DEREGULATION: ECONOMICS OR IDEOLOGY

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CHAPTER I

INTRODUCTION

One principle difference between heterodox and mainstream neo-classical economics is whether social and economic change is driven by group dynamics and social forces or whether historical events can be interpreted in terms of *individual* decision making units responding in a rational manner to altered constraints. Classical economists tended to focus on individual behavior and they were somewhat less concerned with social process and change. In regards to Ricardo, for example, "The historical, the institutional, and the empirical faded into the background, and explicit social philosophy shrank to a few passing remarks" (Sowell 1974, p. 113). Condorcet was among the first to focus on historical events as the means by which social and economic institutions change, followed by heterodox thinkers, such as the German historical school (Grossman 1943). These intellectuals questioned the individualistic approach taken by classical economists. Some historicists abandoned classical theory altogether, preferring to take a unique historical interpretation of human events. From the historicist's point of view changes in ideology, which had its roots in Hegelian thought, was a driving force behind social and economic change: "Hegel's stress upon evolving ideas as the motive force for changes in social organization is implicit in most of the German radical literature, including the historicist movement" (Ekelund and Hebert 1990, p. 251). The historicist's quest was to discover laws of historical development and process, an endeavor in which they were unsuccessful.

Karl Marx continued the search for a theory of historical processes, also adopting many of Hegel's ideas. Marx blended economics, history, sociology, moral arguments and philosophy to develop a theory of socio-economic change. Marx theorized that the injustice inherent in capitalism leads to conflict between two social groups, workers and capitalists, resulting in social upheaval and change. It is through this process of continual conflict between groups that society evolves. It has been claimed that Marx's greatest contribution to the discipline was that he "for the first time 'historicized' or 'socialized' economics" (Grossman 1943, p. 382). On the one hand Marx believed that he had discovered historical processes which were inevitable, but he also took an active role in promoting his ideas, evidently believing that ideological forces could have an influence on social processes and in bringing about the downfall of capitalism. "[H]e possessed the 'political will' to attack static capitalism" (Ibid).

This concern with historical process and change carried over to the U.S. in the form of "American Institutionalism." Like the historicists, Thorstein Veblen was concerned less with the factors determining individual behavior and more with social change. "He was insatiably curious about what makes social and economic processes 'tick' and especially about the mode and method of how societies--as the totality of cultural and technological institutions--change" (Ekelund and Hebert 1990, p. 456). In Veblen's view, institutions arise to support the material conditions of the period in which people live. Changing material or technological institutions (that affect material well-being) will have an affect on other institutions in society and is the process that brings about change. Veblen, Marx and the historicists shared the view that classical and neo-classical economics lacked the ability to explain social and historical processes and were motivated by the endeavor to explain what brought about change in social, political and economic systems. Their approach focused on group dynamics and institutional factors rather than attempting to explain the behavior of individual decision making units and their ultimate affect on social change.

Recent developments in mainstream economics have contributed to the study of social process. Developments in public choice and transaction cost analysis have made contributions to the theory of how political and economic systems develop and have sought to explain socio-economic events in terms of mainstream economic thought. North (1991), for example, has used transaction costs to develop a theory of institutional change. He explains economic history as an attempt to reduce information and transaction costs and to solve the problems of agency. How well different societies are able to overcome these difficulties through the establishment of institutions determines the extent of economic development in a society. "Together with the standard constraints of economics [institutions] define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity" (1991, p. 101). In North's view, economic forces motivate institutional change, which in turn allows society to achieve a higher level of material well-being. This approach to economic history has more in common with Adam Smith's invisible hand than with Hegel's dialectic and the power of ideas.

Public choice is a recent theoretical development which uses neo-classical economic tools to explain the political process. It can no longer be assumed that market failure can automatically be ameliorated by government policy without considering the possibility of "non-market" failure, that collective decision-making may itself be a source of economic inefficiency. According to public choice theory, the behavior of individuals operating in the public sector is also motivated by the timeless and enduring characteristic of human beings to act in their own self-interest. Events in the public sphere can then be analyzed in terms of self-interested parties seeking personal gain, not necessarily acting in the public interest. This method of economic analysis has been applied to economic history (Ekelund and Tollison 1981; Baysinger et al. 1980) to explain how mercantilism developed as an economic system and why it declined.

It is the purpose of this study to apply these recent theoretical developments in public choice and the economics of regulation to assist in explaining the movement toward the deregulation of major industries--that is, to focus on economic rather than ideological forces as the driving force for social change. Or to take what one well-known economist said and turn it on its head: it can be asserted that the influence of ideas is vastly overstated relative to the power of special interests.[1]

STATEMENT OF THE PROBLEM

"[As] a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit" (Stigler 1971, p. 3). This frequently quoted observation by Stigler, and the more general one that rent-seekers benefit from regulation at the expense of the unorganized majority, helped bring economists largely into agreement that economic regulation is an anachronism, and they have generally supported deregulation.[2] Subsequently, deregulation of major industries has been a common occurrence in public policy over the previous few decades, with airlines,

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[1] Keynes stated that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas" (1936, p. 383).

[2] See Winston (1993) for a discussion of the general agreement among microeconomists regarding the benefits of deregulation.

trucking, banking and telecommunications being some of the most notable examples.

Both political scientists and economists have labored to explain why deregulation occurred. One economic explanation is that "deregulation occurs when the costs of regulation exceed the transaction costs of repealing it plus the cost of the remaining market failure" (Noll 1989, p. 1266). This explanation has some appeal where natural monopoly existed (e.g., telecommunications) and technological change may have eliminated or reduced this type of market failure. However, where economic regulation was applied to structurally competitive industries, and where such regulation appears to have primarily benefited the regulated industry, this explanation has less appeal.

Ironically, economists have been given a great deal of credit for the deregulatory movement. Some social scientists claim that the analysis and critique of economic regulation by economists during the 1960s and 1970s played a significant role in persuading legislators and regulators to implement deregulation. Derthick and Quirk state that, "We are convinced that except for the development of this academic critique of policy, the reforms we are trying to explain would never have occurred" (1985, p. 36). While Derthick and Quirk, who are political scientists, laud economists and their analytical critique of regulation, they nevertheless dismiss *economic* explanations for this transformation of public policy. They claim the supply and demand for regulation are not a factor in explaining deregulation primarily due to the fact that "the regulated industries did not ask to be deregulated" (1985, p. 21). That is, there was no explicit demand for deregulation by the regulated industries. In fact many interest groups within the regulated sectors of the economy were often extremely vocal in their opposition to deregulation. As political scientists, Derthick and Quirk do not have a complete understanding of the economics of regulation and how potential competitors are a factor in the equation. It can be demonstrated that an economic explanation for deregulation does not necessarily require that a government sanctioned cartel begin lobbying regulators demanding the discipline and uncertainties of a competitive marketplace. Quite the contrary, these events can be explained to a large extent by examining the marginal changes in the cost of supplying regulation and/or the benefits associated with being regulated that would alter the quantity of this "good" brought to the political arena and, therefore, does not require a "demand" for deregulation as such. As intellectuals often do, Derthick and Quirk stress *ideas* as the motivating force for social change and the primary factor responsible for deregulation. "In Short, the existing stock of ideas shapes the response of political leaders to events by defining the conceptual alternatives from among which they choose" (Ibid, p. 57). A different means of shedding light on this phenomenon is to reexamine the events of this period through the lens of standard economic choice theory, by examining whether social change can be explained applying the devices in the economists' tool kit--supply and demand.

An Historical Illustration

Since deregulation will often be juxtaposed with the decline of state sponsored monopolies in eighteenth century England, it is necessary to explore some theories surrounding the rise and decline of mercantilism. Mercantilism has been traditionally described as the "economics of nationalism"[3] and one method of examining mercantilism has been to view it as an ideology that eventually withered away as new ideas emerged and the

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[3]See Ekelund and Hebert (1990) for a general discussion of mercantilism and the two approaches taken by economic historians.

flaws in the old system were revealed. It has been common for economic historians to explain this period in history almost exclusively as a "progression from error to truth" (Ekelund and Tollison 1981, p. 3). This has been termed the "doctrinal approach," where the policies of this period resulted from "a body of thought summarized in the events of the day," and is the approach that has been most often employed to evaluate this period in economic history. On the other hand, taking modern economic theories of regulation and rent-seeking and applying them in an historical context to evaluate the rise and decline of mercantilism has been called the "policy approach," where social change is viewed as an unintentional by-product of competing interest groups and the affect they have on institutions of the period. This is the method Ekelund and Tollison (1981) employed to help explain this period in economic history.

According to the doctrinal approach, the gradual change in policy from one of economic regulation (meant to limit competition among suppliers and promote exports) to one of promoting *laissez faire* was believed to be primarily the result of intellectual arguments. This approach suggests "that humans and their ideas may be arranged on a continuum with 'mercantile' on one end and 'liberal' at the other"(Ekelund & Hebert 1990, p. 42). Such interpretations of economic history are not inaccurate, merely incomplete, according to Ekelund and Tollison. Their approach instead is to "seek explanations in terms of institutional changes (for example, the growth in the rule of law), which altered the costs and benefits of monopolization to rent-seekers" (Ekelund & Tollison 1981, p. 7).

One set of policies commonly employed by mercantilist nations was regulation that promoted a favorable balance of trade--restricting the import of finished products and promoting the export of such goods. Exports in excess of imports were compensated through payments made in gold, much of which would end up in the monarch's coffers. Therefore, according to the doctrinal approach, policies that encouraged exports of finished goods and discouraged imports benefited the development of central authority in nation-states (after the decline of feudalism), promoted employment and generally strengthened the power of monarchies.

According to the doctrinal approach, the unintended consequences of mercantile policies were unforeseen by the monarchy. Not only did they mistakenly equate money with wealth, but the lack of understanding regarding trade flows and comparative advantage, as well as the manner in which gold flows would increase the money stock, the price level (that is, the quantity theory of money) and eventually erode a favorable balance of trade were ostensibly lost on the rulers of this period. Intellectuals were the driving force behind pointing out these errors in policy and promoting free trade. "Indeed, most common references imply that the intellectual case for free trade made such an impression on legislators that they quickly transformed the policy proposals of these authors into practice" (Baysinger et al 1981, p. 238). Economic historians have advocated this interpretation of history for some time, whereby mercantilism was a set of policies generated from the top and emanating downward through the social and economic structure of the day, eventually giving way to new ideas (Ekelund and Tollison 1980, p. 7).

Ekelund and Tollison explain a favorable balance of trade and subsequent gold accumulations during this period differently, seeing it as "nothing more than the by-product of the interplay of numerous self-interested parties who were seeking rents from monopolization in the early nation-states" (Ibid, p. 5). The state sought revenues from selling monopoly rights (the supply side) while the demand side was from rent-seeking, or the desire to "contrive an artificial scarcity" (Ibid). Selling monopoly rights and thereby limiting imports was one means of creating economic rent from which the monarchy would share. This process was facilitated by the fact that legislation favorable to merchants of the period was relatively easy to obtain from a single, sovereign ruler. The transaction costs associated with influencing the decisions of one individual is (other things equal) less than trying to persuade a large legislative body. Early in the mercantile period monarchs had sufficient and durable authority to grant monopoly privileges and would often do so to capture some of the monopoly rents. Wool producers in England were a typical example. They were more than willing to pay taxes to the crown, that is, share their monopoly rents, as long as the benefits from being regulated exceeded the cost of taxation (Ibid, p. 56).

Under the policy approach the rise of the English Parliament as a governing force (an exogenous event) parallels the decline of mercantilism and the rise of free trade. Not that Parliament, as a rule, opposed the granting of monopoly privilege, but the competition between the crown and Parliament for the right to supply regulation resulted in the uncertain durability of monopoly and made the enforcement of monopoly rights difficult. Ekelund and Tollison claim that "The debate over monopolies was not a debate over free trade versus crown grants of patents, but rather over who would have the power to supply regulations"(Ibid, p. 66). This competition created unintentional consequences that affected the costs and benefits of rent-seeking:

> This struggle embodied an effort by Parliament and the common law jurists, not as historians like Heckscher would have us believe, to invoke competition in England in a public-spirited gesture, but rather to share in the monopoly rents being collected by the monarchy. In this struggle several important institutional changes, which dramatically affected relative rates of return to investments in rent-seeking by both suppliers and demanders, were introduced unintentionally (Ibid, p. 26).

The conflict over who would possess the power to grant monopoly rights unintentionally resulted in the erosion of benefits to being regulated, making monopoly rights uncertain and suspect. "Higher costs due to uncertainty and growing private returns reduced industry demands for regulation and controls in England"(Ibid, p. 149). Parliament did not seek the elimination of monopoly rights; rather, they sought the exclusive power to grant monopoly privilege and this conflict with the crown indirectly and unintentionally brought about free trade.

This conflict over who had sufficient authority to grant such rights was played out to a large extent in English courts of law. The rise of the "common law courts," which were tied closely to Parliament and competed with the crown's courts for jurisdiction, created a great deal of uncertainty whether a monopoly right was actually valid or durable, also reducing the demand for regulation.

> As the power of the monarchy in England declined, the movement toward representative democracy shifted the locus of rent-seeking activity to new forums, primarily the legislature and the judiciary, with predictable implications for the decline of the rent-seeking society of mercantilism. For example, the costs of lobbying a representative body are higher than the costs of lobbying a unified monarchy for monopoly charters because there are many decision-makers rather than one. The rational rent-seeker will reduce his bid for a monopoly right when lobbying costs rise. . . There will be turnover among politicians and uncertainty about the durability of legislation from session to session of the legislature (Baysinger et al. 1980, p. 245).

Thus, the conflict over who had authority to grant monopoly privileges, increased transaction costs as a result of democratic rule and also Parliament's lack of an established bureaucratic structure to implement and enforce regulation, caused a reduction in the granting of monopoly rights. That is, inadvertently institutional change resulted in a decline in the value of being regulated which reduced the demand for monopoly privilege. By applying economic interpretations to the historical record of the mercantile period, Ekelund and Tollison have been able to shed new light on the events of this period in economic history.

Certainly any institutional changes that occurred in the U.S. during the relevant period were not of the same order and magnitude as that which occurred in mercantile England--that is, the rise of democratic rule. However, it can, in a similar manner, be demonstrated that a changing cost/benefit structure, brought about by the endogenous interplay of self-interested parties along with exogenous events, may have altered the value of being regulated and contributed to regulatory reform in the U.S. This policy change was not merely the result of intellectual arguments revealing the "errors" of regulation.

Parallels With Deregulation

There are some unexplored similarities between deregulation during the previous twenty years and the decline of mercantilism in eighteenth century England. The methodology employed to examine the rise and decline of English mercantilism may also be applied to more recent history in an effort to explain why deregulation occurred. Derthick and Quirk (1985) follow in the tradition of many economic historians who view ideas as profoundly influential in the political process and who view social change as a "product of [the] philosophical forces of the times." Applying this ideological principle to the present, Derthick and Quirk (1985) assert that modern day economists can be credited with exposing the deadweight losses and other inefficiencies associated with economic regulation.[4] As Ekelund and Tollison suggest,

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[4] They note, for example, that, "The fight for deregulation of transportation 'has been the story of a few brave but lonely economists stubbornly attacking the American economy's largest legal cartel . . . "(quoted in Derthick and Quirk 1985, p. 9).

however, a weakness of such an approach is that it fails to provide a "transmission mechanism," whereby ideas affect real outcomes.

One manner in which ideas might be an effective transmission mechanism to affect social change is to view the process in the context of public choice theory. Is it plausible that information provided by economic analysis regarding the harm to economic welfare from regulation assisted political entrepreneurs in garnering needed votes and transformed a largely uninterested and uninformed interest group into a major player in the political process? This group was then able to compete with special interest for political favor? In other words, potential social gains were revealed to consumers through economic analysis and political entrepreneurs seized an opportunity to reduce transaction costs and increase "social welfare."[5] This explanation seems unlikely. What an ideological explanation for both the decline of mercantilism and modern deregulation implies is that social developments can be explained "stressing an exogenously determined economic policy divorced from the endogenous interplay of self-interested forces" (Baysinger et al 1980, p.237). Such an explanation should be received with at least modest skepticism by economists. A central thesis of this study is that the endogenous interplay of self-interested parties, along with exogenous events, contributed to the repeal of economic regulation.

This analysis of the ideological/economic interpretation of mercantilism provides an illustration regarding the interpretation of historical events. It is not out of the question nor always unreasonable for a number of individuals to examine the same facts and reach totally different conclusions regarding the implications of those facts. In the process of examining how economic

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[5] Levine (1981) makes an argument similar to this to reconcile public interest and interest group theories.

regulation was first established historians, journalists and others have reached totally different conclusions as to whether regulation occurred because big business sought regulation or whether it was the triumph of the public interest over concentrated power.[6] It's nonetheless possible that different individuals could examine the facts surrounding deregulation and reach totally different conclusions as to what caused regulatory reform. Derthick and Quirk acknowledge this point: "The causes of sociopolitical events generally are obscure, and individual causative factors are hard to isolate and weigh in relative importance" (1985, p. 18). Intellectuals who are persuaded that public policy is driven primarily with concern for the public interest and the power of ideas are likely to interpret political events in light of such a theory and not give much consideration as to how incentives influence the political process. However, unlike traditional economic historians who, when examining the decline of mercantilism, did not consider economic interpretations of the events they were chronicling, Derthick and Quirk overtly reject economic explanations for deregulation. They state that, "We would not have bothered to attempt this analysis were we persuaded that deregulation is explicable mainly by reference to economic events" (1985, p. 19). Therefore, just as traditional economic historians interpreted the rise and fall of mercantilism reflecting ideological forces, advocates of the ideological/public interest view of politics, such as Derthick and Quirk, interpret this major change in public policy as the result of a few politicians,

[6]High (1991) makes note of some prominent scholars, such as Gabriel Kolko and Joseph Pulitzer, who looked at the onset of regulation. Pulitzer believed regulation was a triumph over special interests; Kolko interpreted events differently, believing that industry sought and obtained the regulatory structure for its own benefit. See also Pertschuk (1982) who argues that organized labor joined consumer interests in supporting deregulation even though workers in transportation and communications industries clearly benefited from it.

advocacy groups, intellectuals and bureaucrats seizing an idea (deregulation) of little known but broad benefit to the general public and, in spite of the best efforts of special interests, ultimately succeeding. In their view the "heroes" of deregulation are scholars (particularly economists) who mounted their critique of regulation and brought their criticisms before the legislature and the public. They reject completely an economic explanation for deregulation and also an economic explanation of politics, believing that if economic factors were robust in explaining these events the regulated industries would have no longer stood to gain from regulation and would have demanded to be released from its shackles. "The most active and powerful organized interests were opposed to the policy change. In none of the cases did the regulated industries decide that regulation was no longer in their interests"(Ibid, p. 26).[7]

Derthick and Quirk do not explore fully the economics literature on economic regulation.[8] Their interpretation of the economic theory of regulation is generally limited to a simplistic capture theory and does not acknowledge more sophisticated economic theories of collective decision-making.[9] Self-interested behavior and changes in incentives can reveal themselves in any number of outcomes.

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[7]It will be argued later that this is too strong of an assertion--that many airlines, for example, well before actual deregulation, no longer felt regulation served their long-term interests.

[8]Derthick and Quirk do make reference to Stigler (1971) but do not reference later and very important contributions to the economic theory of regulation, e.g. Peltzman (1976) and Becker (1983).

[9]Posner (1974, p. 341) notes that the political scientist's formulation of the capture theory is, in fact, "almost entirely devoid of theory. They do not tell us why some interests are effectively represented in the political process and others not, or under what conditions interest groups succeed or fail in obtaining favorable legislation."

One analytical difficulty with an ideological or public interest explanations for deregulation is that a great deal of regulation was recognizably inefficient long before deregulation occurred. "When exit required by the theory takes twenty or forty years or has yet to occur, the [public interest] theory can hardly be deemed powerful" (Peltzman 1989, p. 19). Derthick and Quirk indirectly acknowledge this point when they note that "when economists mounted a critique of their own in the 1960's and 1970's they were well within a long tradition of dissatisfaction"(1985, p. 63). This long tradition of dissatisfaction (for example, Levine 1965 and Caves 1962) went even to the Commissioner of the CAB during the 1950s:

> The CAB's procedure and methodology had been subject to criticism since the late 1950s, when Commissioner Louis Hector resigned and sent an open letter to President Eisenhower, criticizing the board's lack of rational criteria, policy flip-flopping through case-by-case, oral decisions, justified after the fact by written opinions (Vietor 1991, p. 31).

