THE TRANSITIONAL GAINS TRAP

1. *Introduction*

One of the major activities of modern governments is the granting of special privileges to various groups of politically influential people. Air transportation, for example, has been cartelized by the CAB, surface transportation by the ICC, and we are prevented from receiving "too-high" interest rates on our bank accounts by the Federal Reserve Board and various other government agencies. On the whole, however, the profit record of these protected industries does not seem to differ systematically from the nonprotected. This raises questions of why these special privileges do not seem to do much good.[1]

2. *General Argument*

The purpose of this article is to discuss this apparent long-run unprofitability of government aid programs. To give a preview of the general plot, it will be my thesis that there are only transitional gains to be made when the government establishes special privileges for a group of people. The successors to the original beneficiaries will not normally make exceptional profits; but, unfortunately, they usually will be injured by cancellation of the original gift.[2] Indeed, we shall be on what, paradoxically, seems to be an inefficient portion of the Paretian frontier.

Although some government restrictions are clearly designed to benefit specific groups of people, this is by no means the only way in which such special privileges can arise. The pharmaceuticals industry, for example, fought hard against the 1962 legislation. Since it has come into effect, they have become, on the whole, satisfied with it, because it turns out that it has reduced the vigor of competition, with the result that their profits are about as big as they were before, without the risk involved in the introduction of new and improved drugs.[3] Even in those cases where the government regulation was fairly clearly motivated by a desire to help some particular group, it usually turns out that at least some features are not to the advantage of the benefited group. Apparently government moves in mysterious ways its wonders to perform, and is not completely controlled even by the best organized pressure group.

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1. All of this has led David Friedman to propound what he calls "Friedman's Second Law," and what others call "Friedman II's Law," which is "the government can't even give anything away."

2. See J. M. Buchanan and G. Tullock, "The 'Dead Hand' of Monopoly," *Antitrust Law and Economics Review* 1 (Summer 1968): 85–96, for a similar analysis of private monopoly. For an earlier analysis in somewhat the same spirit, see G. J. Stigler, "Capitalism and Monopolistic Competition: I. The Theory of Oligopoly—Monopoly and Oligopoly by Merger," *American Economic Review* 40(2) (May 1950): 23–37.

3. *Taxi Medallions*

Let us consider a very simple example of government monopoly creation. This example will be the taxi medallion system, although my simplified description will not correspond exactly to that in New York. In Figure 1 we show the demand for taxicab services with the usual downward-slanting line, labeled D, and their cost as a horizontal line, labeled P. In a competitive environment, the price charged would also be at cost, and C units of taxi service would be purchased at a price, P. With supply of taxis restricted, the price rises to P' and, of course, there is now a significant monopoly profit, shown by the usual rectangle. We shall, for the moment, ignore the question of what happens to the taxis which are idled by this change and simply concern ourselves with the taxi owners and drivers who have the right to drive under the new dispensation, i.e., who have the taxi medallions. It is clear that they have gained a great deal.

Suppose, however, we wait for a number of years. By now, the capital value of the monopoly profit has been fully taken into account in the industry. New entrants enter only by purchasing the medallion, with the result that they get only normal profits.[4] Further, the surviving original owners have op-

3. See S. Peltzman, "An Evaluation of Consumer Protection Legislation: The 1962 Drug Amendments," *Journal of Political Economy* 81 (September/October 1973): 1049–91; see especially 1086–89.

4. See R. D. Auster, "The GPITPC and Institutional Entropy," *Public Choice* 19 (Fall 1974): 77–83.

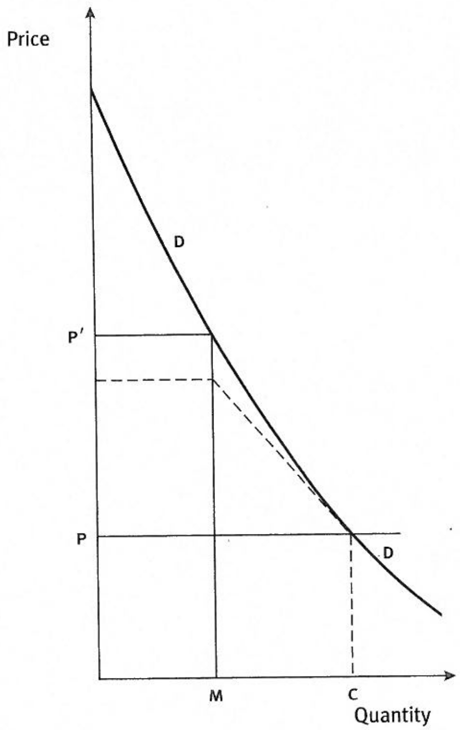

FIGURE 1
Taxi Medallion Monopoly

portunity costs equivalent to the value of the medallions upon which they receive normal returns. The customers, of course, are worse off.

