The Theory of Economic Regulation

George J. Stigler

The state—the machinery and power of the state—is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries. That political juggernaut, the petroleum industry, is an immense consumer of political benefits, and simultaneously the underwriters of marine insurance have their more modest repast. The central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources.

Regulation may be actively sought by an industry, or it may be thrust upon it. A central thesis of this paper is that, as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit. There are regulations whose net effects upon the regulated industry are undeniably onerous; a simple example is the differentially heavy taxation of the industry's product (whiskey, playing cards). These onerous regulations, however, are exceptional and can be explained by the same theory that explains beneficial (we may call it "acquired") regulation....

... We assume that political systems are rationally devised and rationally employed, which is to say that they are appropriate instruments for the fulfillment of desires of members of the society. This is not to say that the state will serve any persons's concept of the public interest: indeed the problem of regulation is the problem of discovering when and why an industry (or other group of likeminded people) is able to use the state for its purposes, or is singled out by the state to be used for alien purposes.

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What Benefits Can a State Provide to an Industry?

The state has one basic resource which in pure principle is not shared with even the mightiest of its citizens: the power to coerce. The state can seize money by the only method which is permitted by the laws of a civilized society, by taxation. The state can ordain the physical movements of resources and the economic decisions of households and firms without their consent. These powers provide the possibilities for the utilization of the state by an industry to increase its profitability. The main policies which an industry (or occupation) may seek of the state are four.

The most obvious contribution that a group may seek of the government is a direct subsidy of money. The domestic airlines received "air mail" subsidies (even if they did not carry mail) of $1.5 billion through 1968. The merchant marine has received construction and operation subsidies reaching almost $3 billion since World War II. The education industry has long shown a masterful skill in obtaining public funds: for example, universities and colleges have received federal funds exceeding $3 billion annually in recent years, as well as subsidized loans for dormitories and other construction. The veterans of wars have often received direct cash bonuses....

The second major public resource commonly sought by an industry is control over entry by new rivals. There is considerable, not to say excessive, discussion in economic literature of the rise of peculiar price policies (limit prices), vertical integration, and similar devices to retard the rate of entry of new firms into oligopolistic industries. Such devices are vastly less efficacious (economical) than the certificate of convenience and necessity (which includes, of course, the import and production quotas of the oil and tobacco industries)....

We propose the general hypothesis: every industry or occupation that has enough political power to utilize the state will seek to control entry. In addition, the regulatory policy will often be so fashioned as to retard the rate of growth of new firms. For example, no new savings and loan company may pay a dividend rate higher than that prevailing in the community in its endeavors to attract deposits.[2] The power to limit the selling expenses of mutual funds, which is soon to be conferred upon the Securities and Exchange Commission, will serve to limit the growth of small mutual funds and hence reduce the sales costs of large funds. . . .

A third general set of powers of the state which will be sought by the industry are those which affect substitutes and complements. Crudely put, the butter producers wish to suppress margarine and encourage the production of bread. The airline industry actively supports the federal subsidies to airports; the building trade unions have opposed labor-saving materials through building codes. . . .

The fourth class of public policies sought by an industry is directed to price-fixing. Even the industry that has achieved entry control will often want price controls administered by a body with coercive powers. If the number of firms in the regulated industry is even moderately large, price discrimination will be difficult to maintain in the absence of public support. The prohibition of interest on demand deposits, which is probably effective in preventing interest payments to most non-business depositors, is a case in point. Where there are no diseconomies of large scale for the individual firm (e.g., a motor trucking firm can add trucks under a given license as common carrier), price control is essential to achieve more than competitive rates of return.

Limitations upon Political Benefits

These various political boons are not obtained by the industry in a pure profit-maximizing form. The political process erects certain limitations upon the exercise of cartel policies by an industry. These limitations are of three sorts.

First, the distribution of control of the industry among the firms in the industry is changed. In an unregulated industry each firm's influence upon price and output is proportional to its share of industry output (at least in a simple arithmetic sense of direct capacity to change output). The political decisions take account also of the political strength of the various firms, so small firms have a larger influence than they would possess in an unregulated industry. . . .

Second, the procedural safeguards required of public processes are costly. The delays which are dictated by both law and bureaucratic thoughts of self-survival can be large. . . .

Finally, the political process automatically admits powerful outsiders to the industry's councils. It is well known that the allocation of television channels among communities does not maximize industry revenue but reflects pressures to serve many smaller communities. The abandonment of an unprofitable rail line is an even more notorious area of outsider participation.

These limitations are predictable, and they must all enter into the calculus of the profitability of regulation of an industry. . . .

The Costs of Obtaining Legislation

When an industry receives a grant of power from the state, the benefit to the industry will fall short of the damage to the rest of the community. Even if there were no deadweight losses from acquired regulation, however, one might expect a democratic society to reject such industry requests unless the industry controlled a majority of the votes.[6] . . . To explain why many industries

2. The Federal Home Loan Bank is the regulatory body. It also controls the amount of advertising and other areas of competition.

6. If the deadweight loss (of consumer and producer surplus) is taken into account, even if the oil industry were in the majority it would not obtain the legislation if there were available some method of compensation (such as sale of votes) by which the larger damage of the minority could be expressed effectively against the lesser gains of the majority.

are able to employ the political machinery to their own ends, we must examine the nature of the political process in a democracy.

A consumer chooses between rail and air travel, for example, by voting with his pocketbook: he patronizes on a given day that mode of transportation he prefers. A similar form of economic voting occurs with decisions on where to work or where to invest one's capital. The market accumulates these economic votes, predicts their future course, and invests accordingly.