It is evident that the intellectual underpinning for regulatory reform were well in place long before any actual changes took place. The intellectual case for deregulation generated some political preference for reform in the early 1960s when "the Kennedy administration . . . sent a procompetitive reform bill to Congress in 1962 but [it] elicited no response. In neither house was the bill even reported to the floor" (Derthick and Quirk 1985, p. 56). What were the factors that made deregulation a viable policy option during the 1970s but not the early 1960s?

It will be shown that important theoretical work in the economic theory of politics goes well beyond simple capture theory and provides plausible explanations as to how regulatory change might occur and, therefore, the economic theory of regulation does not suffer from "implausible pretension" or "extreme simplicity" (Ibid, p. 27). No self-respecting student of the social sciences could totally dismiss ideological factors in explaining social process.[10] However, as Tollison notes, " [T]he interest-group theory must be able to cope with both regulation and deregulation in an explanatory sense. Interest groups can drive the economy in either direction"(1991, p. 63).

As in Ekelund and Tollison's treatment of the mercantile period the aim of this study is to develop a positive theory of social change. Also, as in their treatment,[11] social change can be interpreted not by necessarily uncovering new events, but by reinterpreting what others have revealed about the process by applying different analytical tools. In regards to the doctrinal and policy approach Ekelund and Hebert (1990, p. 43) note that, "Although these two approaches may be viewed as rival theories, there is no reason why they could not be treated as complimentary."

Undoubtedly the causes of deregulation are complex and involve many factors, including the possibility that politicians and bureaucrats were acting in the broad interests of the unorganized majority when advocating deregulation without regard for their own particular interests--what Buchanan skeptically refers to as a "truth judgment" brought about by the political process (1979, p. 273). This analysis does not dismiss that possibility; it only examines whether ideas can be the only or primary explanation for

[10]It should be noted that ideology is not dismissed as playing a role in policy change. The economic theory of bureaucratic behavior explicitly includes the public interest and ideas as motivating forces for individual behavior (Downs 1967). No matter how altruistic an individual, however, the ability for that person to institute change will be affected by costs and benefits. No political figure can achieve their goals unless they are first elected, re-elected or appointed to office.

[11]They rely primarily on the work of Heckshher and his emphasis on the doctrinal approach to mercantilism to support their view that mercantilism was the result of a complex interplay of self-interested parties seeking personal gain at public expense. This study will rely heavily on Derthick and Quirk's detailed analysis of the deregulatory process.

broad social change. "While it is flattering to think that intellectuals affect public policy--and surely they do to some extent--it seems completely out of character for economists to think that intellectual arguments could affect real magnitudes so strongly" (Ekelund and Tollison 1981, p. 151). If self-interested behavior and economic forces were a guiding force in shaping the policies in mercantile England, it seems unlikely that self interest and economic forces have ceased to be a guiding and influential force in shaping economic policy during the twentieth century. Moreover, since the evidence appears to support an interest group (as opposed to a public interest) explanation for the establishment of regulation (see Noll 1989)--that much economic regulation was the result of industries demanding regulation and/or shaping that regulation to their benefit--it seems highly probable that economic forces would also be a factor in explaining the exit of such policies from the political arena. If modern theories of regulation can be applied to explain the rise and *decline* of mercantilism then it seems entirely plausible that those theories, developed to explain how regulation came to pass in a modern context, should also be useful in explaining deregulation. The purpose of this dissertation, therefore, is to use interest group explanations for political behavior and collective decision-making in a manner similar to that employed by Ekelund and Tollison in their evaluation of mercantilism--to explain deregulation in terms of economics by "using the standard theory of choice, without recourse to historical or dialectical explanation" (Baysinger et al. 1980, p. 239). While ideas and intellectual arguments, and their influence on the political process are not unimportant, they do not give a complete explanation for regulatory change in particular, and social change in general. Before examining what this approach can contribute in terms of explaining deregulation it will be useful to examine the contributions and unanswered questions of previous studies of deregulation.

Previous Studies on the Economics of Deregulation

Numerous rationales for deregulation have been provided by economists and other scholars. One, previously alluded to, stems from an original justification for economic regulation, that market failure justifies price and control of entry to achieve a more efficient outcome than would occur with an unregulated market. This has been termed the "normative as positive" approach (Peltzman 1989, p. 4). The positive aspect is the test for the existence of market failure which then brings the normative conclusion that the government "ought" to regulate to achieve a more socially efficient outcome. To explain deregulation using this approach, technological change and/or altered demand conditions change the structure of the industry so regulation is no longer warranted. The difficulty with this argument is that theoretical and empirical analysis during the early 1960s revealed that regulation probably never achieved its stated goals of increased allocative efficiency and where it did affect prices it worked to increase them in non-monopolistic or highly competitive industries.[12] This *ex post* analysis of regulation appears to provide strong support for the economic theory of regulation and relatively little support for the public interest theory of regulation. Therefore, as

[12] Friedland and Stigler (1962) examined regulated electricity prices and found those prices to be no different from unregulated prices. Averch and Johnson (1962) theoretically revealed how regulation may result in "overcapitalization" and, therefore, an inefficient allocation of resources. Jordan (1972) finds that regulation is successful in raising prices in competitive and nonmonopolistic industries, such as surface and air transportation. Joskow and Noll (1981) survey the literature on the efficiency of regulation and find "virtual unanimity" among economists regarding the inefficiency of regulation in numerous markets.

Peltzman (1989, p. 5) notes, if the "normative as positive theory" could not explain the establishment of regulation, then it's not likely to offer a satisfactory explanation for deregulation. There have also been numerous attempts to go beyond the public interest approach and to examine the economic structure of each regulated industry to come up with an explanation for deregulation. While providing insight into why industries may no longer have benefited from regulation, they still leave a number of unanswered questions.

Extending the so-called normative as positive theory may aid in explaining deregulation in industries originally characterized by natural monopoly. Technological change made natural monopoly arguments less tenable in the telecommunications industry, bringing opposition groups into the political process and reducing the durability and expected benefits of monopoly rights. With the development of microwave and satellite transmission facilities, it became unnecessary to incur the large fixed costs of stringing wires cross-country to provide long-distance telephone service and, therefore, regulation due to natural monopoly was difficult to justify, either to consumer groups or to potential providers of service. These technological changes lowered costs, increased returns in some regulated industries and made it feasible for more than one firm to operate. While dismissing economic explanations for deregulation, Derthick and Quirk allude to such a possibility: "For a variety of reasons, the gap between costs and prices widened in certain markets. . . Such gaps increased the likelihood that regulatory issues would receive political attention, for they constituted an incentive to new entrants and required regulatory bodies either to admit new competition on controversial terms or, with equal or *greater* [emphasis added] controversy, to suppress it" (1985, p. 26). Maintaining monopoly under these circumstances may have been too costly an endeavor for the regulated and the regulators relative to the expected benefits. An increase in the influence of potential competitors--brought about by an exogenous event--in the telecommunication industry would provide evidence of a reduction in the durability of telecommunications monopoly and, therefore, the expected benefits of a monopoly right.

Regardless of the viability of competition within telecommunications, Derthick and Quirk do not believe potential competitors played much of a role in affecting deregulation, believing their political influence was weak and insignificant compared to the power of the established industries. It may be accurate that the resources available to potential competitors to influence the legislative process were meager (although, it will be argued later that their evidence supports the contention that potential entrants were a significant factor in the deregulation of telecommunications). This is not a sufficient argument, however, to rule out economic explanations. There are other mechanisms by which technological change and potential competitors could influence the regulatory process and even though their influence appears weak may have nevertheless reduced the present value of regulation, altering the incentives of decision-makers and effecting change. *At the margin,* the presence of potential competitors may increase the political cost and reduce the benefits of supplying economic regulation to the established industries and increase uncertainty about the potential for future rents. Changing *constraints* ultimately resulted in policy change. "Yet in each case technology seems to have created problems for retaining regulation in its old form, and a plausible argument can be made that technology created new organized interests, which in turn divided the old interests or created impossible management problems for regulators" (Noll 1989, p. 1276).

Since the demand for rent-seeking is a function of monopoly profits, a reduction in profits due to regulatory "inertia" could also cause a reduction in the value of economic regulation. This question has been examined by MacAvoy (1979). Pricing in the regulated airline and trucking industries was fairly stable until the late 1960s without much need for price increases, but inflation and rising fuel costs during the late 1960s and the 1970s required price increases to maintain competitive rates of return and to maintain investment. The inability for price increases to keep pace with inflation, and prices charged in unregulated sectors of the economy, could be a factor in reducing the demand for regulation in these industries. MacAvoy makes the point that the impact of economic regulation diverged sharply from what was expected (by both firms and regulators) when regulation was established prior to the 1960s (1979, p. 35). Regulatory inertia would be an endogenous factor that reduced the value of economic regulation.

Vietor (1991) has also examined the factors that reduced rents in the regulated airline industry. Frequent non-stop departures, room, comfort and amenities were the methods used by airlines to compete with one another under regulation. This type of competition increased costs and depleted rents to the regulated carriers. "In the absence of price and entry freedom, capacity was the principal means of competition. . . Modernity, speed, and comfort were critical aspects of service rivalry. No major carrier could afford to fall behind in new aircraft acquisition; thus, the repetition of frantic reequipment cycles, even to the point where domestic carriers ordered inappropriate and unnecessary 747's" (1991, p. 29). According to Vietor these reequipment cycles coincided with inflationary periods of rising fuel costs and economic downturn. Therefore, airlines were a clear example of regulatory induced declining rents, exacerbated by exogenous events--recession, oil price shocks and inflation. In this instance, the regulators could not enforce a perfect cartel. Thus, there is evidence that regulatory induced cost increases resulted in disappearing rents to certain industries. Nevertheless, while these industries did not demand to be deregulated per se, there was (particularly as will be shown in the case of the airlines) a general dissatisfaction and an unwillingness to support the status-quo.

Similarly, the banking industry experienced regulatory induced declining rents during the inflationary seventies. Regulation Q limited what banking institutions were allowed to pay depositors which led to disintermediation and financial innovation. As market rates of interest increased savers moved their funds into money market mutual funds to obtain a higher rate of return and to avoid the adverse effects of Regulation Q (Noll and Owen 1983, pp. 69-83). The existing regulatory structure was not effective in preserving the profitability of financial institutions during this period. An interesting aspect of bank regulation (and one analogous to the establishment of motor carrier regulation during the 1930s) is the quite typical response by the banking industry to declining rents. Rather than seeking deregulation, the industry initially sought to expand regulation to other parts of the industry, in effect, to increase their competitors' costs. "Rather than making savings deposits more attractive to consumers, the industry wanted to make the alternatives less so" (Ibid, p. 73). Established firms, whose cost structures are geared toward an uncompetitive environment (see Vietor 1991, p. 28), have a natural tendency to favor restricted entry into a market and price controls, even if the present regulatory structure is not providing economic rent. That is, regulation still has some value to incumbent firms, but its value relative to the cost of supplying regulation will determine how much is brought to the political marketplace. If regulation is not maintaining rents the response of rent-seekers is not to seek deregulation, but usually an attempt (demand) to restructure regulation in a manner beneficial to the incumbent firms and to continue to restrict competition. It is nevertheless apparent that economic factors facing financial institutions made the benefits of being regulated far less than when regulation was implemented, reducing the value of regulation to the banking industry. Regulatory induced policies that made it difficult for small savers to get an adequate rate of return along with technological and financial innovation may have reduced the value of regulation to the banking industry.

Peltzman (1989) has specifically attempted to analyze deregulation in terms of the theory of economic regulation, believing that a theory that explains what he calls the "entry" of regulation into the political marketplace should also be able to explain its "exit." Peltzman approaches the issue from the point of view that regulatory induced cost increases erodes rent over time, thus reducing the benefits to being regulated. When profits (rents) are eroded we should see exit of regulation (although, he admits the theory does not say how long this will take) from the political marketplace. Peltzman's conclusions are that losses precede exit in most but not all cases (i.e., airlines and railroads were clearly harmed by regulation). Peltzman believes that the loss of rents, however, can not be a necessary condition for deregulation as there are instances where rents precede exit. The trucking industry, particularly organized labor, was earning substantial rents when deregulation occurred, and the industry was highly vocal in opposing regulatory changes. Peltzman believes that when the exit of regulation occurs in spite of rents, this presents a problem for the economic theory of government, and he calls for further research in this area.

Keeler (1984) has attempted to reconcile public interest and interest group theories of deregulation. Airlines, railroads and telecommunications were granted above normal rates of return as long as they were willing to cross-subsidize high-cost segments of the market place. Under regulation, for example, airlines were required to provide service to low density (that is, communities too small to support scheduled air service) markets in exchange for above normal returns on high density routes. "[T]h benefits of service to small communities may have been concentrated enough to encourage small-town boosters to lobby for air service, while the costs to high-density and long-haul users may have been relatively unconcentrated and hard to see" (1984, p. 113). This was the characteristic of most regulated industries under the umbrella of economic regulation, and a general characteristic of the collective decision-making process illustrated by Buchanan and Tullock (1962). That is, there is the tendency for government to impose small, unidentifiable costs on the majority, while delivering concentrated, highly visible benefits to vocal and easy to identify interest groups, including subsets of consumers.[13] AT&T was allowed above normal profits on high density long-distance routes and to business customers in exchange for providing service to less profitable rural communities. According to Keeler (1984) regulatory induced rent depletion and technological change made it increasingly difficult for firms to provide service to high-cost customers, eventually leading to deregulation.

These studies, while revealing, do not adequately address why economic regulation exited the political marketplace. None examine the process of

[13]Posner (1976, p. 43) has noted, "A troubling characteristic of the internal subsidy is its low visibility, which impedes responsible review."

deregulation nor do they address the political scientists contentions regarding deregulation and the public interest.

Organization

While modern regulation and mercantilism have important differences there are also many relevant similarities. "[Mercantilism] is seen as a system engineered by a national elite to secure power rather than plenty, and [modern regulation] as a system which reflects the increase in the influence of domestic pressure groups in securing policies that have important domestic and international repercussions. We argue that, while there are some important institutional differences between the two mercantilisms, they are basically fueled by the same phenomenon--rent seeking"(Ekelund and Tollison 1981, p. 34). Given the assumption that individuals respond in a predictable manner to incentives regardless of the time period in which they live, it seems plausible--if not highly probable--that deregulation occurred, at least in part, due to the changing costs and/or benefits of rent-seeking.

Two pertinent observations in Ekelund and Tollison's *Mercantilism as a Rent Seeking Society* will be relevant in the effort to expand on the causes of modern day deregulation. Any potential monopolist seeking a monopoly right must be fairly certain that that right is going to persist well into the future. "Monopoly rights must be durable to be worth anything to special interests" (1981, p. 55). A reduction in the expected durability of a monopoly right reduces its value and will affect the current or potential monopolist's willingness to expend resources to obtain or protect that right. Other factors constant, we would expect less regulation as the value of being regulated falls. A number of factors, including an increase in the influence of organized opposition groups to regulation as well as institutional changes that changed the cost/benefit structure of regulation, may have had an influence in reducing the expected durability of monopoly rights. Technological change, a decrease in the cost of obtaining information (i.e., the harm regulation imposed on the majority), rising incomes and political entrepreneurs were all factors that could have an impact on the benefits of being regulated. Also, it will be shown that the interplay of the regulatory agencies and the firms within the industry may have inadvertently reduced the value of regulation by bringing unintended scrutiny upon the regulatory process and subsequent regulatory decisions generated additional uncertainty as to the durability of regulation. In regards to the value of economic regulation, it is the expected durability of monopoly rights that are significant rather than merely profits at any point in time.

A second relevant observation by Ekelund and Tollison is that "The rational rent seeker will reduce the bid for a monopoly right when lobbying costs rise" (1981, p. 56). Unique circumstances leading up to the deregulatory period may have increased the opportunity costs associated with the supply of legislation due to the inflationary characteristics of the period and also the public relation difficulties of government in the post-Watergate period. Institutional changes, partly brought about as a consequence of regulation itself, may have substantially increased the costs associated with obtaining and maintaining rent-seeking legislation. Politicians favor policies that will elicit votes. The blatant and obvious protection of big business contrary to consumer interests nor allowing inflation to continue unabated was in the interest of vote-maximizing politicians. It became too costly, relative to the rents at stake, for certain interests to maintain the status quo. The observation by Noll (1989), that political entrepreneurs seeking votes may inadvertently reduce the value of regulation to the beneficiaries and increase the cost of being regulated is relevant. Inadvertently, the institutional changes that occurred during the 1970s increased competition for political influence, reduced durability and increased the transaction costs of influencing the political process.

On the surface it appears logical that if economic arguments are capable of explaining deregulation, rather than ideological influences, there should have been a demand to be deregulated by the regulated industries, as asserted by Derthick and Quirk(1985). However, to address this issue it is necessary to examine the decline in regulation in a context whereby changing economic circumstances altered the constraints faced by the participants in the regulatory process, upsetting "equilibrium"[14] or the status-quo of regulation. Finding an economic explanation for the exit of regulation from the political marketplace entails looking at the behavior of all the major participants in the regulatory process. The interplay between industry, politicians/regulators, courts and other groups can alter constraints resulting in a reduction of economic regulation--even if regulation still has some value to interest groups. To show how this institutional change occurred, this study will relate the theories of economic regulation developed by Stigler (1971) and Peltzman (1974), in particular, to the deregulatory process of the 1970s. In addition, it will be necessary to go beyond what has been called the "Chicago theory of government," to theories that encompass voter rational ignorance and the role of political entrepreneurs.

It has been demonstrated that the rise and decline of mercantilism in eighteenth century England was the result of the interplay between self-interested parties seeking personal gain. According to Ekelund and Tollison, free trade did not arise merely because it was shown to be a "good idea." This

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[14]What is specifically meant by equilibrium in this context will be explained in chapter 2.

interpretation of economic history may have been lost if an economic explanation had been rejected merely because those who had been granted monopoly privileges did not lobby Parliament for the implementation of free trade. Therefore, it would be inappropriate to dismiss economic explanations for deregulation simply because there was no explicit demand to be deregulated from the regulated industries. Producers typically prefer less competition in the market of the goods they sell. As Noll and Owen (1983, p. 161) suggest, in the political arena, "Competition has only a fragile constituency."

During the 1960s and 1970s technological change first widened the gap between cost and prices, potentially luring competitors into regulated industries. Subsequently, inflation and higher oil prices created a regulatory inertia, and, along with conspicuous anti-competitive behavior by industry and regulators, the "irrationalities" of regulation became more visible. Groups, such as, journalists, consumer advocacy groups and the courts, could not help but take notice of these well-publicized examples of behavior which showed that economic regulation was not serving the public interest. The most blatant and publicized examples of regulatory failure occurred with the airline industry and the CAB, an industry that was dramatically affected by the exogenous events mentioned above.

It is, therefore, appropriate to begin with and concentrate on the CAB and the airline industry because the behavior of this agency and the airlines was highly visible and is said to have had a "demonstration" effect on other regulated industries. Because what occurred in terms of the behavior of firms, regulators, politicians and the courts pertaining to the airline industry may have had a "spillover" effect into other regulated areas of the economy, bringing scrutiny upon other regulatory agencies, it is a reasonable area to focus in explaining deregulation in terms of economics. That is, what occurred with this industry may shed light on the causes and effects of deregulation in other industries. Derthick and Quirk have found that deregulation of the airline industry does not fit well with the ideological paradigm. The deregulation of the airline industry is a case which Derthick and Quirk find "politically hard and hence puzzling if only because reform occurred early, before the fashion and feasibility of deregulation had been demonstrated . . ." (1985, p. 17) It is therefore difficult to explain the surprising origin and speed of deregulation in this industry as being attributable solely to a fashionable and powerful idea.

Particularly in the case of the airline industry, regulatory-induced rent depletion caused airlines to pull out of unprofitable markets and led the CAB to engage in egregious behavior aimed at restoring profitability to the industry and the political benefits to regulation(this point will be examined further). Among other factors, this behavior by the regulators caused the regulatory process to receive increased scrutiny from the legislature, courts, the media and, ultimately, the general public as well. The gains to politicians from the original regulatory structure came from brokering an agreement which allowed overall higher profits to the industry in exchange for providing service to organized consumer groups below cost, or where it would not be provided at all (Peltzman 1976). As long as the regulatory regime could maintain above normal returns and redistribute some of the gains to politically significant consumer groups, the industry, Congress and the courts were satisfied with the status quo. However, when regulators were no longer able to maintain a cartel, due either to technological change or regulatory induced rent depletion, economic rents were reduced, and thus the ability to "cross-subsidize" high cost consumers declined, creating pressure for change

(Weingast 1981). All of these actors are consistent with an economic paradigm and do not require a resort to "dialectic explanations." This study intends to examine the process of deregulation in greater detail and, by focusing on endogenous as well as exogenous factors, shed additional light on the manner in which economic forces resulted in deregulation.

