulatory review program or our efforts at statutory change, at least in the environmental area. His September article was written only three months after Anne Gorsuch took office as head of EPA.

The regulatory review program has been quite successful, if only because of the improved information on costs and benefits that agency heads now have when they make decisions. Beyond that, OMB has been quite helpful in spotting problems that EPA had not detected in a few rules. And I am convinced that the review of all existing rules will yield enormous benefits over the next few years. For example, EPA's recent proposal to streamline its grants for sewage treatment plant construction would cut the grant process in length by more than two-thirds, dramatically reducing the burden on states and municipalities (and thus taxpayers) at no environmental cost.

More important, the administration is also seeking the statutory changes needed to make regulation

more efficient. In the environmental area, we have already succeeded in getting Congress to change the statute governing the construction grants program to make it more cost-effective in directing funds to projects with important environmental payoffs. In early 1982 we will recommend changes in the rest of the Clean Water Act.

Crandall's charge that EPA is discarding market alternatives for more traditional technology-based standards once again generalizes from too brief a period of observation. Gorsuch recently announced a new policy to allow much more flexible trading of pollution control obligations among firms, so as to lower the overall cost of control—a suggestion Crandall made in his article. We are considering market approaches both in our review of existing regulations (for example, marketable permits for lead use by petroleum refiners) and in our development of new ones (for example, a "bubble" policy for water pollution analogous to the one for air pollution). We intend to choose whichever approach careful evaluation shows will yield the most effective clean-up, without blindly adopting either new economic approaches or old traditional ones.

In sum, while I agree with Crandall on the goals of our regulatory program and on the need for broader characterization of its benefits, I think his criticisms of the administration's legislative program and attitude toward market approaches were premature and hence misguided. I predict that a year from now Crandall's appraisal of the president's regulatory program will be much more positive.

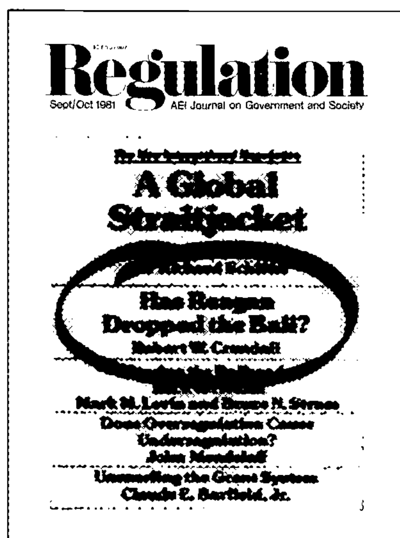
Joseph A. Cannon,
Acting Associate Administrator,
Environmental Protection Agency

ROBERT CRANDALL responds:

Cannon's and Gray's measured responses to my criticism of the Reagan regulatory programs are not without merit. It is all too easy for critics to start taking aim at a new administration before it has a chance to formulate and execute needed policy changes. Moreover, regulation clearly is not and should not be a major priority for the administration, given the other serious problems it inherited, although some signs of progress might have been hoped for by now. I must admit that I was reluctant to pen a sweeping indictment of the Reagan program so soon after the AWACS, tax, and budget battles. One could not expect major legislative proposals in the regulatory arena while those issues were being considered on Capitol Hill.

Gray's and Cannon's espousals of the potential benefits of the OMB review process do not convince me that the administration will be able to forge major changes in regulatory programs without legislation. Unfortunately, I doubt that such legislation will be proposed and enacted any time soon. Congress will begin to lose interest as business firms find their most immediate concerns being addressed by the regulatory relief program now under way. While I do not oppose S. 1080, I do not consider it a major part of the answer to our regulatory problems, and I fear that it may even create a new lobby for regulation—economic consultants.

As for the environmental program, I find it hard to predict just what the administration is likely to do. While at first hostile to market incentives, the Reagan EPA now



seems to be giving them some support, as Cannon suggests. Its support of H.R. 5252 as a vehicle for Clean Air Act reform suggests, however, either that it does not understand how the current law impedes the use of market incentives or that it has no real commitment to expanding these mechanisms into a truly efficient system.

H.R. 5252 does not even eliminate the most ludicrous provision in the act, the percentage reduction standard for new sources of sulfur oxides. Now that the environmental committees in Congress are no longer headed by West Virginians, we might have expected common sense to prevail on this issue. The idea of stimulating the demand for dirty coal as a means of cleaning the air is so absurd that one would have expected an early demise for the clean-air/dirty-coal alliance (to use Ackerman and Hassler's phrase). Where is the commitment to efficient policy?

Finally, one can only hope that EPA will soon be able to report better examples of progress than procedural reforms in doling out pork-barrel funds for municipal sewage treatment plants. Taxpayers ought to be hoping that Gorsuch can find a way to bury this notorious waste of a program in some bureaucratic grave. By the way, why have these grants not been incorporated into the "new federalism"? Municipalities ought to decide for themselves whether their taxpayers find such plants worth the cost. To have the federal government pay 75 percent of the bill is to invite municipalities to propose facilities that return twenty-five cents on the incremental dollar spent. Surely this program should not be made more cost-effective: it should be abandoned.

Perhaps Gray is right. The regulatory program may get off the ground soon, particularly if the economy revives and economic policy makers can be diverted from grappling with yawning deficits and soaring interest rates. I would like nothing better—well, almost nothing—than to see the Reagan administration chart a direction different from the hastily contrived regulatory policies of the 1960s and 1970s. I am sure that the readers of this magazine join me in wishing the administration good luck in this endeavor. But, as a betting man, I am willing to wager that much will remain to be done in 1985 or 1989.