Because the political decision is coercive, the decision process is fundamentally different from that of the market. If the public is asked to make a decision between two transportation media comparable to the individual's decision on how to travel—say, whether airlines or railroads should receive a federal subsidy—the decision must be abided by everyone, travelers and non-travelers, travelers this year and travelers next year. This compelled universality of political decisions makes for two differences between democratic political decision processes and market processes.

1. The decisions must be made simultaneously by a large number of persons (or their representatives): the political process demands simultaneity of decision....

The condition of simultaneity imposes a major burden upon the political decision process. It makes voting on specific issues prohibitively expensive.... To cope with this condition of simultaneity, the voters must employ representatives with wide discretion and must eschew direct expressions of marginal changes in preferences. This characteristic also implies that the political decision does not predict voter desires and make preparations to fulfill them in advance of their realization.

2. The democratic decision process must involve "all" the community, not simply those who are directly concerned with a decision. In a private market, the non-traveler never votes on rail versus plane travel, while the huge shipper casts many votes each day. The political decision process cannot exclude the uninterested voter: the abuses of any exclusion except self-exclusion are obvious. Hence, the political process does not allow participation in proportion to interest and knowledge....

These characteristics of the political process can be modified by having numerous levels of government ... and by selective use of direct decision. The chief method of coping with the characteristics, however, is to employ more or less full-time representatives organized in (disciplined by) firms which are called political parties or machines.

The representative and his party are rewarded for their discovery and fulfillment of the political desires of their constituency by success in election and the perquisites of office. If the representative could confidently await reelection whenever he voted against an economic policy that injured the society, he would assuredly do so. Unfortunately virtue does not always command so high a price. If the representative denies ten large industries their special subsidies of money or governmental power, they will dedicate themselves to the election of a more complaisant successor: the stakes are that important. This does not mean that every large industry can get what it wants or all that it wants: it does mean that the representative and his party must find a coalition of voter interests more durable than the anti-industry side of every industry policy proposal. A representative cannot win or keep office with the support of the sum of those who are opposed to: oil import quotas, farm subsidies, airport subsidies, hospital subsidies, unnecessary navy shipyards, an inequitable public housing program, and rural electrification subsidies.

The political decision process has as its dominant characteristic infrequent, universal (in principle) participation, as we have noted: political decisions must be infrequent and they must be global. The voter's expenditure to learn the merits of individual policy proposals and to express his preferences (by individual and group representation as well as by voting) are determined by expected costs and returns, just as they are in the private marketplace. The costs of comprehensive information are higher in the political arena because information must be sought on many issues of little or no direct concern to the individual, and accordingly he will know little about most matters before the legislature. The expressions of preferences in voting will be less precise than the expressions of preferences in the marketplace because many uninformed people will be voting and affecting the decision.[7]

The channels of political decision-making can thus be described as gross or filtered or noisy. If everyone has a negligible preference for policy A over B, the preference will not be discovered or acted upon. If voter group X wants a policy that injures non-X by a small amount, it will not pay non-X to discover this and act against the policy. The system is calculated to implement all strongly felt preferences of majorities and many strongly felt preferences of minorities but to disregard the lesser preferences of majorities and minorities. The filtering of grossness will be reduced by any reduction in the cost to the citizen of acquiring information and expressing desires and by any increase in the probability that his vote will influence policy.

The industry which seeks political power must go to the appropriate seller, the political party. The political party has costs of operation, costs of maintaining an organization and competing in elections. These costs of the political process are viewed excessively narrowly in the literature on the financing of elections: elections are to the political process what merchandising is to the process of producing a commodity, only an essential final step. The party maintains its organization and electoral appeal by the performance of costly services to the voter at all times, not just before elections. Part of the costs of services and organization are borne by putting a part of the party's workers on the public payroll. An opposition party, however, is usually essential insurance for the voters to discipline the party in power, and the opposition party's costs are not fully met by public funds.

The industry which seeks regulation must be prepared to pay with the two things a party needs: votes and resources. The resources may be provided by campaign contributions, contributed services (the businessman heads a fund-raising committee), and more indirect methods such as the employment of party workers. The votes in support of the measure are rallied, and the votes in opposition are dispersed, by expensive programs to educate (or uneducate) members of the industry and of other concerned industries.

These costs of legislation probably increase with the size of the industry seeking the legislation. Larger industries seek programs which cost the society more and arouse more opposition from substantially affected groups. The tasks of persuasion, both within and without the industry, also increase with its size. The fixed size of the political "market," however, probably makes the cost of obtaining legislation increase less rapidly than industry size. The smallest industries are therefore effectively precluded from the political process unless they have some special advantage such as geographical concentration in a sparsely settled political subdivision. . . .

Conclusion

The idealistic view of public regulation is deeply imbedded in professional economic thought. So many economists, for example, have denounced the ICC for its pro-railroad policies that this has become a cliché of the literature. This criticism

7. There is an organizational problem in any decision in which more than one vote is cast. If because of economies of scale it requires a thousand customers to buy a product before it can be produced, this thousand votes has to be assembled by some entrepreneur. Unlike the political scene, however, there is no need to obtain the consent of the remainder of the community, because they will bear no part of the cost.

seems to me exactly as appropriate as a criticism of the Great Atlantic and Pacific Tea Company for selling groceries, or as a criticism of a politician for currying popular support. The fundamental vice of such criticism is that it misdirects attention: it suggests that the way to get an ICC which is not subservient to the carriers is to preach to the commissioners or to the people who appoint the commissioners. The only way to get a different commission would be to change the political support for the Commission, and reward commissioners on a basis unrelated to their services to the carriers.

Until the basic logic of political life is developed, reformers will be ill-equipped to use the state for their reforms, and victims of the pervasive use of the state's support of special groups will be helpless to protect themselves. Economists should quickly establish the license to practice on the rational theory of political behavior. . . .