The following chapter will explore further theories regarding the origins of regulation and literature relating to rent-seeking behavior. Following sections will explore some of the theoretical explanations as to why economic regulation has often resulted in less, rather than greater, economic efficiency. How particular institutions fit into a rent-seeking paradigm will also be explored--that is, the role of the legislature, courts and regulatory agencies. Later chapters will examine the behavior of the protagonists in the deregulatory process to see how their behavior conforms to and is explained by the theory of economic regulation, and more broadly, an economic theory of politics. Derthick and Quirk often cite the behavior of individuals within political institutions to support their theory of how ideas transformed public policy. This study will attempt to reinterpret that behavior in light of an economic paradigm. Finally, how these factors may assist in explaining the deregulation of trucking and telecommunications will be explored. It should be noted that, while regulation can take many forms, the primary focus of this study is economic regulation, that is, the institution of price controls and restrictions on entry, rather than social regulation, such as environmental and safety regulation, which have been on the increase of late.[15]

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[15]While social regulation can have economic impacts and thus be inspired by rent-seeking, this type of regulation is beyond the scope of this study.

CHAPTER II

THE CAUSES AND CONSEQUENCES OF ECONOMIC REGULATION

Introduction

To infer how economic factors played a role in the exit of regulation from the political marketplace it will be necessary to examine the justifications and theories explaining why the government established controls on entry and price. Arguments that economic regulation serves the public interest were widely accepted at one time, but theory and experience created doubts among economists and other scholars whether economic regulation actually achieved these normative goals. Some public interest arguments will be examined below. Following sections will explain how regulation can have value to interest groups and, therefore, be administered and established to benefit private interests over the public interest. The role political institutions play in establishing and maintaining economic regulation will also be examined. By defining those factors that affect demands for regulation and examining the institutions that support those demands, it is the objective of this chapter to reveal how those demands may have waned during the relevant period and the role political institutions may have played in the process.

Public Interest Theories

Historically, the primary justification for regulation of industry has been that of market failure, or that economic regulation furthers the public interest. "Regulation operated to cure market failures by substituting the expert planning decisions of an administrative agency for the defective allocations of the failed market" (Levine 1981, p. 179). Some industries, for example, are characterized by large capital expenditures and low marginal cost such that average cost declines over all relevant ranges of output.[16] The costs of providing the first units of output are high but decline as more of the good is produced, and two or more firms will operate at higher costs than a single firm. Power generating industries, hospitals and some transportation industries have such characteristics, where it is more cost efficient to have only one producer supplying the entire market.

In Figure 1, an unregulated natural monopoly produces Q_m, below the efficient output of Q_c, and sets price at P_m. Efficient pricing and output would require the firm to operate at a loss, however, where price and output is P_c and Q_c, respectively. During the previous century, it was argued that rail service to smaller communities possessed the characteristics of natural monopoly, where it was efficient to have only one rail line serving a community (i.e., competition would require the costly duplication of rail lines, etc.). It was argued that unregulated natural monopoly, as stated above, would lead to price above marginal cost, large deadweight losses and may also lead to substantial economic profit to the monopolist (the rectangle $P_m$abc in Figure 1), which society may find unacceptable. This concern over possible monopolistic abuse was ostensibly the reason for the first major regulatory effort of the Federal government, the *Act to Regulate Commerce* and the establishment of the Interstate Commerce Commission in 1887 to regulate railroads.[17]

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[16]See Carlton and Perloff (1990, p. 113) for a discussion of natural monopoly.

[17]Posner (1974, p. 337) contends that "The railroads supported the enactment of the first Interstate Commerce Act, which was designed to prevent railroads from practicing price discrimination, because discrimination was undermining the railroads' cartels."

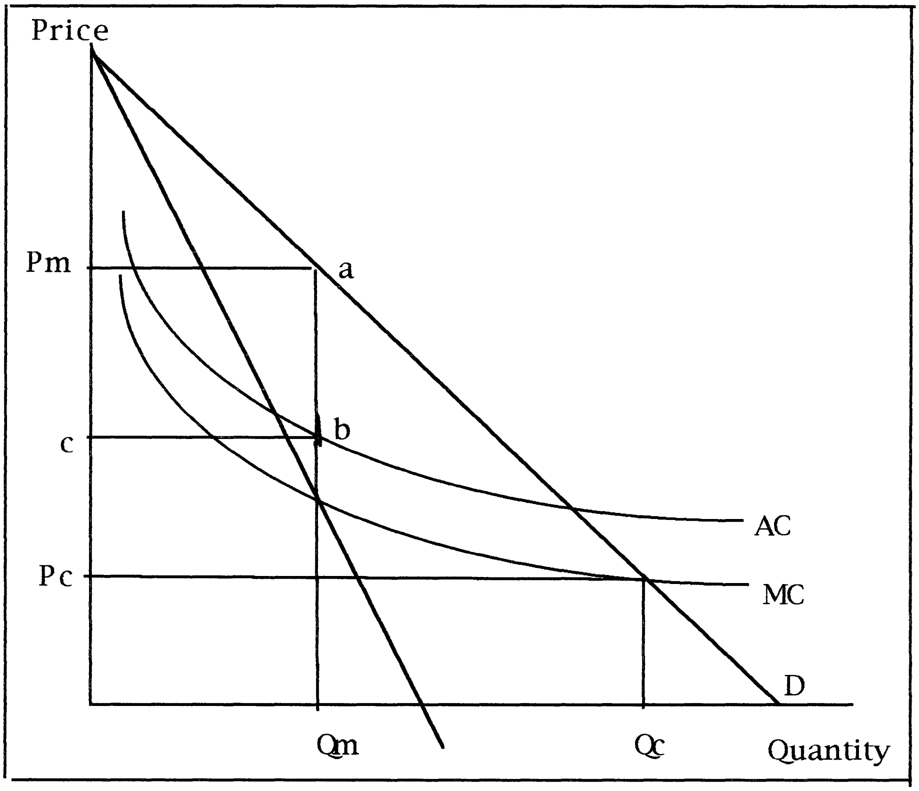

Figure 1. Natural Monopoly

In the case of natural monopoly described above, it's at least theoretically possible that government intervention would not be necessary to arrive at an efficient price and level of output. Applying the Coase (1960) theorem to the problem of natural monopoly, those who suffer the consequences of monopoly could bid more to cure the problem than the benefits to the monopolist. In Figure 2, where constant returns to scale are assumed for simplicity, the monopolist gains the area of rectangle A by restricting output and raising price. There is a loss of consumers' surplus indicated by the trapezoid $P_m abP_c$. Consumers would be willing to pay an amount up to the value of $P_m abP_c$ to obtain Q_c, which is obviously greater than the monopolist's gains. However, even though both parties would clearly benefit from such an arrangement, this solution to market failure is unlikely to occur due to the significant transaction costs involved in organizing a large number of consumers.

Since the Coase theorem will not hold when transaction costs are substantial, Noll (1989, p. 259) illustrates another consideration concerning regulation and market failure, and where economic regulation may serve the public interest. When large numbers of individuals are involved and thus high organizational costs are present, political entrepreneurs may act as agents for the afflicted interest group, pointing out harm and acting on their behalf. Politicians could potentially reduce transaction costs allowing for a more efficient solution, that is, an output closer to Q_c and price close to P_c in Figure 2. Therefore, when there is market failure and large transaction costs government regulation may improve efficiency.[18]

[18]Pogue and Scontz (1978) point out that government action is not costless and government action may eliminate the welfare gains from eliminating monopoly.

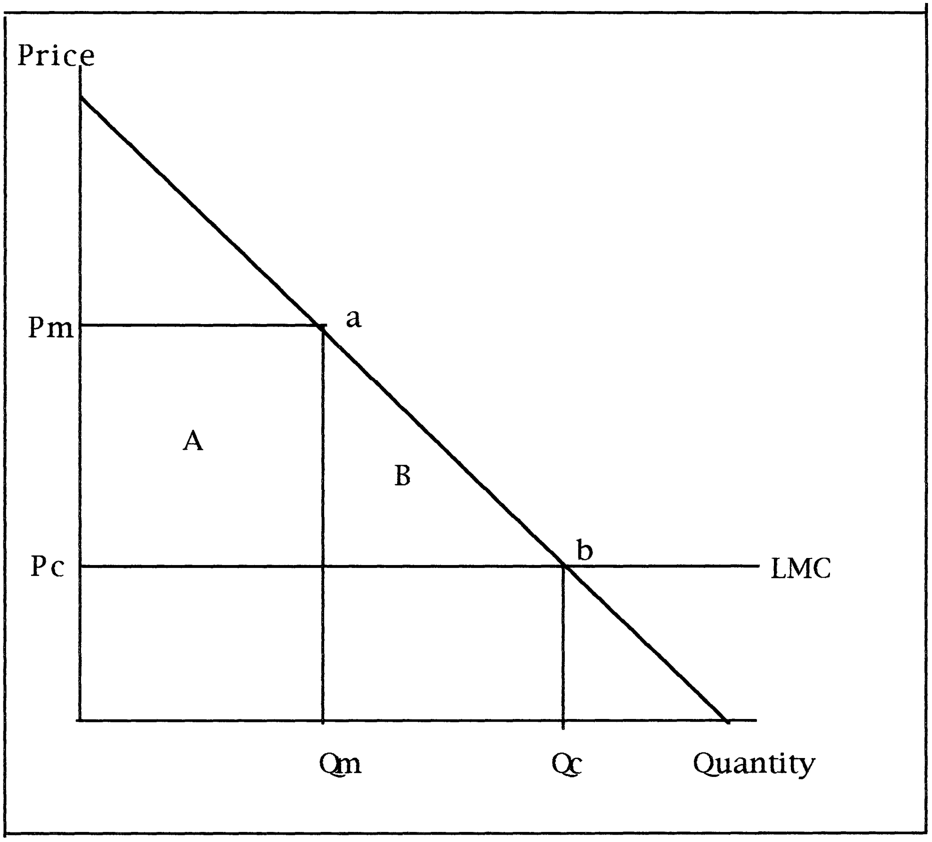

Figure 2. Coase Theorm

Another frequently used but less persuasive justification for regulation has been "destructive competition," where a market is characterized by instability and uncertainty which generates a great deal of risk to producers consumers. Under the theory of destructive competition firms will enter and exit frequently and engage in below cost pricing, creating extreme uncertainty about quality, availability and prices. This behavior will allegedly lead ultimately to a few producers capable of monopolistic pricing. These chaotic characteristics of the market, it has been claimed, can only be curtailed by restriction of entry, regulation of price and other controls placed on the entire industry. However, economists have been skeptical of such a theory and this argument, "...subsequently ... has been rejected in economic research" (Noll 1989, p. 1257).

Prior to the establishment of the Civil Aeronautics Board (CAB), and before trucking was brought under the umbrella of the ICC, losses in the airline and trucking industries were allegedly the result of such a chaotic market structure. However, Caves (1962) notes that the airline industry was subject to some control of entry and prices prior to 1938,[19] and, therefore, there was not absolute freedom of entry and pricing prior to the establishment of the CAB. Caves claims losses to the industry during this period were due to competitive bidding for airmail contracts after 1934 and the effects of the Great Depression and "have nothing to do with competitive market conduct" (1962, p. 383).[20] Nevertheless, destructive competition was one of the primary

[19]Vietor (1991, p. 21) notes that the "[g]overnment literally created the market." In 1930, to facilitate mail delivery, the federal government allowed the fledgling air carriers to "agree among themselves as to the territory in which they shall have paramount interest."

[20]Douglas and Miller (1974, p. 189) note that, "Despite allegations of pending collapse of the system, domestic air travel grew from 189.2 million revenue passenger miles in 1934 to 410.3 million in 1937."

arguments put forth to justify regulation of trucking and airlines during the 1930's. Edgar Gorrell, president of the Air Transport Association in testimony before Congress during the 1930s stated that, "there is nothing to prevent the entire air carrier system from crashing to earth under the impact of cutthroat and destructive practices" (quoted in Vietor 1991, p. 23). If the theory of destructive competition were valid, it was never made clear how trucking and airline markets differ from other competitive markets and why there was not widespread "instability" of this sort.

It is seemingly a paradox that both too little and too much competition have been used to justify economic regulation. The Second Report of the Federal Coordinator of Transportation, produced in 1934, explains the reasoning behind federal control of interstate trucking. In his report the Coordinator is evidently aware that regulation of trucking is being sought primarily by railroads, stating that, "Much of the demand for regulation. . . has come from railroads, for their own protection" (quoted in Weiss and Strictland 1982, p. 209). Nevertheless, he states at the beginning of the report that, "It is clear that no regulation or restrictions should be imposed upon any form of transportation merely for the purpose of benefiting some other form of transportation" (Ibid).

The trucking industry is characterized in the Coordinator's report as "highly competitive" with "ease of entering," conditions that economists would associate with market efficiency. The primary competition to rail traffic in the early days of trucking was from short-haul traffic, which was generally unprofitable for the rail lines, so this competition was of little concern to the railroads. However, as roads steadily improved during the 1920s and 1930s, competition from trucks hauling freight longer distances raised the ire of the railroads because these were their most profitable routes. Low rate "back hauls," where a trucking firm sets minimal charges so that trucks do not return empty, are said in the report to be of "great danger to the entire transportation industry"(Ibid, p. 212). In summing up the need for regulation, the Coordinator cites waste and duplication of service and costs greater than benefits imposed on customers by a highly competitive market (a lack of quality service, for example). Summing up the need for regulation in the trucking industry he remarks that, "free for all competition has never worked successfully, either here or elsewhere"(Ibid, p. 214). In spite of the fact that the airline and trucking industries were not characterized by natural monopoly, the Interstate Commerce Commission began regulating interstate trucking in 1935, and the Civil Aeronautics Board was established in 1938 to regulate interstate airline traffic, ostensibly to further the public interest.

In spite of the arguments put forth to justify regulation of industry, theory and experience have provided economists with a healthy dose of skepticism with regards to the idea that regulation serves the public interest: "Were [the public interest] theory of regulation correct, we would find regulation imposed mainly in highly concentrated industries (where the danger of monopoly is greatest) and in industries that generate substantial [social] costs or benefits. We do not" (Posner 1974, p. 336). With public interest theories of regulation in doubt, economists have looked for other explanations to explain the establishment of the regulatory apparatus and in doing so have turned to examining (using economic tools) the collective decision-making process.

Interest Group Theories

It is well known that firms have an incentive to form cartels, whereby the firms within a particular industry behave as a monopoly, restricting output and extracting economic rents. To form a cartel privately, though (ignoring the problem of usually being illegal), requires monitoring and control of entry into a market. However, policing of members privately is often difficult and prohibitively costly. Once a private agreement is in place, cartel members have a strong incentive to "cheat" due to the fact that individual members can usually gain from increasing output if others in the cartel do not. This incentive to cheat often causes the cartel to eventually break down, eliminating the economic rents to all members. To overcome the organizational costs involved in forming and maintaining private cartels, producers will seek legal sanctioning of the cartel (hence the term rent-seeking). Such an action, while still costly, may solve the inherent difficulties in forming private agreements by having the government monitor firm behavior and enforce the law. Historically, industries have successfully obtained the help of government regulators to overcome these difficulties in forming cartels privately.[21]

Stigler's Capture Theory

It is therefore the desire for rents through the formation of legalized cartels that many economists believe provides a more robust explanation for the establishment of economic regulation. This "interest group" explanation for regulation, put forth by Stigler (1971) postulates that industries "capture" the regulators so that regulation is manipulated to benefit the firms involved.[22] Capture occurs as the regulated and the regulators associate and

[21]See Ekelund and Tollison (1980) and Carlton and Perloff (1990) for a discussion on the difficulty of forming a cartel privately.

[22]An egregious example of capture is provided by Stigler (1971). Two states, Texas and Louisiana, placed a 7000 pound weight limit on trucks serving two or more rail stations and a 14000 pound limit on trucks serving, and hence not competing with, only one rail station. As Posner (1974, p. 341) has noted, it is

become sympathetic toward each other. Individuals employed at regulatory agencies may find attractive employment opportunities in the regulated industry before and after their tenure at an agency. Given the difficulty regulators have in gathering information, the major source of information for the agencies in administering their decisions will be the regulated firms or trade association of the industry. Therefore, regulatory decisions will benefit producers because of the close, mutually beneficial relationship that develops between the regulators and the regulated.[23]

As evidence for his theory, Stigler notes that some industries are able to acquire beneficial regulation claiming to be vital for national defense. As a consequence these industries are able to obtain controls on new firms entering the industry rather than direct subsidies from the government (even though a subsidy would be less costly from a social standpoint) because subsidies would need to be shared among a growing number of new firms, dissipating the benefits to those already established. Unless an industry has a very low elasticity of supply it will prefer (and obtain) restrictions on entry by new firms rather than direct cash payments from the government. Restrictions on entry, price-fixing and control of substitute/complement relationships are some of the beneficial legislation industries have been able to acquire from government regulators and result from the "demand" for

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not only capitalists who capture the regulators as Marxists would claim, but a number of groups, including labor unions, farmers and any groups able to muster sufficient political clout.

[23]Posner (1974, p. 344) notes that the term "capture" may be too limiting of a description. It may be more appropriate to use a broader term such as "economic theory" so as not to preclude the possibility of special interests establishing regulation in the first place, not merely shaping it to their benefit after it has been established. Regulation "can be viewed as a product whose allocation is governed by the laws of supply and demand."

regulation.[24] The supply of regulation comes from votes, money and resources (campaign workers) provided to candidates (whose desire is election or reelection) by those groups who benefit from being regulated.

In Stigler's theory, established industries benefit at the expense of consumers and potential competitors. However, if consumers are harmed by economic regulation why don't they organize against it? Stigler (1971) addresses this issue by pointing out that decisions by individual voters in the political arena are affected by costs and benefits just as they are in the private sector. If a policy has a negligible effect on a voter it usually does not pay for the voter to be well informed on such an issue. He is "rationally ignorant" of the political process. His vote is not likely to have an effect on the outcome of an election, so the costs of acquiring any additional information (beyond what's cheaply available) generally outweigh any additional benefits if a particular policy imposes a very small cost on him. Stigler asserts that this tendency to disregard the "lessor preferences of majorities" can 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" (1971, p. 12). [25]

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[24]An additional explanation for entry restrictions and price fixing as opposed to a subsidy is provided by Tullock: ". . . it is simply that the pushing through of such a benefit not be obvious to the very much larger collection of voters who will be injured by it" , and that "if a program was set in hand to give me $1 million a year out of the Treasury, I would face a series of annual votes on that $1 million. If on the other hand, the laws were rearranged is 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" (1980, p. 219).

[25] Many of Stigler's assertions, such as the theory of rational ignorance, are traced back to Downs (1957) *The Economic Theory of Democracy.* There is also the economic argument that producers have an advantage in influencing the political process in that they tend to be small in number and relatively easy to organize politically with the ability to prevent free-riding, where this is generally not the case with consumers, who are too numerous to overcome organizational costs.

Stigler looks at occupational licensing to test his interest group theory of regulation. Licensing is a common method of restricting entry into an occupation and presumably raising the incomes of those who are able to acquire a license. He theorizes that (1) the larger the occupation the more political influence the occupation will have and the quicker that occupation will be regulated, and (2) the more concentrated the occupation is in urban areas the lower the organizational costs, and the sooner licensing will occur. While his empirical results do show some support for his theory, they are not robust. However, an interesting and relevant hypothesis made by Stigler is that the presence of an organized opposition group to licensing (regulation) will result in higher costs associated with acquiring a license (regulation) and will prevent or weaken the implementation of regulation driven by special interests. That is, he gives an economic explanation as to why regulation may be slow to occur or why the presence of an organized opposition group could possibly reduce the expected benefits to being regulated as well as increasing the costs to the public sector of supplying regulation.

Peltzman's Formalization of Stigler

Peltzman's (1976) important theoretical development, and his subsequent reassessment (1989), extended and clarified Stigler's (1971) work and showed how regulators (by which is meant the whole regulatory apparatus of politicians, committees and regulatory agencies) "will allocate benefits across consumer and producer groups so that total political utility is maximized" (1989, p. 10). In other words, politicians wish to maximize votes and cannot do so by totally ignoring the interests of consumers or others who would be harmed by regulation. He, therefore, extended the theory of economic regulation to show how regulators "will not serve a single economic interest" (1976, p. 211). That is, his analysis explained the often observed phenomenon whereby regulators subsidize subsets of consumers, ones who would pay a higher price for a good or service or not receive the good or service at all without the help of regulators, as well as shedding light on why highly concentrated *and* highly competitive industries are often the ones regulated.