Can we suggest a compensation scheme which would get us out of the mess? Normally, the answer to this question is "no," because the implied transaction costs are excessive. If we could somehow identify those people who are now not using a cab but who would at a slightly lower price and tax *them* so that the distribution of the burden followed the dotted line in Figure 1, it would be possible to gradually buy back the monopoly from its current owners, and hence benefit everyone. Unfortunately, we have no way of doing it, and hence my reference to the situation as being an "inefficient point on the Paretian frontier."

There is a possible way in which we might get out of the trap. It may be

that the monopolistic organization of the industry is not efficient for one reason or another. The number of taxicab medallions in New York has remained unchanged for very long periods of time. It seems unlikely that the demand and cost of taxicabs during that period of time have continuously been such that the unchanged number of cabs maximized the monopoly gains. A brief examination of the other regulated industries or specially privileged areas will usually lead to the same conclusion. The owners of the monopoly are not efficiently exploiting the consumer, not because they are stupid, but because the political problems involved in manipulating government are great. Any change in the number of cabs other than doubling or tripling them would require that the medallions be given fractional value, unless it were intended to change the proportionate ownership of different medallions. The problems of having the individual owner of a medallion suddenly find that he had the right to operate 1.07 cabs (or 0.93 cabs) would probably preclude any possibility of political success for such a move. Certainly the transaction costs for getting such a proposal approved by all the cab owners would be immense.

Note that frequently the gains obtained by the organizers or beneficiaries of this kind of a cartel arrangement, even in the transitional period, are quite small. On Figure 1 when the cartel was introduced, there was a sharp reduction in the total number of units produced. Clearly, the cost of reducing capacity in this way could be quite considerable and must be borne by someone. In the particular case of the New York medallions, they were actually provided for all existing cabs and, in the short run, had very little effect. Later, when the demand for cabs went up, they restricted the growth of the cab business. In order to achieve immediate profits, it would have been necessary to dispose of some producing assets in order to get the monopoly gains. This is, of course, not a special characteristic of this type of monopoly.

4. *Blue Laws*

To take an example of the way this kind of thing works, let me offer my own explanation for the reason that Blue Laws are frequently supported by the mercantile community. They are not, of course, the main force behind the Blue Laws. Suppose a community has a certain number of supermarkets which are open seven days a week. It is proposed that they be required by law to close all day Sunday. Merely having the store open imposes certain costs that cannot be totally eliminated. There have to be a certain number of people on duty, the lights have to be turned up to a certain level, heating and air conditioning have to be handled a little differently than when the store is closed, etc. Thus, a reduction in the number of hours the store is open does reduce the total cost. In essence, each sale is accomplished with somewhat less in the way of cost because the customers are compelled to come more closely grouped, and various economies can be derived from that. In a way, requiring that the stores close down on Sunday is somewhat similar in its effect to destroying one-seventh of the stores.

If a private business acquired all of the stores in order to extract monopoly rents, it would find it necessary to reduce its capacity. Presumably, it would do this in part by closing down stores and, to some extent, by reducing the time they are open. The private business could seek the most profitable combination of these two methods of reducing capacity. But this is not really a political opportunity available to the mercantile supporters of Blue Laws; hence, their monopoly will be less efficient than a private monopoly.

The result, then, of forcing the stores to close on Sunday should be, temporarily, a rise in profits. If they are in a highly competitive environment, this profit will be completely competed away; but many retail stores are in monopolistic competitive environments and this will partially protect them from that contingency. Still, a good deal of the cost-saving will inevitably pass on to the consumers, who presumably would prefer to pay a little more and have the greater convenience of having the stores open all week.

Once the Blue Laws have been enacted, however, the stores are operating at somewhat above normal return on their assets, and the customers find themselves a little more crowded in their shopping than they really want to be. Under the circumstances, the construction of new stores is highly likely. Eventually, then, we will have the situation in which there are more stores than there were before and the return on all stores is, once again, normal. The customers are not being served quite so well, so we have a social cost; but it is not practically possible to put a tax on the customers and use that tax to buy the stores back to their original position. On the other hand, although the store owners are now making normal profits, the repeal of the Blue Laws would be quite inconvenient for them. With the Blue Laws repealed, some of them would surely start opening on Sunday and the costs saved by going to a six-day week would be reimposed upon them. They would suffer a considerable transitional loss.