Railroad Rate Reform

TO THE EDITOR:

Mark M. Levin and Bruce N. Stram's basic premise in their article ("Nursing the Railroads Back to Health," September/October) is that the U.S. railroad industry is in a "sorry state" financially. We cannot agree.

First, the Association of American Railroads' data for average return on investment does not give a clear picture of the situation because it includes major railroads which operated at net losses during the period, such as Conrail. The data also comes from a period before the im-

plementation of Staggers Act reforms and does not reflect the railroads' performance in 1981.

Second, the authors' comparison of the AAR figures with the recently determined ICC standard of 11.7 percent for "revenue adequacy" assumes that the latter standard is valid. The fact is, however, that the methodology behind it is currently under challenge in court, and the outcome could have a major impact on the characterization of the railroad industry's financial health. For example, the new standard grossly overstates the railroads' investment base, particularly by including in investment the cost of both original track assets and subsequent betterments. If certain railroads shifted to depreciation accounting for their track structures, they would report substantial increases in net income. A 1981 study by the General Accounting Office, *Accounting Changes Needed in the Railroad Industry*, found that the use of betterment accounting allowed ten selected rail carriers to understate their net income by more than 33.3 percent in each of the years 1976, 1977, and 1978. Using the method established by the GAO, a similar study indicated that the rail income of Class I railroads was understated by an average of 73.1 percent in 1980.

Moreover, the ICC arrived at the cost of capital by applying the current cost of borrowing to all outstanding debt and by including deferred taxes in the investment base. The inclusion of these two fictitious components has the effect of considerably inflating the assumed cost of capital.

It is interesting to note that, under the ICC's previous yardstick of revenue adequacy, thirteen railroads were earning adequate revenues for the period 1975–77. That standard was a much more comprehensive yardstick, because it recognized the differences in accounting practices between railroads and other industries and considered other financial factors besides the cost of capital. Under the new standard, none of the ten "highest-investment" railroads was deemed to have achieved adequate revenue, and there is little reason to believe that any of them will reach that level in the near term. Thus the authors' plan would provide no effective restraint on rate increases for captive utility coal shippers.

The electric utility industry accounts for over 75 percent of the nation's coal consumption, the greater part of which is shipped by rail. Utilities do not object to paying legitimate cost-based rates for coal transportation. Moreover, they recognize that certain rail carriers may need a subsidy if they are to achieve a reasonable return on their investment.

However, captive shippers, including utility coal shippers, should not be required to make more than an equitable contribution to that subsidy. For example, as the ICC recognized in its recent *Ex Parte* No. 347 decision, captive utility shippers should not be required to pay for facilities and assets that are not used for their benefit. The ICC should also require the railroads to demonstrate that they are eliminating traffic that does not cover its costs and that they are maximizing their revenues from competitive traffic, as the Staggers Act requires.

Frederick L. Webber,
Edison Electric Institute

MARK LEVIN and BRUCE STRAM respond:

While Webber articulately states the case of coal shippers seeking reduced rail rates, he has not persuaded us to recant. We still think that ICC regulation has been irrational and that it has, not surprisingly, impoverished the railroad industry. We further believe that any rational system of regulation must permit railroads to earn competitive rates of return and that the best way to do this, given the current railroad rate structure, is to grant gradual rate increases.

Contrary to Webber's assertion, newly available data do not reveal any dramatic increase in rail profits; they show a 5.1 percent return on investment in 1981 compared to 4.3 percent in 1980. Excluding Conrail would increase the industry's rate of return to only 6.0 percent, a figure still far from acceptable. (Why Webber thinks Conrail, a major coal hauler, should be excluded from the data is unclear.)

Webber tends to see demons and heresies in the fact that railroad accounting methods differ from those imposed on utilities. The railroads' use of betterment accounting does make it somewhat difficult to compare their results directly with those of industries using depreciation accounting. As to which accounting system better represents earnings as a return on capital, reasonable men can disagree. In times of rapid inflation, depreciation accounting tends to overstate earnings. Betterment accounting tends to draw down earnings unduly in times when capital expenditures are unusually high and inflate earnings when the reverse is true. While a shift to depreciation accounting is likely to increase the level of profits, it does not necessarily increase the rate of return earned, since the reconstructed investment base is likely to balloon. In any case the numbers in hand have correctly signaled that the industry is in trouble: since 1971 railroads generating 22 percent of industry revenues have gone broke, and more bankruptcies are predicted among major midwestern and western carriers.

In our view, both kinds of accounting distort economic reality. It would be preferable for the ICC to determine railroads' investment base by taking the replacement cost of their assets and depreciating it by a reasonable estimate of the economic rather than technical life of the assets. If this were done, we suspect railroad revenue needs would be set higher than under either betterment or depreciation accounting.

Webber also takes the ICC to task for using the current cost of capital in calculating returns. This method is indeed different than the historic cost method widely used to regulate the electric utility industry, and intentionally so. When a firm faces competition, as railroads do for most of the commodities they move, it must base its decisions on current costs, not historic costs.

Finally, we find implausible Webber's argument that railroads need the ICC to prod them into maximizing profits. Their incentives to act in their own self-interest are already sufficient. ■