In Stigler's theory politicians wish to maximize their political support (i.e., votes). In formalizing Stigler's analysis, Peltzman notes that, "Greater majorities are assumed to imply greater security of tenure, more logrolling possibilities, greater deference from legislative budget committees . . . ."(1976, p. 214) Therefore, the politician/regulator wishes to maximize votes (or a majority, M) according to,

$$M = n \times f - (N - n) \times h, \tag{1}$$

where,

n = number of potential voters in the beneficiary group
f = the probability that a beneficiary will grant support
N = total number of voters
h = the probability that those taxed oppose the transfer

Peltzman uses Stigler's assumptions that beneficiaries of a government policy pay with both votes and dollars, where dollars are used to "mitigate" opposition (i.e., campaign contributions, efforts to convince the majority not to oppose a transfer of wealth, etc.). Greater majorities provide more security, perks, etc. to the politician/regulator. In the political process both the winners and losers face information and transaction costs, however, so that the value of both f and h lies between zero and unity. Therefore, the probability of support for a wealth transfer is

$$f = f(g), \tag{2}$$

where,

$$g = \frac{T - K - C(n)}{n}, \tag{3}$$

and where,

> T= total dollars transferred to beneficiary group
> K=dollars spent by beneficiaries on campaigning, lobbying and mitigating opposition
> $C(n)$=cost of organizing, which is positively related to n.

The marginal benefits to g are positive but decreasing, so that,

$$f_g > 0, \quad f_{gg} < 0.$$

An increase in n broadens the base of support for a wealth transfer but will also dilute the benefits for each member of the group, and increases the cost of organizing (i.e., creates "free rider" difficulties), reducing the probability of support and, therefore, the assertion is made that "lobbying and campaigning costs will rise faster than group size"(Ibid, p.213). There is a limit, therefore, on the ability for groups to achieve a transfer of wealth. Peltzman also assumes the regulator chooses K and T.

Peltzman assumes that the transfer T is generated by a tax of t (where t could be a regulated price so that producers are the beneficiaries) and B is wealth to be redistributed (or consumer surplus once again in the case of regulation), so that

$$T = t \times B(N - n). \tag{4}$$

Peltzman assumes that opposition to the tax (or regulation) is a function of the tax and per capita "education" expenditures that mitigate voter opposition, z, so that,

$$h = h(t, z), \tag{6}$$

and

$$z = \frac{K}{N - n}. \tag{7}$$

An increase in z mitigates opposition but there are increasing costs associated with such efforts so that,

$$h_z < 0, \quad h_{zz} > 0.$$

An increase in the "tax" increases opposition and from which there are assumed to be increasing costs associated with wealth redistribution. That is, a rising t will increase opposition at an increasing rate:

$$h_t > 0, \quad h_{tt} > 0.$$

It is typically observed that regulators do not allow maximum profits to regulated firms. Therefore, Peltzman then goes on to extend Stigler's analysis and formalizes Stigler's observation that "the political process automatically admits powerful outsiders to the industry's councils" (1971, p. 7). After making substitutions, Peltzman differentiates equation (1) with respect to T:

$$M_t = f_g - h_t\left(\frac{1}{B + tB_t}\right) = 0. \tag{8}$$

The marginal product of t in raising revenue is equal to $B + tB_t$ and must be positive for an interior solution. A tax or a price that maximized revenue to the beneficiary would imply that this term be equal to zero, however. "That it must be positive implies that these losers must be taxed less than the interests of the winners would dictate"(1976, p. 217). To obtain a majority the regulator must not allow the winner to receive a maximum return, so that "pure producer protection will not, in general, be the dominant political strategy" (Peltzman 1989, p. 9). In other words, in the case of economic regulation, the regulator will not allow a profit-maximizing price. The regulator wants to please any group that has "any significant marginal political weight" but is constrained in this endeavor by the cost and demand conditions within the regulated industry (Ibid, p. 10).

Peltzman (1989) goes on to explain an interesting implication of this theory. An increase in fixed costs in the regulated industry (X) would under an unregulated environment come directly out of producer's surplus. In a regulated environment, however, the regulator will spread the increased cost over all groups and increase the price of good X so that consumers bear sum of the "pain" of the cost increase (Ibid). Therefore, a changing industry cost structure will alter the amount of surplus available (B) and regulators will attempt to pass part of this cost increase onto consumers in order to maintain a majority. Conversely, a declining cost structure will not result in the producer capturing all of the additional surplus. The regulator will pass some of the benefits to consumers in the form of lower prices.

These implications can be seen from a graphical representation in Figure. 3. A vote maximizing politician is faced with trading wealth between consumers, measured by price, and producer wealth measured by profit. The constraint or profit hill is effected by changes in demand conditions that would alter the amount of surplus available, as well as the cost structure of the industry, so that,

$$\Pi = \Pi(p,c), \tag{9}$$

and,

$$\Pi_p > 0, \ \Pi_c < 0.$$

For a politician to maintain a given majority, M he trades off higher prices to consumers with higher profits to producers. A higher price offered to producers will bring forth more efforts to mitigate opposition. To maintain his utility, the politician provides benefits to producers in the form of higher profits and receives greater "contributions," which can then be spent on maintaining a majority." Therefore,

$$M = M(p,\Pi), \tag{10}$$

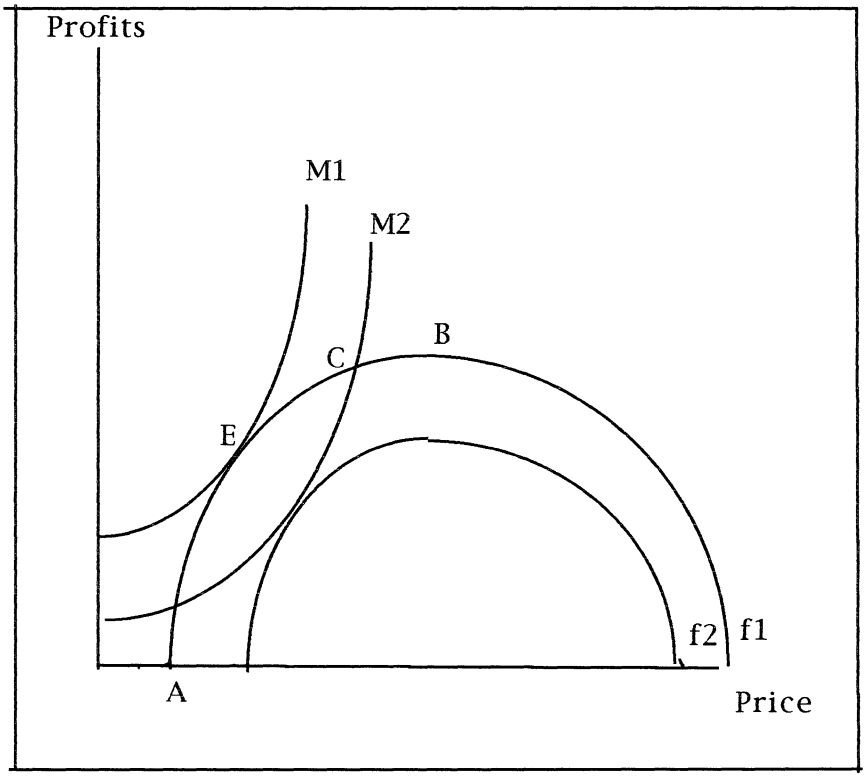

Figure 3. Maximizing Political Utility

where p is equal to price or consumer wealth and Π is equal to producer profit, and,

$$M_p < 0,\ M_\Pi > 0.$$

Thus, the indifference curves slope upward to the right. The objective of the politician/regulator is to reach the highest indifference curve possible given the constraint--that is, to maximize a majority or to achieve the greatest number of votes possible.

The regulator/politician must make a tradeoff between the interests of consumers and producers. Greater producer profits require greater campaign contributions, lobbying, etc. which reduces opposition to higher prices. Therefore, higher political utility is obtained by moving from a southeast to northwesterly direction. It is clear from Figure 3 that the greatest political utility does not come from allowing producers to maximize profits, which is point B where maximum producer wealth is obtained, nor by allowing consumers to retain all of their surplus, which is point A where maximum consumer wealth is obtained, but at some intermediate point that considers the interests of some consumer groups and does not allow producers to "maximize profits." In this case maximum votes or "political utility" is obtained at point E. Peltzman's theory provides insight into the seemingly paradoxical result that often highly competitive (e.g., agriculture) and monopolistic enterprises are the industries most often regulated--regulation of these industries provide the greatest gains in political wealth to the regulator. A relatively small amount of political wealth is gained from regulating oligopoly, point C. Also an increase in costs, which causes the profit hill to shift downward to f2, will also result in an increase in prices.

This observation that regulators take into account the interests of at least some consumer groups gives theoretical weight to the commonly observed practice of "cross-subsidizing" certain high-cost, politically organized users of the regulated good. High marginal cost users of a good are subsidized by the low-cost user (e.g., under airline regulation communities that would not be able to support air transportation, or low density routes, were subsidized by fares charged on high density routes). Such a policy provides the greatest political benefit to regulators. An implication of Peltzman's theory is that regulatory equilibrium may be upset by changes in demand or costs in the regulated industry, which alters the profit hill, f, or by changes in the iso-vote curves, M.[26] It is clear that regulatory equilibrium in this model can be upset by increases in industry costs and by changes in the availability and access to information and, subsequently, the probability that those harmed by regulation will oppose having their wealth taken--as well as changes in support from potential beneficiaries. Increases in the marginal political weight of those harmed by regulation results in steeper indifference curves.

Becker's Theory of Pressure Groups

Becker's (1983) analysis produced another significant contribution to the theory of economic regulation that incorporates a dynamic element into the regulatory process, with implications similar to Peltzman (1976) and Stigler (1971). Interest groups pressure regulators to redistribute wealth in their favor and potential losers in the political process will organize and exert influence to avoid having their wealth taken. If deadweight losses are sufficiently small, group A, with more money and smaller organizational costs, will likely be able to extract wealth from group B, which with greater organizational costs, cannot prevent free-riding. However, groups are

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[26]See McChesney(1991) for a partial equilibrium analysis of Peltzman's theory.

sensitive to deadweight losses and, as such costs increase (possibly due to the wealth redistribution), losers become increasingly empowered to expend money and influence on the political process. "Losers need not passively accept their fate, but can trim their losses and the gains to winners by lobbying, threats, disobedience, migration, and other kinds of political pressure to raise their influence" (1983, p. 377). As in Peltzman's (1976) theory, there is a constraint on a pure profit maximizing solution by producer groups and a mechanism by which the regulatory "equilibrium" can be upset. Factors that increase deadweight losses to "losers" in the political process will increase the potential gains associated with efforts to mitigate losses. It's therefore possible for losers in the political process to become winners in the face of changing costs and/or benefits. An implication of Becker's analysis is that "[p]olicies that reduce the total wealth available for redistribution will be avoided, because, other things being equal, they reduce the political payoff from regulation" (Peltzman 1989, p. 13).

The Social Costs of Rent-Seeking

When an industry is successful in obtaining a monopoly deadweight losses result. It was common to *only* look at the loss of gains from exchange when evaluating the social cost of monopoly. Some studies have indicated that these costs are relatively small.[27] For a time these studies led some to believe that allocative efficiency is not particularly important and, therefore, monopoly should not be of much public concern (Tullock 1967, p.224).

Consider Figure 4 (a reproduction of Figure 2), where once again constant returns to scale is assumed for simplicity. A firm is initially

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[27]Harberger (1954), for example, has estimated these costs to be less than one percent of GNP.

producing at a competitive price and output of P_c and Q_c, respectively. If a firm is able to achieve monopoly status, output falls to Q_m and price increases to P_m. Area B was said to be the only social cost associated with monopolization, an inefficiency where potential gains from exchange go unrealized. That is, the additional benefits to consumers of producing to Q_c outweigh the additional costs as represented by the long-run marginal cost curve. Area A was assumed to be a transfer from consumers to producers which may have some affect on income distribution but would not be considered "inefficient."

Tullock has made the assertion that looking only at deadweight losses results in an "underestimation of the welfare costs of tariffs and monopolies" (1967, p. 224).[28] The potential for monopoly profits through rent-seeking draws resources into attempts to acquire those profits while those who would be harmed use resources to avoid having their wealth taken. He compares the rent-seeking process to a thief investing in equipment to commit larceny, and potential victims of crime investing in alarms and other devices to protect their property. The stolen property is a pure transfer but the resources used to commit and prevent crime are wasted from a social viewpoint. Just as a thief has an incentive to invest in lock picks, flashlights and other criminal paraphernalia, a potential monopolist might be willing to invest resources at least equivalent to area A to obtain monopoly status. Tullock states that,

> Surely we should expect that with a prize of this size dangling before our eyes, potential monopolists would be willing to invest large resources in the activity of monopolizing. In fact the investment that could be profitably made in forming a monopoly would be larger than this rectangle, since it represents merely the income

[28]See also Tullock (1980) for an elaboration on rent-seeking costs.

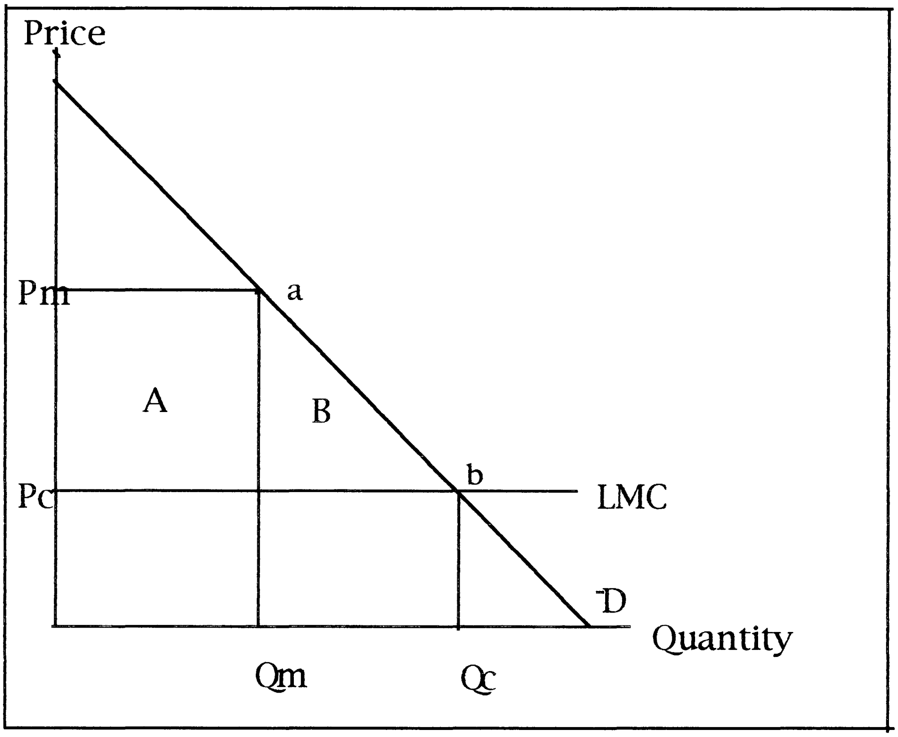

Figure 4. Rent-Seeking Costs

transfer. The capital value, properly discounted for risk, would be much more (Ibid, p. 231).

Assuming that the competition to obtain monopoly profits results in complete dissipation of the rents,[29] the social cost of monopoly includes the area A as well as area B. Resources employed in the process of obtaining monopoly profits through rent-seeking are not used to produce goods or services of value to society. Entrepreneurial talent is diverted toward influencing public policy in the firm's favor rather than creating innovative low cost production techniques or developing new products or services. Lawyers, who could be writing contracts and facilitating exchange, instead are lobbying government officials and promoting what is in effect "plunder."[30] These rent-seeking costs have been estimated to be potentially larger than the traditional deadweight losses associated with monopoly (Posner 1975).

Market Rent-Seeking

The social costs associated with lobbying the government for rents differs substantially from, and should not be confused with "market rent-seeking."[31] An economic profit (or rent) is a payment to a resource owner

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[29]See Jadlow and Jadlow (1988) for a discussion on the conditions necessary for complete rent dissipation and Hazlett (1993) for some empirical evidence on rent dissipation. It should be noted that complete dissipation of rents would not necessarily imply that rent for the ultimate monopolist disappears and, therefore, rent seeking is "irrational." The resources an individual spends to obtain a monopoly right may be less than the total social cost of rent-seeking. For example, if five risk neutral rent seekers compete for a randomly awarded monopoly right worth $50,000 and each invests $10,000, the rent is totally dissipated from a social point of view, even though the winner of the monopoly "right" earns economic rent (Ekelund and Tollison 1981, p. 23).

[30]See McCormick et al (1984). They argue that if rent is fully dissipated and durable it does not pay society to deregulate. If rents are not fully dissipated nor durable there are gains to society from deregulation.

[31]This discussion draws from Buchanan (1980) and Ekelund and Tollison (1981).

over an above what that resource could have earned in its next best alternative. Market rent-seeking is a natural out-growth of the competitive market process and can occur through developing innovative low cost production techniques--which may allow a producer to earn economic profit and may also benefit society by freeing up resources for other productive uses. The development of new goods or services may allow an entrepreneur, at least for a time, to earn economic rent. Receipts in excess of opportunity costs (profits) are an important signal for resources to move into profitable endeavors and out of those that are less profitable--a signal that consumers value certain goods more highly than others. Production in the profit generating endeavor will expand while output in those markets experiencing losses will decline. Profits (or losses), therefore, act as a signal that serves a very important economic function in determining an efficient allocation of resources. Therefore, seeking and acquiring rent through the competitive market process has "socially desirable consequences." As long as there are no restrictions on entry (or exit), profits will be driven to "normal" levels and will not remain far above (or below) opportunity costs indefinitely.

Political rent-seeking, as described by Tullock (1967), is the use of scarce resources to create a pure transfer of wealth, "an artificial scarcity." Seeking this type of rent has socially undesirable characteristics. Not only is production of the good in question reduced, but lobbying for legislation to acquire monopoly rights uses valuable resources that could have been used to expand productive capabilities. These resources are wasted from a social point of view--they create no value since they are not used to expand the supply of available goods and services. It is rent-seeking of a political nature that this study is concerned with.

The Extraction of Private Rents

In the traditional rent-seeking models described above politicians are passive "brokers," facilitating exchange of consumer surplus for political rents. McChesney (1997, 1991), primarily by applying Coase's (1937) theory of the firm to political behavior, has extended the role of the politician from one of a mere broker to one who actively seeks to enhance his own well-being. Instead of politicians merely creating rents and in the process receiving votes, campaign resources, cash contributions, favors, etc., politicians may actively seek to enhance their own welfare rather than waiting to respond to interest group demands. "Politicians are seen not as mere brokers redistributing wealth in response to competing private demands, but as independent actors making their own demands to which private actors respond" (1997, p. 157). According to McChesney, politicians engage not only in rent-creation but also in what he calls "rent extraction." When politicians threaten to enact usury laws, regulate health care or increase taxes, political contributions and lobbying efforts by organized interests typically increase. Sufficient contributions may kill the attempt at extracting private wealth. McChesney's model assists in explaining previously unexplained political behavior--namely, why some industries, groups or activities are regulated while others are not. A payment of sufficient size will kill proposed legislation.[32] Not surprisingly, whether politicians engage in rent creation or rent-extraction depends on which will benefit them the most. If demand conditions in a particular market are inelastic politicians will gain more by

[32]For instance, in response to the Clinton administrations health care plan of 1993, representative Jim Cooper received campaign contributions between $500,000 and $1 million dollars by working on a plan "less destructive" to the health care industry (McChesney 1997, pp. 57-8).

offering the creation of political rents (after which they may threaten those rents to obtain more of the surplus for themselves). However, elastic demand conditions in a product market makes rent-creation deals problematic, but may afford an opportunity for extraction, particularly when there is highly specific capital employed in an industry (Ibid, p. 28).

A potential example of rent-extraction would be the creation of political rents and then the mounting of a threat to take those rents away through deregulation. In this case, shareholders who have the value of rents capitalized into stock prices would presumably "pay up" to not suffer a loss of wealth. Opportunistic politicians may be more inclined to threaten a loss of wealth because current legislators were not party to the original deal and would not keep the status quo unless they too were compensated (Ibid, p. 23).