5. *Related Phenomena*

For Blue Laws the transitional gain was extremely small. In other cases, there may be quite large initial gains. The organization of a new labor union, which raises wages by 15 percent for its current employees,[5] does bring a very large improvement in the well-being of the current laborers who remain employed. Essentially, however, this is simply a capital gift to the existing laborers; it does not significantly benefit the new laborers who will, in the long run, replace them in the industry. With wages in this industry averaging 15 percent above wages elsewhere, the number of people who want to become employees immediately becomes much larger than can be employed. Under the circumstances, some method of rationing jobs is necessary. If this method is a straight hereditary method, i.e., in order to get in, you have to be children of the previous members of the union, then the gain is retained permanently within these families.

More normally, however, the method of rationing these high wage jobs is through the seniority clause. Senior employees have a prescriptive right to their jobs.[6] Granted the work force is not entirely stable; this means that the entire burden of unemployment falls on the new workers. Since in the early years, in any event, the employer will be restricting employment and investing in labor-saving devices (because of the higher wages he is paying), this phenomenon may mean that the new entrant to the union spends a good deal of time as a very low seniority worker with only intermittent employment.

Presumably, the situation is brought into equilibrium with the discounted lifetime income stream for becoming a union member (which means a long period of intermittent employment at first and then high wage employment later) equal to the return on taking a nonunionized job. When this equilibrium has been reached (and it surely has been for all of the older unions), once again we are in a situation where no one is better off as a result of the existence of the union than he would be had the union never been organized. Unfortunately, there is a deadweight social loss and there are a number of

5. Normally, of course, with some reduction in the total number of employees, so some people get hurt even at that time.

6. In some of the lower paid occupations, the opposite phenomenon is currently occurring. Unemployment insurance rates are now high enough so that there is a desire on the part of the senior employees to take paid vacations periodically, with the result of what is called "reverse seniority."

people, the members of the union, who will lose very considerably from the ending of the union. The transitional gain has been completely "sunk," but the possibility of large transitional losses remains.

A somewhat similar situation exists with respect to agriculture. The very large gains in value of farm products, as a result of the Agricultural Adjustment Administration's initial work, were quickly capitalized into the value of land. Whoever owned farm land at the time the program was instituted made immense gains, but these gains were fully capitalized. We are now stuck with the situation in which there are significant social losses, but a powerful political group would suffer transitional losses by the termination of the program. No one is gaining now in the sense that his income is higher than it would be had the institution never been established, except, of course, those people who have received larger inheritances from their parents than they otherwise would.

The higher-than-competitive wages that are now paid in much of the government sector are another example. They depend essentially on the fact that families of government employees now make up something on the order of one-third of all voters.[7] Government employees use a somewhat odd method of capitalizing the gains. Suppose some category of government employee is paid more than is necessary to attract an adequate number of suitably qualified personnel. There will be an excess of people who want the job. They must be rationed in some way, and the method used by the United States government (and, indeed, by many local governments) is the civil service examination. If the prices being paid are at the market level, then the civil service examination would be more or less unnecessary. The number of candidates who would turn up for the jobs would be about that which is needed, and the methods used in private industry to select suitable employees could be used.

On the other hand, if the pay is above that necessary to attract adequate labor, then the civil service exam takes the form of a rationing device. The exam is made harder than is necessary or it covers irrelevant matters such as knowledge of American history. As a result, the employees are actually overqualified for the job itself, although not for the examination. In equilibrium, individuals choosing to take a civil service job would expect about the same discounted lifetime earnings as if they had taken a job in private industry which had an inherent requirement for higher quality labor than in the civil service job.

7. This estimate is a little shaky, but government employees do make up about 19 percent of all employed persons. They appear to vote about 50 percent more frequently than do nongovernment employees, and hence the computation of one-third. For investigation of the evidence on this point, see T. E. Borcherding, ed., *Budgets and Bureaucrats* (Durham, N.C.: Duke University Press, 1977). Currently, Richard L. Moss is making a much more careful investigation of the matter as part of his doctoral dissertation at Virginia Tech.

There is a significant social cost in the sense that the jobs are held by people whose native capacity is such that they could hold better jobs equally well. For example, the private post offices that are now so successfully competing with the government Postal Service, in those areas where they are legal, normally hire much lower quality labor and pay a much lower wage than does the Postal Service. It should be emphasized that, although this is true, they also get much more work from their employees. A custom of working only part of the day has developed in the Postal Service, and many letter carriers are done with their day's work in much less than an eight-hour stint.[8]

In the particular case of the civil service employees, the initial increase in their wages is essentially a pure transfer. It is only with time, as the higher wages attract higher quality labor, that a social cost not connected with the transfer itself is generated. With respect to most of the other activities we have discussed, however, the benefit received by beneficiaries comes by way of a change in the economy which is not, in and of itself, a pure transfer. They are given monopoly privileges of some sort in most cases.