In McChesney's analysis, attracting contributions either to create rents or from the threat of expropriating them requires that politicians be able to make "credible threats"[33] to private wealth and/or requires the ability to establish durable legislative deals with interest groups. If there is a high probability that politicians will be unable to deliver on political rent creation deals or if their threats of extraction are not credible, the services of politicians will be less valuable. "If durability cannot be achieved in rent creation, either because politicians act opportunistically or because only short-term deals are made, both private producers and politicians will invest less in working toward creating rents" (Ibid, p. 89). Thus, politicians openly pay a price by engaging in opportunism--such behavior may reduce the future ability to receive payments for "services." Even though a deal entered

[33] Similar to disciplining a child, a politician while reluctant to expropriate rents, must convince others of his willingness to do so. "That is, the threat to expropriate--which is not the politician's preferred strategy--must be credible" (1997, p. 39).

into by a previous legislature provides no benefit to the current crop of politicians, overtly repealing such legislation could be costly. Politicians must weigh the cost and benefits of such opportunistic behavior carefully. The utility maximizing politician has an incentive to maintain the value of his services. He knows that repealing an established deal may reduce that value, and therefore he has an incentive to avoid (or at least avoid the appearance of) opportunistic behavior.

Another important point made by McChesney is the value of political organization. The more organized an interest groups is--that is, the interest group is able to lobby and articulate its interests to the legislature with one clear voice--the lower the transaction costs between private parties and politicians. Everything else equal, more organized groups will be more likely to affect legislation: "[I]t is cheaper to negotiate with an organization representing millions of persons rather than with those millions individually" (McChesney 1991. p. 83).

McChesney also points out that "[g]athering information about supply and demand elasticities, entry costs, and the size and mobility of capital stocks is costly to politicians" (1997, p. 36). As in many types of exchanges, would-be purchasers of political favors have an incentive to hide their true willingness to pay. Politicians test for the value of legislation by testing over time what resources interest groups are willing to devote to obtaining political rents or to not having their wealth expropriated. Of course, politicians, as providers of political favors (and extortion) also have an incentive to hide their preferences for and willingness to supply legislation (Parker 1996).

The observation that politicians are more than mere passive brokers in the exchange of legislation, and that the ability for groups to organize politically to achieve rent-seeking goals are important signals as to the value of legislation, may assist in explaining some aspects of deregulation and why it occurred--or why deregulation occurred to a greater extent in some industries rather than others. McChesney's analysis of the behavior of politicians may also assist in explaining some aspects of the deregulatory process--particularly why deregulation appeared first in the regulatory agencies (this question will addressed in a later chapter). Nevertheless, durability is an important element in conducting many types of exchanges. For "political services" to have value, institutions must be structured in a manner that preserves the durability of legislation.

The Creation of Durable Agreements

In a market economy the judicial system plays a significant role in promoting wealth creation. The judicial and legal system may facilitate production and exchange and enhance a society's wealth through enforcement of contracts and property rights. However, economic theories of government also place the judiciary as a facilitator of private interests over the public interest. While the federal judiciary is considered "independent" from the legislative and executive branches of government, from an economic perspective this independent status of the judiciary may enhance rather than inhibit the ability of Congress to pass legislation beneficial to interest groups.

Federal judges are not elected officials; they are appointed by the president and have lifetime tenure. In this manner, judges cannot be replaced merely because the legislature or the president do not agree with their rulings. Congress, by not being permitted to reduce the salaries of federal judges while they are in office, have limited leverage over the judiciary. One interpretation of this institutional structure is that these factors insulate the judiciary from the political process, that is, from direct influence by Congress, the executive branch or special interest groups. Thus a public interest perspective of the independent judiciary is that it exists to "protect society from unconstitutional actions by the other branches, and judges are motivated in this pursuit by concern for the public interest" (Anderson et al. 1989, p. 215). In light of this view, the manner in which the federal judiciary is established would appear to hamper interest group politics. Nevertheless, while an independent judiciary increases the cost of interest group politics, Landes and Posner (1975) assert that the benefits to special interests of a judicial system seemingly divorced from the political process outweigh the increased transaction costs, and that an independent judicial system ultimately fosters, rather than inhibits, special interest politics. It is their contention that the independent judiciary has a powerful influence on the durability and, subsequently, the value of economic regulation. Therefore, from an economic perspective one would be mistaken to think of the courts as being merely a thorn in the side of interest group politics. In terms of explaining how economic factors affected deregulation, it's important to examine those factors that increase (decrease) the durability of legislation, and therefore, affect the extent to which interest groups are willing to expend money and resources to influence the political process.

The value of legislation, that is, the demand, will decline as the expected durability of that legislation falls. An enacting legislature could guarantee little in terms of the durability of legislation if the judiciary were under the direct control of each subsequent legislature. Legislation passed in one period would be subject to the changing "political winds" of each election cycle, and whether special interest legislation would continue as law would depend to a large extent on the political views of those legislators currently in office. If legislation passed in one Congress can easily be overturned when a new batch of congressmen are sworn into office the value of legislation to those who want to transfer wealth to their particular group would be reduced and their subsequent willingness to pay for legislation would decline.[34] Suppliers of legislation would receive less in terms of votes, campaign contributions, special favors, etc. An independent judiciary, while increasing the probability that initially legislation may be declared unconstitutional, also increases the probability that the courts will subsequently rule according to the original intent of the law, making it likely--though not certain--that once legislation is enacted it will not be overturned in subsequent periods. An independent judiciary has the effect of both increasing the transaction costs associated with initially obtaining special interest legislation (the increased possibility of legislation being nullified by the courts) and increasing the demand by making it more durable. "[U]nder plausible assumptions the increase in the value of legislation will exceed the increase in its cost, since a modest increase in the cost of enacting legislation could multiply many-fold the length of the period in which the legislation was expected to remain in force" (1975, p. 879). By enforcing legislation in terms of the original legislative intent, the judiciary maintains its distance from the current legislature and the political process. Therefore, by continuing to enforce legislative deals according to the original "contract," courts become "highly valued" and respected institutions because they are apparently divorced from the political process and the current legislature. [35]

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[34]An implication of this point is that both legislators and interest groups have an incentive to see that there is less "turnover" in the legislature.

[35] In support of the theory that independent judges are more highly valued, Anderson et al (1989) examined data for judges at the state level and found a positive relationship between their level of "independence" and judges' salaries.

While it is possible for a current legislature to impose some sanctions on the judiciary if the court is not ruling to its liking (the Congress may refuse to raise judges' salaries with the cost of living or fail to make proper appropriations, for example) this is an unlikely occurrence, as it may hamper the ability of the current legislature to pass legislation beneficial to its favored groups. This general tendency for the courts to rule according to the original intent of legislation is supported by casual observation. For example, the 1953 landmark Supreme Court case *FCC Vs RCA Communication* which stated in effect that the commission was not free to "create competition for competition's sake," set precedent in regard to the Court's attitude toward economic regulation, and continued to affirm in the Court's view that the regulatory structure was justified from a public interest perspective and operating according to the original legislative intent. It is a testament to the durability of legislation that much of the economic regulation enacted during the 1930's or earlier endured for many decades.

The Rent Seeking Role of Regulatory Agencies

The legislature, in its desire to make mutually beneficial exchanges with interest groups, has an incentive to reduce the transaction costs of enacting legislation and will want, as much as possible, to reduce the likelihood of judicial nullification. One means by which the legislature may be able to reduce the probability of judicial nullification is to establish an informational buffer zone between itself and the courts. Landes and Posner (1975) assert that when the probability of judicial nullification is high, the legislature is likely to establish administrative agencies (such as the ICC, FCC, CAB, etc.) to carry out the details of special interest legislation, thereby obfuscating the private benefits of regulation. They refer to these agencies as the "dependent judiciary," implying that the legislature has substantial control over these regulatory bodies.

To enhance the probability that legislation will be carried out to benefit interest groups the statutes the agencies are to administer are often laid out in broad and ambiguous terms using phrases such as "just and reasonable rates" and "public interest, convenience and necessity." The administrative agencies are given much discretion in carrying out their duties.[36] When regulatory issues are complex (which often results in the regulated industries becoming the main source of information for regulatory bodies, i.e., regulators become captured) the courts are not likely to have a practical vehicle with which to analyze regulatory decision-making. Derthick and Quirk are aware of the ambiguous nature of the statutes given to regulatory agencies by Congress, but interpret the ambiguity as allowing regulators to better serve the public interest and are apparently unaware of how this delegation of power could facilitate interest-group legislation: "Congress laid down only the general outlines of a mandate or a standard of private conduct to be enforced and left the commissions to fill in the detailed requirements"(1985, p. 62). Derthick and Quirk go on to point out that "Congress could have enacted detailed regulatory statutes, but preferred that experts with broad delegations of regulatory authority act on its behalf" (Ibid). Thus, in their view regulatory agencies were established to administer legislation in the public interest. Nevertheless, they go on to point out that these agencies, and their relationship to the other branches of government, are somewhat of an enigma which have "troubled constitutional and administrative law for decades" (Ibid).

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[36] For example, *The Interstate Commerce Act* states that " . . . such just and reasonable rules, regulations and requirements . . . to be observed by the carriers or brokers so classified or grouped, as the Commission deems necessary or desirable in the public interest." (GPO 1973, p. 144).

Congressional Control of Regulatory Agencies

Scholars have long debated the relationship of administrative agencies to Congress. Weingast (1981) and Weingast and Moran (1983) have illustrated how monitoring and control of agencies by Congress depends on how well legislative goals are being administered. "Congressmen on the relevant committees may appear ignorant of agency proceedings because they gauge the success of programs through their constituents' reactions rather than through detailed study" (1983, p. 769). While congressional control of administrative agencies is neither absolute nor exact, their general tendency to carry out the wishes of Congress and their relevant oversight committees are quite apparent, and under normal circumstances those wishes are influenced by constituency groups. Interventions into administrative decisions occur in response to direct interest group demands and through congressional oversight where the "purpose is to police those areas functioning poorly" (Ibid).

Congressional control of the agencies occurs through indirect and informal means: ". . . hearings and investigations are used to influence decisions and stymie unwanted policy initiatives by uncooperative agency members (with potentially negative consequences for careers). The incentives provided by the threat of large-scale intervention may be the most important consequence of sporadic, but carefully targeted, congressional investigations. Consequently, agencies undertake few policy initiatives without informal congressional consent" (1981, p. 152). As pointed out by Landes and Posner (1975) this indirect relationship hides and facilitates interest group favors by establishing vague directives under which agencies are to administer legislation ostensibly in the interest of the public. It also allows for congressional intervention, at a price, on behalf of constituency groups. (McChesney's [1997] model can also be incorporated into the relationship between Congress and the agencies. By instituting policy changes indirectly through the agencies this helps mitigate the cost of engaging in opportunism. Congress can initiate regulatory change through the agencies and can appear to be "restraining" the agencies from carrying its directives "too far," thereby, preventing the appearance that it reneges on previously established legislation. This possibility, and the evidence supporting it, will be examined in a later chapter.)

This analysis sheds light on the role that regulatory agencies played in enabling special interest legislation to become law and not be overturned by the federal courts. One could plausibly assert that "detailed regulatory statutes" would most likely have been in extreme danger of nullification, particularly during the 1930's when much economic regulation was enacted. The 1930s was a period in which the federal courts took an especially dim view of economic regulation, so the details of the regulatory process were left to agencies with direct ties to the legislature. This does not imply, however, that the legislature is capable, or even desirous, of excluding the judiciary from monitoring the regulatory agencies. In Landes and Posner's (1975) view the independent judiciary is also used as a disciplinary mechanism to keep the agencies in check during subsequent legislatures. That is, the legislature also uses the courts to be sure that the agencies do not make rulings contrary to the interests of the enacting legislature. "The legislature will, however, preserve judicial review of administrative determinations in order to assure that the agency, in its eagerness to serve the current legislature, will not stray too far from the terms of the legislative 'deal' establishing the regulatory program that the agency administers"(1975, p. 888). In Peltzman's (1976) model politicians wish to maximize their political utility and can not do so by allowing industry (or other groups) to capture the regulators in a pure profit maximizing way. To optimize their political utility it is in the enacting legislature's interest to maximize the present value of legislation, and to accomplish this they cross-subsidize highly visible and influential groups, usually organized consumer groups who would otherwise pay an extremely high price or not receive service at all (Peltzman 1975; Keeler 1984).

One of the principle tenants of capture theory is that job prospects for staff employed by regulatory commissions in private industry provide an incentive to make decisions largely in the interests of the regulated industry.[37] This interpretation of administrative behavior had been used to predict that regulatory agencies would be resistant to opening up competition in regulated markets because this would amount to "biting the hand that feeds." As long as the regulatory agencies can provide the industry with higher profits, firms have an incentive to hire former commission members and staff because they will be familiar with the regulatory/political process and be able to influence that process in the firm's favor. Former regulatory staff members, being known quantities, will be the most productive at currying favor with the regulators. Evidence that commission members moved primarily to higher paying positions in regulated industries after tenure at an agency is strong.[38] Evidence suggests that under typical circumstances these organizations will tend to cater to the group with the high per-capita interest

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[37]This discussion draws from Buchanan and Tullock (1962), Downs (1957), Downs (1967) Noll, Peck and McGowan (1973) Posner (1974) and Niskanen (1996).

[38]According to Eckert (1981) more than half of 142 ex-commissioners whose post-commission jobs were known took private sector jobs in a related industry.

and ignore the interests of the public whose individual stake is so slight it does not pay to organize opposition. Because government service is often a stepping stone to more lucrative private sector employment it is often difficult for regulators to separate their personal interests from the public interest. This beneficial relationship between regulators and regulated firms make administrative agencies prefer low visibility and to be resistant to change. The agency has an incentive to avoid scrutiny because low visibility is more conducive to catering to small particular interests at the expense of the "cumulative" interest, even though the costs to the latter group may outweigh the benefits to the former. Even though social costs are often greater than the private benefits to interest groups, an agency will, under normal circumstances, not want to incur the wrath of groups with a large individual stake in their decisions. It appears however, that this tendency for the agencies to rule in the interests of the regulated industries broke down during the period just prior to deregulation, and subsequently the agencies were the source of pro competitive initiatives. (An economic explanation for this phenomenon will be explored in chapter four.)

While it is a contention here and elsewhere that regulators are interested primarily in their own welfare, these individuals face a differing set of constraints than individuals who confine themselves to the private sector. Ultimately, the agencies are just that--agents of the legislature who establish, fund and monitor their actions--and individuals who generally function with the implicit guidance and approval of politicians. However, the manner in which the legislature controls the agencies is subtle and indirect. Therefore, explaining the behavior of agencies does not require resorting to dialectical explanations.

Prior to the 1970's scrutiny of regulatory bodies was rare. These organizations were considered "one of the backwaters of American government" and unless there was a scandal "they received little or no attention from the national press" (Derthick and Quirk 1985, p. 70). A number of factors worked to change the scrutiny received by regulatory bodies, including their own decisions, the courts, and macroeconomic and political factors. However, economic theory predicts that the behavior of political organizations and government agencies are subject to certain disciplines similar to the market test for a firm: "The external judgment on the organization causes a firm-like concern for efficiency in a broad sense; for any given access to resources, agencies whose activities require the voluntary acquiescence of individuals external to the agency will attempt to do as well as the given resources permit in the theater of external judgment" (Noll et al 1973, p. 122). It's also pointed out that external scrutiny of an agency generally comes as a result of the behavior of the agency or at the behest of an interest group. "An external, legal, or political test of an agency decision generally comes only as a direct consequence of some action by the agency that directly invites it or that causes some interest group to appeal the decision" (Ibid, p. 123). This implies that individuals within the agencies are sensitive to how they are viewed by other public officials as well as the general public and they will tend to be constrained by such external scrutiny. The implications are that an agency will tend to be "captured" only when the agency's decisions do not bring significant and undesirable scrutiny from third parties. Therefore, while economic and organizational theory suggests that there is "inertia" in regulatory behavior it also suggests under what circumstances regulatory bodies are likely to under-take change. Another implication is that economic explanations for deregulation cannot be dismissed merely due to the fact that regulatory agencies apparently abandoned industry interests as a criterion for decision-making.

Overview of the Judiciary and Regulatory Agencies

One manner in which modern regulation and mercantilism differ is that modern legislatures possess a bureaucratic mechanism to assist in the enforcement and implementation of regulation in the form of regulatory agencies (i.e., the ICC, FCC and, formerly, the CAB). These regulatory bodies are subservient to the three main branches of the federal government. They are under the influence of Congress, the president and the federal courts. Congress is directly responsible for establishing the regulatory agencies and provides funding for their operation. Presidents make appointments to the commissions that govern the agencies (although they cannot remove commission members at will), and, most notably, federal courts can overturn their decisions. Any of the institutions that have influence over the regulatory agencies may alter the incentive structure and the choice set of these regulatory bodies.

According to Landes and Posner, the court's principal incentive over time is to maintain its image as a highly valued and respected "non-political" institution. The independence of the judiciary creates a beneficial relationship between the courts and the legislature by 1) increasing the stature of the courts (and judges) and 2) making it likely that once laws are enacted they will not be subject to the vicissitudes of the political process and thus be more valuable to special interests. "If courts are not valued highly, the imposition by the current legislature of coercive measures that impair the courts' effective functioning will not be perceived as highly costly, and such measures will therefore be imposed more often" (Landes and Posner 1975, p.885). It is apparent that as long as the court can uphold its image by ruling in terms of the original intent of the law, it will have an incentive to do so. This interest group explanation for an independent judiciary has important implications with respect to an economic explanation of deregulation. Any factor that reduces the durability of economic regulation will also reduce the willingness of interest groups to expend money and resources to acquire interest group legislation. The precise mechanism by which courts respond to incentives is difficult to discern. However, the courts clearly responded and intervened in the regulatory process at a period in time when regulation was "functioning poorly."

Summary

This chapter has attempted to provide explanations as to why government intervenes in private markets by establishing price and entry restrictions. One economic explanation is that regulation has value to special interests by providing a low-cost means of organizing a cartel. Therefore, private interests will expend resources to influence the political process for legislation that reduces entry and price competition and that provides "political rents." Institutional structures within government that facilitate rent-seeking have also been highlighted. A general understanding of why rent-seeking behavior takes place and the costs and benefits involved, allows an illustration of how those same forces and institutions may have operated to reduce the value of regulation and altered the cost-benefit structure of rent-seeking. The next chapter will attempt to show how endogenous and exogenous factors altered the ability to supply and maintain economic regulation apart from the existing stock of ideas.

CHAPTER III

THE ROLE OF ENDOGENOUS AND EXOGENOUS FACTORS IN AIRLINE DEREGULATION

Introduction

In regulating cartels, Peltzman (1976) has explained the frequently observed phenomenon of politicians/regulators not allowing firms to capture all of the available rents from regulation. He's shown that political utility is not maximized by considering only producer interests; rather, regulators will spread the benefits of the cartel to high-cost, highly visible and well-organized consumer groups also. Producers will acquiesce with such a "cross-subsidizing" scheme as long as profits under the government sponsored cartel exceed the additional cost of providing high-cost consumers with service. In the case of the airline industry (as well as other regulated industries) there is well documented evidence that the regulatory structure pursued objectives consistent with Peltzman's theory. The CAB attempted to "internally subsidize" the airlines by allowing returns higher than would be expected under "cost-of-capital" considerations, thereby attempting to provide economic rents to the industry, while concurrently requiring airlines to provide service beyond what the market, if left to itself, would provide (Caves 1962; MacAvoy 1979).

As noted previously, an institution that plays an important role in the establishment of cartels through the political process is the regulatory agencies. An argument has been made that regulators act as agents of the legislative branch (Landes and Posner 1975; Weingast 1981; Weingast and Moran 1983). It is also well known, however, that, in the case of the airline industry, the CAB could not enforce a perfect cartel and non-price competition eroded economic rents (Keeler 1984; Vietor 1991; Peltzman 1989). In other words, endogenous factors contributed to real changes that affected the cost/benefit structure of economic regulation, or in Weingast's terminology there was a "disequilibruim" in the regulatory regime. Weingast states those factors necessary to maintain an equilibrium in terms of the original legislative deal: ". . . as long as the relevant variables of public opinion, balance of power of interest groups, presidential initiative, and precential legal decisions are stable. As long as these variables remain constant, the political rewards from various alternatives remain constant"(1981, p. 160). It is clear that these variables were not constant during the late 1960s and early 1970s. There was a change in the balance of power among interest groups, which occurred partly through the interplay of the interest groups and the relevant institutions. That economic regulation was meant to benefit private interests over the public interest became glaringly apparent--in large part due to the interplay of regulators and firms. These endogenous factors coincided with problems of inflation, recession and higher fuel costs. In addition, there was the additional factor that the regulated industries were dissatisfied with the status-quo and were demanding change in the regulatory structure, even if not explicit deregulation. Moreover, consumer interests who had benefited from cross-subsidization were no longer benefiting. It is evident that intellectual arguments and ideas were subordinate to the private interests of those individuals who had a stake the regulatory process.

Peltzman (1989) has also alluded as to how these "real" changes may have influenced policy change. A reduction in wealth will reduce the available rents for redistribution, which was clearly the case with respect to the airline industry. The attempt to maintain rents by regulators imposed highly visible costs on consumers, empowering interest groups opposed to economic regulation:

> If the [industry's] cost increase is large enough, the producer rents may no longer be sufficient to generate the requisite political support for continued regulation. In Becker's (1983) framework the loss of rents reduces the pressure for continued regulation of this industry relative to other industries, and the higher price increases the counter pressure from consumers. Suppose further that the cost increase has in fact been induced by regulation. Then the deadweight losses emphasized by Becker become especially important. There is now only attenuated support for continued regulation but also the potential for major gains in political utility from deregulation (Peltzman 1989, p. 21-21).

Rising consumer complaints, lack of industry profitability and the potential influence of upstart, unregulated firms increased the political costs of continuing to support the old regulatory regime. This chapter will attempt to show how the "endogenous interplay of self-interested parties" along with exogenous events worked to undermine traditional economic regulation.

The Decline in Airline Rents

The airline industry's significant decline in profitability during the late 1960s and early 1970s is well documented. Rates of return on stockholder's equity for the interstate trunk and regional airlines compared to all manufacturing indicate that airlines were earning below average rates of return during the decade leading up to deregulation (Bailey et al. 1985, p. 25). In contrast, during the 1950s and early 1960s the airline industry under regulation was generally profitable, generating above average rates of return. However, profitability was achieved in part because technological progress (i.e., larger, more efficient aircraft) allowed airlines to earn rates of return higher than manufacturing returns even while "average fares fell significantly in real dollar terms" (Ibid, p. 24; see also Vietor 1991, p. 29). Subsequently, a number of endogenous and exogenous factors combined to reduce airline industry rates of return to levels significantly below the CAB's target rates and significantly below rates of return in other industries.[39]

The failure of airline regulation to achieve any of its goals of profitability and stability became glaringly apparent by the early 1970s. A factor perhaps most revealing in this regard is comparing rates of return on investment between the regulated interstate market and the relatively unregulated *intra*state markets of California and Texas during the early 1970s. Table 1 compares the return on investment of two such intrastate carriers, Air California and Southwest, with the interstate trunk and local carriers. It was evident (this information became widely available during congressional hearings) that unregulated air carriers could offer comparable service (at lower fares) and still earn rates of return higher that the regulated interstate trunk and local carriers, because the intrastate carriers operated more efficiently than the regulated carriers. As noted previously, the discrepancy in profitability and costs between regulated and unregulated carriers could be attributed to "load factor" differences. Pacific Southwest Airlines (PSA), an intrastate airline, flew its Boeing 727-200 aircraft configured with 158 seats flown 60 percent full, while American Airlines flew its identical aircraft with 120 seats flown at 55 percent capacity (Bailey et al 1985, p. 31). The low rates of return to the interstate carriers could be attributed to the inability to control non-price competition, driving up costs for the regulated carriers. In the financial community the problem of regulation's impact on industry profitability was well-known. Because of the process in which the CAB set prices, for example,

[39]The CAB had a target rate of return of approximately 12 percent (see Bailey et al. 1985, p. 30).

Table 1

Estimated Return on investment (in percent)[a]

Year	Air California	Southwest	Trunks	Locals	Trunks and locals
1973	52.56	9.63	5.62	9.30	5.87
1974	31.91	22.81	6.79	12.19	7.19
1975	16.51	23.44	2.79	4.88	2.95
1976	16.71	23.44	2.79	9.78	8.68
1977	16.25	18.29	9.97	13.57	10.31

[a] Calculated from carriers' annual reports (adapted from Bailey et al. 1985, p. 30).

"you could never catch up to costs, especially in an inflationary environment."[40]

Even though prices tended to be higher in the regulated portion of the industry, the airlines' financial difficulties were directly attributable to the inability of the CAB to control all forms of competition between the carriers, which increased costs and eliminated rents. In evaluating the economic condition of the airline industry just prior to deregulation, MacAvoy and Snow (1977, p.32) note that, "Although air carriers have been able to attract needed capital in the past, the performance of the present regulatory system does not provide confidence in the future. Regulation has contributed to a pattern of cyclical earnings. Only twice in the past eighteen years has the industry's return exceeded 10 percent." As intrastate service expanded, not only was the difference in prices, costs and profitability apparent to investors, but the harm regulation imposed on consumers was becoming more visible. "The evidence showed that consumer benefits were being withheld by the regulatory process, and a different regime was needed to bring lower fares to the U.S. public"(Bailey et al 1985, p. 31).

Regulation was clearly failing its objectives of stability and above normal profits to the airlines. In addition, the harm imposed on consumers was becoming clear--not only to politicians and consumer advocates, but to the general public as well.[41] With the major airlines increasingly unable to maintain profitability on their "high density" routes it was

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[40]Oppenhiemer and Company research notes, November 11, 1975 (quoted in Derthick and Quirk 1985, p. 153).

[41]A prominent Washington attorney writing about regulation during the late 1970s notes that "there has been a growing public reaction against regulation of all kinds, manifested by sunset legislation, hostility against such agencies as the FDA and OSHA, and disgust at the debacle which the ICC has made of the railroads" (quoted in Brown 1987, p. 134).

becoming difficult for the regulatory apparatus to maintain its dual objectives of cross-subsidizing high-cost consumers and providing the industry with stable returns. Economic theories would suggest that under these circumstances agencies "captured" by regulated firms would attempt to take the necessary steps to achieve their implicitly mandated objectives. That is, there would be an attempt to restore the durability and subsequently the value of the original legislative "deal" to the relevant interest groups,[42] along with maintaining the political viability of economic regulation. Theory also suggests that with profitability, public opinion and other factors changing, there would be an environment conducive to change in the regulatory structure.

Captured Regulators Stimulate Reform

Empirical examination of the behavior of regulatory policy has been highly consistent with the Stigler (1971) and Peltzman (1974) models of economic regulation. "There is substantial evidence from the Civil Aeronautics Act of 1938, from the behavior of Congress, and from the behavior of the Civil Aeronautics Board that there was a mutual desire to support an air transport system in the United States larger than the private market place would support" (Keeler 1984, p. 112). Brown (1987, p. 68), for example, has pointed out that over the course of its history the CAB's operating procedure was to "smooth" industry profits. When industry profits fell, the CAB would

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[42]In terms of Downs' (1967) analysis, there would be a discrepancy between what the agency ought to be doing and actual results. Given the constraints the agency faces there would be an attempt to eliminate this "performance gap," which, according to Downs, is an essential element for agencies to undertake change. The first phase in eliminating a performance gap would elicit behavior consistent with a captured relationship, and this is precisely the behavior that occurred during the late 1960's and early 1970's.

encourage anti-competitive behavior (i.e., raise fares). With adequate and/or rising profits in the industry, the CAB would tend to promote competition through discounts and lower fares. As the demand for air travel increased, however, the former behavior tended to bring more howls of protest from consumer groups. Nevertheless, in the face of rising costs the CAB made an attempt during the early 1970s to strengthen the airline cartel. One method used to control non-price competition was an administrative mechanism called "capacity limitation agreements," which limited regulated trunk and regional airlines as to the number of flights on their high-density routes with the objective of increasing load factors and overall profitability for the interstate carriers. These attempts at restoring profits to the airline industry proved unsuccessful.[43] The failure to maintain profits in the industry led the CAB to undertake increasingly extreme and obvious measures aimed at restoring profitability. Given the problems that non-price competition, recession, inflation and higher fuel prices imposed on the industry,[44] the CAB was apparently willing to go to almost any measure to achieve what it believed to be its primary legislatively mandated goals of protecting the industry from competition and, implicitly, consumer interests.

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[43]The CAB mandated the reduction in the number of weekly round-trip flights between a number of major markets between 1971 and 1974 which proved successful in reducing load factors, but consumers complained about the difficulty in obtaining tickets. Other forms of competition between the carriers developed, however. There were "lounge wars" with "electronic draw poker machines. Live entertainment proliferated, with musicians, magicians, winetasters, and Playboy Bunnies" (Vietor 1991, p. 31).

[44]For example, fuel prices increased 222 percent between 1969 and 1978, rising to one-fifth of operating expenses (CAB ,*Handbook of Airline Statistics,* [1972] p.464). Rising unit operating costs required the CAB to institute "dramatic price increases" that "attracted political attention to its own regulatory failings" (Vietor 1991, p. 29).

The costs that regulation imposed on consumers, and the increased pressure for regulatory reform, is exemplified by the CAB's five year *Domestic Passenger Fare Investigation* (DPFI), which concluded in 1975. This investigation produced the previously mentioned "capacity limitation agreements," an attempt to restrict non-price competition such as the number of flights on a particular route, but ultimately produced further cost-increasing competition (i.e., "lounge wars") as well as generating consumer complaints about the lack of available flights. The DPFI failed in its endeavor to increase profitability to the industry. What the DPFI did accomplish (unintentionally) was an obvious increase in economic inefficiency, higher prices and much intense criticism from consumer and other interest groups (Vietor 1991, p. 31). Noll and Owen sum up the behavior of the CAB during this period, a period in which information about the harm imposed by regulation was widely abundant and a period in which it became obvious even to the average citizen that price and entry restrictions were meant to protect the airline industry, with little regard for the "public interest":

> [The CAB] refused even to process applications by new companies to enter the interstate airline business. It denied standing in regulatory proceedings to consumer interests. It attempted to organize collusive agreements among airlines to reduce service in competitive markets so that airlines could earn higher profits. And it engaged in an almost comical process of trying to cure by regulation the recurrent outbreaks of competition in service amenities, even to the point of writing regulations that defined the size of a coach-class seat and the amount of meat that could lawfully be served on a sandwich (1983, p. 156).

Rising consumer awareness of regulation's costs provoked so-called consumer advocates, such as "Nader's Raiders," to produce a large volume of books and other publications that highlighted agency "incompetence" and "pro-business" bias and "took the critique of regulatory agencies out of learned journals and gave it a semipopularized, widely accessible form" (Derthick and Quirk 1985, p. 42). As one consumer advocate noted in testimony before

Congress, "Economic regulation has become a disease, insidiously destroying the long-term potential of the air transportation industry, the affordability of air travel by a large majority of the population, and the faith of citizens in their government."[45] The inability to provide profits to the industry, hide the special interest aspects of legislation, and "spread the benefits" of the cartel to other groups created a "disequilibrium" and an environment in which current politicians needed to intervene and recapture maximum "political utility." Moreover, an increasing number of interest groups opposed to regulation (Nader's Aviation Consumer Action Project, American Conservative Union, National Association of Manufacturers, American Farm Bureau Federation and the National Federation of Independent Business) became active in Congress, pushing for reform (Ibid, p. 122). By 1977 some of the major regulated carriers (e.g., United and Pan American) and several intrastate carriers wishing to expand to other markets were testifying before Congress and were arguing, if not for complete deregulation, at least some degree of regulatory reform (Noll and Owen 1983, p. 137).

Derthick and Quirk also note the manner in which regulators responded to the lack of industry profitability, a response supportive of capture theory because of the extreme and obvious measures to protect the airline industry from competitive pressures, and also supportive of the contention that regulatory decisions stimulated reform. In 1967, for example, the CAB rejected the application by a charter airline, World Airways, to offer trans-continental service for $75. "The CAB's handling of the World application became one of the symbols that reformers invoked to demonstrate the perversity and

[45]Testimony of Mimi Cutler, Director of the Aviation Consumer Action Project, *Regulatory Reform in Air Transportation ,Hearings* before the Senate Subcommittee on Administrative Practice and Procedure of the Committee on the Judiciary, 94th Cong., 2nd sess. (1975), 1150 (quoted in Brown 1987, p. 37).

ridiculousness of regulation" (Derthick and Quirk 1985, p. 22). A rumor circulating in Washington D.C. during the height of congressional activity on deregulation, was that it was Robert Timm, CAB chairman from 1973-74, who was most responsible for deregulation of the airline industry, not because he supported regulatory reform, but because of his initial,[46] unabashedly blatant attempts at protecting the established industry. At the time of his appointment, he was considered by airline executives as the best thing to happen to the industry since the jet engine.[47] The CAB's status as a captured entity of the airline industry was further revealed during Senator Kennedy's 1974 Congressional hearings that focused on the behavior of the CAB. Over the course of its history the CAB's Bureau of Enforcement had typically spent only 3 percent of its time on consumer complaints and 60 percent of its time monitoring charter airlines to be sure they did not undercut the regulated fares of the major carriers (Ibid, p. 51).

Moreover, as the demand for air travel increased and local service expanded it did not require sophisticated economic analysis to see that regulated airline pricing was near cartel levels. In relatively unregulated *intra*state markets in California and Texas airfares were sometimes fifty percent that of regulated markets, even though the routes were roughly equal distance. In June 1973 the fare from Los Angeles to San Francisco was $18.43 while the fare from Chicago to Minneapolis was $38.49. Each route is about 340 miles (Vietor 1991, p. 33).

As noted previously (Landes and Posner 1975), interest group theory suggests that regulation was instituted and structured originally to allow

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[46]Toward the end of his brief term he supported more competition in the industry.

[47]*New York Times,* April 8, 1973.

regulatory agencies much discretion in following the laws passed by Congress, which facilitates those laws being administered in a manner beneficial to interest groups and the legislature.[48] This "familial" relationship is facilitated in part because the industry becomes the primary source of information to the regulatory agencies.[49] In other words, regulators, given the implicit directive from Congress and behaving in their own self-interest, will do what is required to maintain a cartel and maintain the ability to redistribute wealth, i.e., cross-subsidize consumer groups. It is rather ironic that the economic behavior of regulatory agencies would provide a stimulus for reform. During the period that industry profits were on the decline the relationship between the airlines and the CAB progressed to the point that it was overtly obvious even to an untrained eye that regulatory decisions were made with the interests of the airlines as the primary criteria. A larger number of

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[48]Prior to the mid 1970s and for the roughly forty year period after the 1938 legislation, Congress apparently implicitly supported the protectionist actions of the CAB. Brown reports that a 1974 congressional staff study found that hearings before Congress had essentially supported the actions by the agency, and that any changes to the regulatory statutes tended to "refine and expand the scope of economic regulation" and were "based on the premise that it was appropriate and necessary to employ regulation as a tool of controlling the industry" (1987, p. 5-6). Even though Congress tended to tinker with the regulatory statutes up until the 1970s there's every reason to believe that Congress sanctioned the manner in which the CAB and other agencies went about the business of enforcing legislation. It's also interesting to note that "[a] wave of attack in the 1950s and 1960s addressed not their form but the performance of [the regulatory agencies] functions" (Derthick and Quirk 1985, p. 63; see also Krislov and Musolf 1964 for a discussion on the operating procedures and criticisms of regulatory agencies long before deregulation).

[49]After the Kennedy congressional hearings in 1974-75 agencies began to rely more on "outsiders" for information, primarily economists. "At the FCC, [Chairman] Ferris did not install prominent advocates of procompetitive deregulation as deliberately as did Kahn at the CAB, but what he did was tantamount to that. He enlarged the role of economists in policy-making by enlarging the functions of the FCC's Office of Plans and Policy and naming an economist to head it. [They] were strongly critical of traditional public utility regulation; as such, they exemplified the 'latest and best thinking'"(Derthick and Quirk 1985, p. 79).

consumers were becoming visibly effected by regulator's "protectionist" policies. For example, data indicate that the demand for air travel increased substantially during the 1960s--rising at an annual rate of 18 percent from 1965 to 1969.[50] With a larger portion of the public flying the regulated carriers, anti-competitive conduct brought more howls of protest from consumers. "Opposition from recreational travelers was perhaps more vigorous than in previous periods because of the tremendous growth in the 1960s of that segment of the airline industry and the growth of consumer advocacy organizations" (Brown 1987, p. 96).

There is ample evidence that forces were in place making the viability of traditional economic regulation of the air transport industry problematic. The balance of power among interest groups was changing, brought about by changing market conditions and "cheaper" information. These changing constraints were partly due to the interplay of the regulators pursuing what they considered their institutionally mandated objectives or the "endogenous interplay of self-interested parties." These changing constraints would likely result in pressures for a new "arrangement"(although this new arrangement would not necessarily be complete deregulation). It is important to recall that the willingness to supply economic regulation depends on hiding or minimizing the costs imposed on a large body of voters (i.e., reducing the probability that those harmed will oppose having their wealth transferred), while concurrently supplying obvious benefits to well-organized constituencies. Regulation was failing to provide and transfer sufficient wealth to its beneficiaries, while concurrently imposing increasingly visible

[50]Civil Aeronautics Board, *Handbook of Airline Statistics* (1972, p. 464). The number of domestic revenue passengers carried rose from just over 75 million in 1965 to over 150 million in 1970 (*Statistical Abstract of the United States,* 1977, p. 666).

costs on consumers. The failure to provide rents and the damage the regulators wrought on the political process, instituted pressure for change,

The Effect on Cross-Subsidies

In spite of these egregious attempts at restoring profitability to the airline industry, by the early 1970s rates of return (exacerbated by inflation, higher fuel prices and periods of recession) were persistently below that of other industries implying that air carriers were not being adequately reimbursed for supplying service to low-density markets. Because carriers were not being adequately subsidized on their high-cost routes, pressures were mounting from the regulated carriers to curtail unprofitable cross-subsidized routes: ". . . service quality competition on the high density routes tended to eliminate excess profits on these routes, and airlines not receiving adequate subsidies to operate low-density routes withdrew service from those routes" (Keeler 1984, p. 113; see also Keeler 1978, p. 90-93). A 1976 Department of Transportation study found that between 1960 and 1975 the certified carriers dropped 173 service points from their schedules, a 30 percent decline.[51] In addition, MacAvoy and Snow (1977, p. 22) note that between 1970 and 1975 smaller communities receiving scheduled air service declined by 14 percent and the number of flights at smaller communities still receiving service declined by 25 percent.

Providing service to markets that would not support passenger service without government intervention was a hallmark component of airline regulation and a linchpin in the legislative "deal" of the 1930's, and as

[51]Given the criteria established by the CAB for suspending service, that such suspensions could be delayed if they were contested, this data probably understates the pressure to quit providing unprofitable service (see Bailey et al 1985, p. 31).

Peltzman (1976) has shown, a tool used to increase the political benefits and durability of regulation.[52] Further developments in interest group theory suggests that the perception of regulation serving the public interest is important for regulation to be viable politically as well as durable.[53] Historically, the interest group pressure on Congress and the regulatory agencies to support cross subsidizing was clear. Brown's analysis supports such an inference by noting that "there [has been] a strong desire for the extension of air service to smaller communities, particularly where satisfactory surface transportation is unavailable. These communities have articulate and forceful spokesman in Congress" (1987, p. 71). It was clearly evident that regulation was failing these smaller communities as the regulated carriers withdrew service.

By the mid 1970s the market was beginning to find a solution to this gap in service. Commuter airlines were providing service to 230 communities with populations under 100,000, which was occurring as regulated carriers

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[52]Keeler (1984, p. 114) also points out that population increases in many small communities along with the interstate highway system mitigated the need for regulation and air service to these markets in the decades preceding deregulation. MacAvoy and Snow (1977, p. 22) also note that subsidies to local service carriers prompted them to procure all-jet fleets, which ultimately gave them an incentive to abandon local service. Once there was no longer a subsidy, it was not profitable to operate jets on short-haul routes.

[53]According to Tullock, for special interest legislation to "sell" and to be viable it must be packaged in such a way as to appeal to voter ideology: "Logrolling is one method of getting through that benefit to a minority at a dispersed cost to the majority. It is easier to do this, however, if you are able to deceive the majority so that their opposition is minimized; hence, in a democratic system straight transfer from the poor to the wealthy producers of wheat would certainly lose" (1989, p. 20). In support of Tullock's theory, there is evidence that the CAB attempted to avoid "straight transfers," presumably due to the fact they were a political liability: "Revenues from a carrier's more profitable routes were used to subsidize losses on unprofitable routes. The internal subsidy strategy eliminated the possibility of a carrier making an excess profit on one route while requiring government subsidy on another route, a practice which had been a political liability" (Brown 1987, p. 71).

abandoned service. It was, therefore, this *unregulated* segment of the market that was filling the gap in air service to smaller communities which occurred "only because of an exemption of economic regulation" (MacAvoy and Snow 1977, p. 23). A demonstration that these "high cost" markets could potentially be serviced without regulation had the potential for eroding support for regulation. In addition to the airlines, regulation was also experiencing reduced support from another beneficiary group--communities that previously were unable to obtain scheduled air service without the assistance of the CAB. To use Peltzman's terminology, the inability for regulation to "spread benefits optimally" tended to reduce support among a primary constituency and upset equilibrium and increase pressure for change.