Any economist will, of course, say that pure transfers are better as a way of transferring money than the establishment of monopoly privileges. Indeed, in the case of agricultural subsidy programs, it used to be quite common for economists to demonstrate that all the beneficiaries could be given the same benefit for a small fraction of the cost to the rest of the population.

This argument is a little oversimple because it starts by assuming the total cost to the transfer is simply its tax rate. Of course, there is also an excess burden attached to each tax, and this excess burden, as in Figure 1, can be substantially identical to the excess burden of the monopoly. Nevertheless, it must be admitted that if you look over the set of government institutions which are used to generate special benefits for special groups, it is usually true that a well designed set of taxes could generate the same revenue for the beneficiaries at much lower cost to the victims.

Why, then, is the less-efficient technique adopted? So far as I know, there are only two explanations for this. The first, which is fairly old, is based on

8. "Mail Carrier Likes His Job," *Washington Post* (June 14, 1974): A-7.

the information cost.[9] Not to repeat here the full details of the argument,[10] it is simply that the pushing through of such a benefit for a special class requires that the cost of the benefit not be obvious to the very much larger collection of voters who will be injured by it. This, in turn, requires a certain degree of complexity in the subsidy and direct cash payment raised out of direct taxes would normally not meet that requirement.

In addition to this argument, Rubin has recently suggested another.[11] He points out that budgetary allocations are reconsidered every year in almost all countries. On the other hand, once an institution has been set up, it is not automatically reexamined on a regular basis, nor does its continued existence require a positive affirmative vote in the legislature. Under the circumstances, then, if a program was set in hand to give me $1 million a year out of the Treasury, I would have to face a series of annual votes on that $1 million. If, on the other hand, the laws were rearranged in such a way that I got a monopoly worth $1 million a year, this monopoly would remain in existence (and probably largely unnoticed) until such time as positive effort was made to terminate it. In the first case, I would have to have returned to the lobbying effort every year; whereas in the second case, once I get it, I keep it until something untoward happens.

Rubin points out that under these circumstances pressure groups would prefer the type of preferential benefit which does not require continuous budgetary appropriations, simply because it is cheaper. They only have to make one lobbying effort and then perhaps a defense seven or eight years later, if the issue comes up for further discussion. This is quite different from running a continual lobby to raise the issue every year as part of the budget process.

Whether one or the other (or both) of these explanations is correct, or whether there is a third which either replaces or supplements these, is not of vital importance to our present concerns. It is certainly true that this type of institution is very widely found in our society and the social cost is great. It is also true that, in general, the benefits are now long in the past. They were transitional benefits at the time the institution was first founded. As of now,

9. See G. Tullock, *Toward a Mathematics of Politics* (Ann Arbor: University of Michigan Press, 1967).

10. Ibid., 103–6.

11. See P. H. Rubin, "On the Form of Special Interest Legislation," *Public Choice* 21 (Spring 1975): 79–90.

there is no one who is positively benefiting from the organization and there is a large deadweight loss. However, there is a large number of people who would suffer large transitional costs if the institution were terminated. These transitional costs in many cases are large enough so that compensation of the losers would impose upon society an excess burden which would be of the same order of magnitude as the cost of the present institution.

6. *Summary and Conclusion*

It is hard for an economist to recommend any positive action to deal with this kind of situation. It is, as the title of this article suggests, a trap. I can recommend very strongly that we try to avoid getting into such traps in the future, but what about the ones into which we have already fallen? In those cases where there are efficiency gains from reorganizing the industry, we could presumably compensate the present beneficiaries; but the political possibilities seem to me to be very small. In those cases where the excess burden on the necessary tax for compensation would be as great as the deadweight loss, this alternative is not available even in theory. Granted the omnipresence of institutions of this sort and their very large deadweight loss, it is conceivable that simultaneously abolishing all of them would lead to a net gain for almost everyone. The individual would lose his particular privilege, but would gain from the loss of privileges of other people. It is doubtful that such a change would be truly Pareto optimal, but it might come close. As to its political practicality, I take it I do not have to explain why I think it is low.

The moral of this, on the whole, depressing tale is that we should try to avoid getting into this kind of trap in the future. Our predecessors have made bad mistakes and we are stuck with them, but we can at least make efforts to prevent our descendants from having even more such deadweight losses inflicted upon them.