A Disequilibrium

The egregious attempts at maintaining profits on high-density routes were meant in part to preserve the practice of cross-subsidizing high-cost users of air travel. The behavior of the CAB during this period is undoubtedly consistent with its previous interpretation of the statutes and consistent with its own interests--that is, stability and profitability for the industry along with maintaining service to smaller, low density markets. However, in pursuing these objectives regulators at the CAB brought about unintentional and unwanted external scrutiny of its behavior and review of its functions. The CAB's behavior was in part responsible for reducing information costs to consumers and increasing the deadweight losses associated with regulation. That is, increased scrutiny of the regulatory process was an unintended consequence of the behavior of the CAB and was one manner in which a desire for a new regulatory equilibrium manifested itself.

The CAB's inability to maintain constituency support and the increasingly visible costs imposed on consumers increased the scrutiny of the CAB from a number of sources--most notably from Congress. Because regulation was "functioning poorly," Congress acquired the impetus to step in and scrutinize regulatory practices (Weingast 1981, Weingast and Moran 1983). The regulatory generated (or endogenous) political costs associated with economic regulation created a disequilibrium in the political marketplace and created an environment that was ripe for political entrepreneurship. As noted by Weingast (1981), as long as the regulatory apparatus is performing its intended functions, Congress and the executive branch distance themselves from the regulatory agencies. However, agency behavior aimed at blatantly maintaining industry profitability was bound to generate constituency pressure on the current legislature, which, along with the courts, had ultimate responsibility for their oversight. Derthick and Quirk acknowledge that it was the behavior of the CAB that was at least partly responsible for regulatory reform: "The protectionism of the CAB. . . was so extreme as to constitute a very important stimulus for reform" (1985. p. 58). Brown in his analysis of airline deregulation quotes an unidentified "informant" close to the legislative process claiming that, "deregulation would not have been well accepted if the CAB had not gone so far under [chairman] Timm in limiting competition . . ."(1987, p. 135)

Because it could no longer provide adequate benefits to beneficiaries (producers and subsets of consumers), economic regulation produced a general dissatisfaction with the status-quo among virtually all the interests involved. Brown notes that during the 1974-75 congressional hearings "it became clear that there was widespread dissatisfaction with CAB regulation, even among the regulated carriers" (1987, p. 108). Therefore, even without intellectual justification, the changing cost/benefit structure of the regulatory regime would likely have been sufficient to generate a demand from interest groups for some type of change. Declining rates of return along with the increasingly explicit costs imposed on consumers stimulated pressure for change and would have been sufficient to promote political entrepreneurship. Intellectual insight would be secondary to the changing incentives of interest groups.

Consistent with Becker's (1983) framework, the increasing costs to the majority of consumers, would indicate that deadweight losses were increasing and since those losses were associated with regulation, this increased pressure from the previous "losers" in the political arena for legislative action in their favor. There were declining political benefits and rising costs associated with maintaining the status quo. (As noted previously, it is also useful to recall that in McChesney's (1997) model politicians are not passive brokers in the political process. They will not stand idly by when changing constraints reduce benefits or impose costs from previously enacted legislation.) It was partially the endogenous interplay of firms and agencies that made the maintenance of the original 1938 legislation costly and difficult for the current crop of legislators. "Because his ultimate goal is securing and enhancing his power, the politician prefers decisions that directly elicit favorable votes" (1989, p. 7).

In terms of the Stigler/Peltzman model, there was an increase in the probability that those harmed would oppose regulation as well as an increase in the number of individuals adversely effected. In addition, exogenous factors, such as the increase in inflation, higher fuel prices along with political events (e.g., the Watergate scandal and the unpopularity of the Vietnam war) created an increasingly negative opinion of government among the general public, which coincided with a period in which regulation itself had depleted rates of return within the airline industry. Because the loss of rents and harm to consumer groups (increasing deadweight losses) were visibly attributable to regulation, there was an opportunity for the welfare of all parties involved to increase from some new arrangement. The old regime not only failed to maintain rents (which subsequently generated a desire on the part of industry to "restructure" and alter the old regulatory regime); regulation was "functioning poorly" from a political standpoint and affecting potential "majorities," as well as imposing costs on a growing body of consumers that were becoming increasingly visible.

Summary

This chapter has highlighted the manner in which exogenous factors--inflation, recession and higher fuel costs--combined with endogenous factors---the inability to control non-price competition--eroded rents to the airline industry. Institutions established to facilitate rent-seeking were themselves partially responsible for the loss of rents. The systematic behavior of regulators attempting to maintain rents and the cross-subsidization of high-cost consumers resulted in increasing deadweight losses emphasized by Becker (1983). Thus, potential benefits of deregulation were unintentionally revealed. Establishing and maintaining special-interest regulation has been shown to require hiding special-interest aspects to voters. Airline regulation lifted this veil from the political process. Therefore, not only did economic regulation have less value to interest groups, the increasing visible harm to consumers increased the benefits to organizing and opposing the status-quo.

In this process, regulatory agencies appeared to operate just as the Stigler/Peltzman model predicted. That is, they were "captured" by the regulated firms and relevant coalitions of consumers. It's quite clear that in initially attempting to increase industry profitability the CAB behaved in a manner clearly consistent with economic theory, giving strong empirical support to capture theory. For this reason, economic and organizational theory seemed to predict that agencies would resist change and would seek to "enhance" and "maintain" their function by continuing to serve the interests of the regulated firms. Hence, in spite of the inefficiency and inequity of regulation, economists and other experts on the workings of government were skeptical deregulation would occur any time in the near future.

On the other hand, Derthick and Quirk, contend that the behavior of the CAB and other regulatory agencies is inconsistent with such theory during a later period, that "[b]y the end of the 1970s, capture was no where in sight" (1985, p. 91). Rather than being obstacles to change, the regulatory agencies actually began to loosen restrictions on prices and entry prior to Congress enacting any change in regulatory policy. According to Derthick and Quirk, one explanation for this surprising behavior is that the change in policy at the regulatory agencies was due to a fashionable and powerful idea that "seeped" through the institutional structure in Washington, evoking change in decades old policy in which a large and influential segment of the economy had a vested interest. While it's true that under certain constraints regulatory agencies tend to be significantly influenced by special interests and are resistant to change, there is also the reasonable assumption that regulatory bodies will only be "captured" if such behavior is implicitly sanctioned by Congress (Weingast 1981). The legislature can implicitly instruct these subservient agencies to interpret broad legislation differently when new information comes to light, and in a manner that suits the interests of politicians. Therefore, by applying a more sophisticated approach to economic behavior, it may be shown that deregulation by the regulatory agencies may be a way in which Congress "market tests' potential legislation and a manner in which to avoid the appearance of opportunistic behavior.

CHAPTER IV

REGULATORY AGENCIES DEREGULATE: IDEAS OR INTEREST GROUP DEMANDS?

Introduction

As noted previously, the view that deregulation resulted from ideas (or more precisely by resorting to dialectical explanations) shares much in common with the doctrinal approach to mercantilism. Policy change arises from ideas that emanate through the institutional structure beginning at the top and filtering downward. Derthick and Quirk's interpretation of the deregulatory initiatives that occurred within the regulatory agencies reflects such a view. These initiatives were in their view attributable to the president and powerful members of Congress "signaling" their approval of regulatory changes made by the major regulatory agencies (the FCC, ICC and CAB) prior to Congressional enactment of deregulatory legislation. While not explicitly deregulatory, these initiatives by the agencies appeared to open the door to major deregulatory efforts by Congress and the president. Policies that incrementally encouraged a more competitive environment were found to occur universally, though not simultaneously, in all the major regulatory agencies.[54] By the mid 1970s, before any major legislative initiatives to deregulate, individuals who advocated more competition in regulated industries were appointed as chairmen of the regulatory agencies, which included Alfred Kahn, an academic who was known as a vociferous proponent

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[54]The FCC was instituting modest reforms by allowing MCI to offer private line service between St. Louis and Chicago during the late 1960's. See 13 FCC 2d 420-41 (1968). Even prior to The Motor Carrier Act of 1980 the ICC had been instituting reforms, such as liberalizing application procedures for new entrants into the trucking industry, that fostered competition.

of deregulation, at the CAB. Commission members and staff at regulatory agencies also became increasingly composed of individuals (ideologically on the left and the right) who were hostile toward economic regulation and eager for reform. Commission members and chairman in office before the Kennedy hearings in 1974 frequently and systematically changed their views on regulatory policy[55] while in office and *after* Kennedy the hearings--from complete hostility toward deregulation to eventually initiating regulatory reform.[56] This was a generally unpredicted change in attitude by the regulatory agencies toward the regulated industries, and, as Derthick and Quirk have aptly pointed out, would apparently be an anomaly incongruous with an interest group theory of government and an event which virtually no economist predicted would occur.[57]

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[55]Robert Timm, who chaired the CAB when President Ford came into office, had been staunchly opposed to deregulation and a blatant promoter of protectionist policies, but later on in his term initiated an internal CAB study, the results of which he urged from the outset support deregulation. Regulators are influenced by incentives and outside scrutiny regardless of the intensity of their ideological views. Even Alfred Kahn, who came to office with a deregulatory agenda, was initially circumspect to implementing deregulation and took an initially cautious approach (conducive with Downs' analysis that individuals within agencies will search for the best way to close a performance gap). In a memo to a CAB staff member, Kahn wrote: "I do not myself know to what extent I declare a commitment to gradualism insincerely, merely to reassure Congress and the industry I am not a madman, and that I am solicitous of the financial fortunes of the industry, and anxious not to impair them (Memo, Alfred Kahn to Roy Pulsifer, "Your Comments on my January 20 Talk to the Security Analysts," January 24, 1978, CAB files. Quoted in Derthick and Quirk 1985, p. 73)."

[56]For example, ICC commission member Daniel O'Neil told a Senate Committee in 1973 that "vigorous enforcement of regulatory laws . . . probably is the best course to follow." (*Nominations--February-March 1973,* Hearing before the Senate Committee on Commerce, 93 Cong. 1 sess. GPO 1973, p. 174). However, after O'Neal was elevated to the chairmanship of the ICC "deregulation became the goal of the ICC" (Derthick and Quirk 1985, p. 154).

[57]James Q. Wilson, a prominent political scientist discussing the behavior of regulators, notes that "few economists [and] scarcely any political scientists [were] prepared for the events of recent years (quoted in Brown 1987, p. 5).

From an ideological perspective, these events are evidence that the seeds of intellectual criticism toward regulation finally bore fruit, that "prevalent ideas had a powerful and direct influence on the behavior of the chairman"(Derthick and Quirk 1985, p. 93). Derthick and Quirk imply that it was the behavior of individuals within the agencies, driven by ideas, which stimulated Congressional reform and which also lowered the value of regulation to regulated firms. "[T]he regulatory agencies increased pressure on Congress to act, because Congress felt its prerogatives were being challenged, and specifically to act in a strongly pro-competitive way, because it became very hard for Congress to endorse any less reform than the regulatory commissions themselves chose to undertake. The commissions' actions also compelled the protected industries to reexamine their opposition to reform by thoroughly destabilizing, and thus reducing the protectionist value of, the regimes in which they had a stake" (1985, p. 61).[58]

One of the consequences of administrative action may have been to lower the value of regulation (an endogenous factor). However, it's unlikely that Congress was a casual, disinterested bystander of the actions taken by the CAB and other regulatory agencies. Derthick and Quirk's interpretation of events ignores the economic aspects of the relationship between Congress and the regulatory agencies and confuses the direction in which influence ran. As outlined above (Weingast 1981), Congress signals its interests to the regulatory agencies subtly through hearings, appropriations, confirmations etc.[59]

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[58] There was a self-interest component to regulatory decisions. For example, the CAB was increasingly concerned about its public image by promoting the use of discount fares and then claiming credit for their use (see *Regulatory Reform in Air Transportation,* p. 1712, cited in Derthick and Quirk 1985, p. 155).

[59]Posner (1974, p. 338) discussing the affect Congress has on regulatory agencies notes that "[u]nlike business firms, government agencies must go to their capital markets--the legislative appropriations committees--every year."

Congress controls the funding of regulatory agencies, and thus can wield subtle yet powerful influence over these bodies when appropriate. These influences are in response to interest group demands and/or in response to the interests of the relevant oversight committees. This chapter will attempt to illustrate the possibility that regulatory reform within the agencies was a means to market test new legislation (Weingast 1981) and a means by which Congress could avoid the appearance of acting opportunistically.

Hiding Opportunistic Behavior

It has been noted that interest groups and politicians generally benefit from the durability of legislation (Landes and Posner 1975). In McChesney's (1997) model politicians and private parties enter into implicit and unenforceable contracts either for rent-creation or to prevent rent-extraction. Political opportunism, the breaching of the implicit contract, may destroy the willingness of private parties to pay for rent creation or to avoid extraction of wealth. Thus, durability creates a more certain environment for private decision-makers to operate and consequently the services of politicians are more valuable. By agreeing to long-term contracts both parties gain. However, changing power among interest groups may alter the incentives for legislators to engage in politically opportunistic behavior, which implies that current politicians will more likely renege on an earlier agreement: "[N]ew arrivals on both sides succeed to the interests of the original contracting parties. A legislator not party to the original bargain has less incentive to abide by the political rent-creation deal struck by his predecessors unless he too is compensated" (McChesney 1997, p. 23). Any politician's willingness to abide by the original deal will depend on the costs associated with such action (foregone future deals) relative to the compensation offered by those whose wealth is threatened. If the costs of political opportunism should decline and/or the costs of abiding by the original agreement should rise, then it's less likely that compensation from those groups party to the original deal will be sufficient to maintain the status-quo. In the period prior to deregulation, as noted above, a confluence of factors (endogenous and exogenous) came together that reduced the benefits of regulation and that also increased the cost of maintaining regulation in its old form--and likely altered the balance of power between interest groups. The inability to maintain cross-subsidization of particular consumer groups, the rising visible costs to the majority of consumers and the decline in rents made the original legislation costly for the current crop of politicians.

The administrative agencies are subordinate to their legislative oversight committees, and to some degree the executive and judicial branches as well. The political benefits of this relationship in terms of facilitating interest group legislation have been highlighted above (Landes and Posner 1975; McChesney 1997) and have previously been shown to provide two primary benefits to the legislature and to interest groups: 1) the legislature can use the agencies to hide special interest relationships (i.e., establish vague laws that the agencies will administer in accordance to interest group pressures) and 2) the possibility of intervention with regulatory agencies on the behalf of constituency groups affords "payment" for such services.[60] An additional benefit of a "dependent judiciary," not previously explored and not unrelated to the others, is that the agencies can also be used to hide or

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[60]Evidence of this relationship and the sanctioning of the "special interest" aspects of regulation is provided by Brown: "When the Board announced its intention to deny recertification of a local carrier on the basis of high subsidy needs, Congress intervened. The option of denying certification to a local carrier judged to be too dependent on subsidies was removed when in 1955 Congress directed the CAB to grant permanent certificates" (1987, p. 73).

obfuscate opportunistic behavior on the part of politicians from interest groups, the intent being to repeal the previous legislation while subsequently not reducing its ability to sell future legislation or to extract private rents. Because the relationship between Congress and the regulatory agencies is obscure, legislators may be able to distance themselves from administrative decisions while testing the viability and the potential benefits of repealing or changing legislation.

As McChesney (1997) has suggested, if legislators were to maintain the previous legislative deal what they would offer to interest groups (in exchange for payment) is the maintenance of above average returns in a market, but in the case of the airline industry returns had already been depleted by regulation, with little prospect that regulation in its old form was capable of restoring profitability. By the mid 1970s regulation, recession, and inflation had already substantially reduced rates of return to the airline industry, therefore, reducing the costs to the legislature of repealing the original legislative deal. However, even though the original deal was creating political costs for the current legislature, blatant repeal of the original legislation could be costly. As noted by Parker (1996, p. 20), ". . . there are no legal mechanisms analogous to a binding long-term contract by which an enacting Congress can prevent a subsequent one from amending legislation in ways unfavorable to a group, or from repealing it altogether! Such bad faith, by reducing the value of legislation to interest groups (and the benefits it bestows), also imposes costs on [current] members of Congress since the price legislators could demand for enacting such legislation would be lower." Political opportunism could, therefore, lower the willingness of interest groups to pay for future favors or to avoid rent extraction. It has already been noted that there was seemingly "pressure" on Congress to advance legislation that went "at least" as far as the administrative agencies had already taken regulatory reform. This apparent separation of administrative action from direct legislation by Congress can be explained not necessarily by ideas but by the desire to avoid the appearance of "bad faith" behavior on the part of legislators, which would undermine the value of their services. By having the contract, seemingly through no fault of the current crop of legislators, breached by administrative action, the current legislature avoids the appearance of not living up to the original bargain.

Political Entrepreneurism and Congressional Hearings

The manner in which Congress first initially addressed regulatory issues supports such an interpretation of events--that is, the process by which the legislature went about examining regulatory issues can be interpreted as consistent with a desire to alter the previous deal that was "functioning poorly" while not appearing to renege on previous legislative deals. The loose, indirect control of the agencies by Congress allows them to signal the desire for a new tack in administering previously enacted legislation, while at the same time not alienating valuable constituencies.

With the potential political rewards from deregulation becoming apparent, pressures were mounting for some type of action by the legislature. The Congress set out initially to examine regulatory issues in the airline industry, not through the agency with direct jurisdiction over airline regulation. Rather, hearings were initiated in late 1974 through Senator Kennedy's Subcommittee on Administrative Practice and Procedure, rather than the Subcommittee on Aviation, which was the committee that would be responsible for instituting legislative reform. Senator Kennedy's "[o]versight hearings and committee reports were powerful weapons with which to embarrass and ridicule the regulatory commissions for anti-competitive conduct" (Derthick and Quirk 1985, p. 66). However, when in 1976 Senator Cannon's Aviation subcommittee began to examine the regulatory issues "his [hearings] were in the nature of legislative explorations rather than critical oversight of the commissions and began with an impartial tone" (Ibid, p. 67). Hence, after the Kennedy hearings altered the way in which regulators interpreted the original statutes, the committee that had jurisdiction over actual legislation could "explore" possible solutions to problems in an "impartial" manner. The Kennedy hearings, while proposing little in the way of substantive legislative changes, achieved its most important objective of prompting a change in the manner in which the CAB, and other regulatory bodies,[61] administered their responsibilities. "The CAB reversed most of its policies criticized during the Kennedy investigation between. . . December 1974 and the opening of the Cannon subcommittee hearings in April 1976" (Brown 1987, p. 112). Because the original statutes were rather vague, the CAB could alter its interpretation of economic regulation and still remain within the boundaries of the law. Actions by Congress had the effect of signaling its desire to reinterpret the previously established deal, but these actions did so in a manner that was less costly (in terms of legislative deal making) than would be the case if Congress itself took immediate and direct action to repeal regulation.

Congressional hearings, therefore, were one vehicle by which politicians could pursue and enhance their political utility. Given the endogenous and exogenous increase in the political costs of maintaining

[61]Evidently, even the ICC was affected by the hearings, for by 1975 the Department of Transportation noted that the ICC had some "favorable final decisions" and several cases that moved in the direction of deregulation" (Derthick and Quirk 1985, p. 71).

regulation in its old form, members of Congress used congressional hearings in an entrepreneurial spirit, capitalizing both on the publicity the hearings provided and as a means of influencing decisions of the agencies. The 1974-75 Subcommittee on Administrative Practice and Procedure hearings were meant for public consumption and political benefit and used by congressional staffers to gain publicity for high profile public officials. The "Kennedy hearings" were described as a "dramatic success" and calculated to attract the attention of the press and the public. "'The way to get to the press's and the public's attention,' a staff aide later said, 'was with the consumer stuff,' not just high prices, but also lost luggage and the suffering of household pets shipped as freight"(Derthick and Quirk 1985, p. 41). Public relations was as important an aspect of the hearings as the prospect for increased economic efficiency.

The legislative goals of the Kennedy hearings were initially extremely modest, with Steven Breyer, Senator Kennedy's staffer who organized the hearings, proposing only "modest procedural revisions of airline regulatory statutes. . ." (Derthick and Quirk 1985, p. 51) However, the entrepreneurial aspects were clear as "it's influence lay in disseminating a populist critique of government regulation to the press and the attentive public"(Ibid, p. 41). While the legislature signaled its displeasure with the original deal, there was no publicly held wholesale endorsement of the type of deregulation that finally emerged in 1978. The hearings and attention from the press had the effect of informing the public on what would have been a rather mundane and uninteresting subject. This entrepreneurial action was an unqualified public relations and advertising success (Ibid p. 43). But the activity by legislators was also driven in part by what was already widely known about regulation and a response to the costs (i.e., votes) economic regulation was imposing on politicians. Derthick and Quirk implicitly acknowledge this point:

"Typically, events must occur or background conditions of popular mood or opinion must develop in such a way that the politician sees in the advocates' prescription a way of responding to a problem of particular immediacy or of addressing the rising concerns of the public"(1985, p. 39). By the late seventies a majority of the public believed that regulatory agencies operated with the interests of the industry in mind, not the consumer (see chapter six). The deregulation that finally emerged was the result of a process that weighed the relative costs and benefits of regulation.

Stephen Breyer, one of Senator Kennedy's assistants who helped organize the 1974 hearings, hints at an entrepreneurial motivation: "[T]here may be an advantage in placing initial responsibility for reforming a particular program in the hands of a committee that does not ordinarily supervise the agency concerned" (quoted in Brown 1987, p. 136). The airlines, who were not the focus of the Kennedy hearings and when spotlighted were frequently characterized as victims of inept policy, would be less inclined to believe that important members of Congress were not concerned with their interests, nor that the legislature was acting in bad faith. "As an 'outsider,' the subcommittee was not constrained or tainted by direct political ties with the regulated industry"(Ibid). Nevertheless, as a method of influencing the behavior of the regulators, "the Kennedy hearings came as a particularly nasty blow to [the CAB's] pride (Derthcik and Quirk 1985, p. 91). The fact that there was the appearance of Congress being drawn to deregulation, as implied by Derthick and Quirk, rather than an actual instigator would have potential benefits as it is less apparent that politicians are reneging on an earlier agreement. Approaching deregulation in this manner also gives the impression that Congress responds favorably to public interest issues, rather than taking responsibility for how the original legislation had been administered. How the hearing process may have influenced agency decision-making in an entrepreneurial manner is hinted at by John Robson, the CAB chairman who followed Timm and served prior to the arrival of Alfred Kahn:

> The fact is I didn't have many views on [airline regulatory policy] . . . The intellectual underpinnings were available. . . Then Ted Kennedy had surfaced the issue in hearings he held late in 1974 and 1975 so that deregulation became politically more visible (from Derthick and Quirk and Quirk 1985, p. 69).

Thus there are explanations conducive with economic theory regarding Derthick and Quirk's contention that it was the *idea* of regulatory reform that was primarily responsible for pro-competitive initiatives within the agencies. According to their interpretation this idea seeped into the political structure of Washington. "[Deregulation] tended to subtly permeate the perceptions and beliefs of officeholders everywhere--in Congress, the courts, even the regulatory commissions themselves" (1985, p. 57). In their view this idea (originating in intellectual discourse) emanated from powerful political forces, i.e., the president and powerful members of Congress, down to the regulatory commissions, which began the deregulatory process, much as some economic historians believe the idea of free trade worked through eighteenth century political institutions. "For pro competitive deregulation to occur within the commissions when it did, some members had to switch policy positions--and presidential cue giving undoubtedly contributed to these switches" (1985, p. 66). Derthick and Quirk's interpretation of the deregulatory process are not incongruous with the interpretation presented here. They acknowledge (unintentionally) this point when they state that,

> It is impossible to tell to what extent the commissions were influenced by the ideas themselves or by the sanctions and rewards disposed of by influential institutions: the president's power to make appointments to the commissions; the capacity of the Congress to call them to account and embarrass them in public; and the right of the courts to revise their decisions and chastise them (1985, p. 91).

It is obvious that legislators attempt to influence the decisions of regulators, but, rather than this influence being motivated by the subjective perceptions of how the world should be governed, they used ideas as a vehicle to promote, in an entrepreneurial manner, an agenda consistent with their own interests. During the Kennedy hearing a host of intellectuals--including academic economists, members of the Council of Economic Advisors and individuals from the Department of Justice--were brought forth to criticize airline regulation on grounds of efficiency and equity (Brown 1987, p. 108). It was, given the economic and political climate of the period, in the interests of politicians to subtly signal the political necessity of reinterpreting the originally enacted statutes. That is, an alternative explanation for these events is that, given the political costs generated by regulation, the executive and legislative branches desired to put the onerous task of deregulating on the agencies and avoid the appearance of opportunistically breaching the original deal by indirectly communicating their desires to the subservient regulatory agencies. Congress and the president could wield their influence while "testing the waters" of regulatory reform through administrative action, without initially proposing new and potentially politically damaging legislation that would harm the value of their services. "By pursuing deregulation within the bounds of existing legislation, [the regulatory agencies] performed an important 'market test' for Congress"(Weingast 1981, p.169). The systematic change of view by regulators of the manner in which they interpreted the existing statutes and their sudden and surprising support of deregulation supports this market test theory. Derthick and Quirk acknowledge that by the time the Congress was ready to act on deregulation in late 1977 and 1978 the regulatory agencies had already reduced any potential cost to politicians of enacting regulatory reform: "Moreover, because of administrative action there was no longer a great deal of the traditional regulation left to defend. Deregulation was, in large part, a *fait accompli*" (1985, p. 150). Derthick and Quirk also point out that , " . . .it is important finally to note that the appeal of deregulation as a policy fashion was immeasurably increased when its potential for political success began to be demonstrated"(1985, p. 55). This "policy fashion" was not written into legislation until it had been "market tested" and shown to be politically viable and enhance "political utility." Actual legislation did not proceed until politicians had a good estimate of the political cost and benefits associated with such action. Administrative action also provided legislators with the opportunity to intervene, which they frequently did (possibly for a fee) on behalf of rent-seekers when regulators went "too far" in loosening regulatory restraints.[62]

Summary

Ideological explanations are not necessary to explain the pro-competitive rulings of the regulatory agencies. A plausible explanation is that Congress signals its dissatisfaction (from constituency pressure and oversight committees) when policies are functioning poorly. Allowing some distance between itself and the regulatory agencies performs two important functions: It allows Congress to market test new legislation before it is actually enacted, and it also allows the legislature to avoid the appearance of behaving opportunistically and potentially upsetting its ability to engage in future deals with interest groups.

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[62]In respect to trucking deregulation, for instance, the legislature instituted "a moratorium on further administrative deregulation for the purpose of allowing Congress to act" (Derthick and Quirk 1985, p. 150).

Derthick and Quirk often note the behavior of individuals within political institutions as evidence for their contention that ideas promoted deregulation. However, a reinterpretation of events, using standard choice theory, indicates that their chronicling of events is consistent with an economic interpretation.

CHAPTER V

Deregulation and The Legislative Process: Ideas or a Test of the Willingness to Pay

Introduction

Where the value of an exclusive operating right has an explicit price (a taxi cab medallion, for example) the value of regulation can have an objective measure when those rights are traded. Uncertainty over the threat of deregulation and free entry can drive the value of such rights to zero. In most cases, however, these operating rights are not explicit (nor is bribery legal or commonplace) and are not traded, so the value of restricted competition can only be measured indirectly--for example, by examining the behavior of interest groups and regulators when new legislation is proposed or when the threat of deregulation takes place. That is, it may be possible to implicitly infer the value of economic regulation when examining the behavior of interest groups.

Political Organization as an Indication of Rents

In McChesney's analysis one way in which the political process will test the amount of potential political rents and hence value that interest groups place on regulation is through an interest group's ability to organize and articulate its views before the legislature. "The total amount of net surplus available is itself a function of the extent of interest group organization" (1997, p. 146). A well organized group demonstrates that regulation (or the potential for rents) is highly valued by the group, with such a demonstration eliciting a favorable response by the legislature to interest group demands. An additional point made by McChesney is that interest group organization reduces transaction costs, increasing the ability for politicians and interest groups to enter into agreements: ". . . politicians must engage in costly negotiation with private groups over the amount and form of consideration to be paid for regulatory action or inaction" (1997, p. 144). In addition, "Any private group will be more effective the better organized it is. Greater organization allows a group to make higher pecuniary offers to politicians. It also lowers politicians' cost of negotiation. . ." (1997, p. 145) Therefore, a testable proposition is that, everything else equal, the less organized a group is politically, the more likely it is that economic regulation will exit the political marketplace. That is, when an interest group is not well organized, the greater is the probability that demands for regulation will go unheeded. This proposition can be tested by examining the legislative processes of airline deregulation and the organizational strength of the airlines.

Interest groups understand well the importance of cohesiveness in achieving legislative outcomes favorable to their group. The value and primary purpose of trade associations is to represent the collective interests of the group before the legislature. The airline industry invested resources in attempting to achieve such influence through political organization. A memorandum by the ATA (Air Transport Association) during the period that new legislation was being contemplated stated that " a positive, unified industry position will substantially increase chances of assuring the best possible legislative result, and help avoid the adoption of extreme or unacceptable proposals" (quoted in Derthick and Quirk 1985, p. 158). In spite of the awareness of the benefits to organization, and despite the fact that the airline industry had relatively few firms, they were unable to adequately present themselves as a single interest group before Congress. There was a lack of political organization in spite of the fact that Congress gave the airline industry plenty of opportunity to organize and even attempted to facilitate organization by tailoring proposed legislation to the industry.[63]

It should be noted that while the original 1938 statutes were still in effect from 1974 to 1978, regulation itself and administrative action (as noted earlier) had rendered the old agreement essentially worthless, both to politicians and the airlines. In effect, the legislature was offering a totally new "deal" (under differing constraints) to the airlines in proposing new legislation. However, collectively there was little or no consensus among the airlines on what shape potential legislation should take. But there was also a general concern over the durability (or lack thereof) of any newly enacted regulatory measures as a direct result of the uncertainty caused by administrative action. By 1978 there was pressure by the airline industry on Congress to *not* adjourn without passing legislation that entailed some degree of legislative reform and hence deregulation (Vietor 1991, p. 35). While the airlines could not agree collectively on what any new legislation should entail, there was virtual agreement, because of the past failures of regulation, that there must be changes to the original statutes. While not explicitly demanding deregulation, the airlines were requesting procedural changes, but because the potential rents and hence the value of regulation was uncertain, the type of and extent of regulatory change was also uncertain.[64]

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[63]Derthick and Quirk report that the Transportation Department produced an analysis, which was presented to Congress, that "was designed to assist in tailoring reform advocacy to the particular airlines" (1985, p. 157). This supports McChesney's contention that "politicians would invest resources to encourage (subsidize) otherwise unorganized groups' attempts to organize, so as to lower politicians' cost of negotiating" (1997, p. 145).

[64]One could argue that adjustments to a new equilibrium in the "political marketplace" requires considerable time for the market participants to gather information, much in the same way new equilibriums occur in the private sector due to technological change and innovation.

After a long period of operating without knowing what the future operating constraints would be, the airlines' positions evolved to the point which they preferred the uncertainty of a deregulated market to the uncertainty of a regulated one. Moreover, as evidence that the political process was groping toward a new equilibrium (rather than hell-bent on deregulation) it's unclear whether administrative action opened the door to deregulation or would impede reform. Congress left plenty of maneuvering room for politicians to "test the market" in advancing deregulation by weighing the relative influence of interest groups even up to the conference committee stage of legislation. Administrative action had not made deregulation inevitable. "It was quite unclear whether [administrative deregulation], in the long run, would advance the cause of reform or limit its success." (Derthick and Quirk 1985. p. 148) As late in the legislative process as early 1978 some influential legislators were saying that administrative deregulation had been adequate and wholesale reform was unnecessary.[65]

While the ability to organize gives politicians information as to the "surplus" available in a particular market, interest group organization also lowers transaction costs, increasing the ability for politicians and interest groups to enter into agreements. However, in spite of attempts by Congress and the industry to organize, "no two carriers took positions that were completely alike" and "there was no clear industry position--no concrete counterproposal nor any clear refusal to contemplate a bill" (Derthick and Quirk 1985, p. 157). The process of legislative reform (and ultimately deregulation) demonstrated

[65]Senator Barry Goldwater argued that administrative changes showed that the original 1938 legislation was flexible enough to "accommodate" changing circumstances. *Congressional Record*, (April 19, 1978, p. 10663-64).

an attempt by the legislature to lower transaction costs but was primarily meant to test the value the industry placed on new legislation.

In spite of this evidence , Derthick and Quirk claim that lobbying efforts on behalf of the airlines during the period of administrative reform by the CAB indicated that the airlines expected to capture significant rents from the continuation of a government sponsored cartel. In other words, implicitly in their view, continued economic regulation of the airlines had substantial expected value. They state that, " [t]he political strength of the reform forces was sufficient to produce major legislative victories despite *intense and unified* [emphasis added] opposition by the regulated industries" (1985, p. 147). This statement implies that the airlines continuously were able to speak forcefully with one voice what their mutual interests were in terms of new legislation. While individual airlines did lobby somewhat forcefully, it would be a mischaracterization to say that the Air Transport Association (ATA), the airline industry's main lobbying association, was a well organized group, holding unified and clear opposition to deregulation. The airlines had virtually no influence over the writings of the 1978 legislation in spite of Congress providing every opportunity to grant provisions beneficial to the *industry.* Derthick and Quirk's analysis is actually consistent with postulates of standard choice theory. The process of legislative reform within Congress (and eventually deregulation) demonstrates an attempt by the legislature to test the value producers placed on potential regulation.

In light of political organizations' economic impact of transmitting information about available surplus and affecting transaction costs, the behavior of the participants in the deregulatory process is more explainable in terms of economics--that is, why there was little or no demand for deregulation. Individual airlines, in spite of perceived regulatory failure, had justifiable reason to fear a competitive marketplace. The regulated market was one for which their cost and organizational structures were best suited, and, while regulation had not always performed to their liking, this structure had at least allowed individual airlines to be somewhat profitable in the past and most important had protected the established firms from competition. "Route structure and fleet composition, the essential plant and operating method of the airline business, were artifacts of public policy." (Vietor 1991, p. 38) It's understandable, therefore, that a stock analyst, in analyzing the potential impact of deregulation on the individual airlines would state that "the potential fallout and impact on different companies is almost indefinable."[66] A competitive environment would entail a costly restructuring for most firms and a highly uncertain outcome. Eastern Airlines was seen in Congress arguing, on behalf of institutional investors, that discussion of "free entry" proposals be ended "as soon as possible" (Derthick and Quirk 1985, p. 154). The behavior of the airlines is supportive of Peltzman's (1989, p. 20) contention that firms will continue to support regulation because of the promise of some rents, but the rents may not be sufficient to generate effective support.

The intensity of opposition to deregulation varied across firms, from the initially fierce (but waning) opposition by American Airlines to the relatively early defection by United, which felt it had been singularly stifled in a regulatory environment. Perhaps this behavior can be explained at least in part by examining the ability of each firm to operate in a more competitive environment.[67] Nevertheless, fear of competition by individual airlines was

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[66]Oppenhiemer research meeting notes, February 10, 1975 (Quoted in Derthick and Quirk 1985, p. 154).

[67] Industries able to profit from change in the regulatory environment may be a force for change but are limited by uncertainty and the prospects that change is likely to benefit "newcomers" more than incumbent industries (See Noll, Peck and McGowan, 1971).

not an irrational concern. A number of large airlines that were able to survive under a regulatory umbrella eventually disappeared entirely, had to declare bankruptcy and restructure, or were merged with other firms in a deregulated market.[68] Therefore, it's not surprising that most of the carriers "did not surrender their abiding preferences for traditional regulatory regimes" (Derthick and Quirk 1985, p. 147). In large part the failure of the industry to retain regulation was not their warranted concerns of how each would fare in a free market, but their inability to speak and articulate what the *industry's* interests and preferences were in terms of a regulated market. Given the past failure of regulation to maintain rents to the industry, and the uncertainty created by the regulatory agencies, their individual behavior was entirely rational, while their lack of ability to organize politically is an indication that the prospects for rents offered by a continuation of regulation were low. These outcomes are consistent with the proposition that a confluence of "real" factors came together that reduced the value of regulation to the airlines--partially evident through their lack of ability to organize--and additional factors that increased the cost of supplying regulation and maintaining the status-quo.

Perhaps the lack of cohesion on the part of the airline industry was a by-product of regulation. In effect, political disorganization was also an endogenous result of regulation and the inability of regulators to control all forms of competition. This conflict between smaller carriers and the large trunk carriers was one factor that drove a wedge into a consensus on new regulation and is one more illustration as to how regulation was not ultimately able to prevent competition. Declining rents and a diversification of interests

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[68]Some of the most notable were Braniff, Pan-American, Continental and TWA.

made it difficult for the airline industry to present a united front in the political marketplace:

> Unanimity was hard to achieve because the airlines tended to form policy views independently and insist on them emphatically, and individualism that followed naturally from the industry's structure and the character of its regulatory environment. Above all, the highly politicized and bitterly fought contest for route awards inevitably made them political rivals. The smaller trunk carriers resented the "big five" which dominated the market. There had been running disputes over the CAB's "route strengthening program," favoring smaller carriers, and the capacity limitations agreements, which helped only a few large ones (Derthcik and Quirk 1985, p. 156).

United was the first major carrier to "defect" and cast support for "total deregulation" as early as 1975, although United continued to believe that "restricted entry" was vitally important for a healthy industry (Derthick and Quirk 1985, p.156). Other than the fact that the original legislation had not "worked" there was no mutual agreement on how any new legislation might benefit the industry as a whole. Each airline invested substantially in lobbying Congress individually rather than lobbying collectively. This was demonstrated by the fact that the ATA gave "modestly" to political campaigns, while each individual carrier contributed substantially to individual campaigns.[69] The airlines were inclined to believe that their best prospects were to articulate their own interests before Congress rather to expect to benefit from "collective action." While the ATA was attempting to organize the individual carriers, each airline continued to devote their primary lobbying efforts in a competitive manner, in an attempt to influence legislation in terms of their own individual interests. "Throughout 1977 and 1978, in the crucial phases of congressional action, each airline spoke only for itself if it spoke at all" (Derthick and Quirk 1985, p. 159).

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[69]Braniff and American Airlines both gave large illegal campaign contributions to Richard Nixon's 1972 presidential campaign.

One indication of the "expected value" of any new regulation was "how much" was required to get individual airlines to support deregulation. "If expected political rents net of the costs of organizing and procuring favorable regulation are positive, the producers will demand regulation" (McChesney 1997, p. 91). While most airlines stated at the outset that they were generally opposed to deregulation, the support of a few was eventually obtained with what one might call relatively modest payoffs and/or vague threats. Frontier Airlines changed its position after a proposal by the Carter administration to alter the way it was subsidized for small community service, an amendment that was worth a "few million dollars" to the airline (Derthick and Quirk 1985, p. 160). Western Airlines changed its position from opposition to support of deregulation after it became concerned that they were paying "too heavy a price" in the form of potential lost route awards (Ibid. p. 160). With potential gains from regulation unclear but potential losses from political retribution much more apparent, airlines eventually defected and cast their support toward deregulation. By 1977, opposition to deregulation by the trunk and regional carriers had all but crumbled (Bailey et al. 1985). During Congressional hearings in 1977 the president of Eastern Airlines testified that "it seems strange . . .to find myself arguing for continued government intervention in what might be a free market" (quoted in Derthick and Quirk 1985, p. 154) This was hardly the rhetoric of someone who was committed to investing resources in maintaining a government sponsored cartel.

Once the price of changing positions was revealed to be rather low and the cost of supporting the status-quo was high, firms "grew weary of controversy, of being in a visible confrontation with the president, or of the effort and expense of lobbying."[70] As Tullock (1989) has pointed out, the willingness to lobby for rents reflects the expected return on investment from such efforts. By deciding to withdraw or reduce lobbying efforts, rent seekers are implicitly expressing the expected amounts of rents "net of transaction costs" to be obtained from regulation. This was the signal the airline industry was sending to Congress:

> At the 1978 House hearings, the carriers who had kept up the opposition the year before were thoroughly disorganized. In addition to Western, Continental gave the committee bill its qualified endorsement, while several other airlines--American, Eastern, TWA, Northwest Orient, and Braniff--failed to put in appearances (Derthick and Quirk, p. 161).

Proposed regulatory changes were quite modest (as noted above) until quite late in the legislative process. It was not until after the nature and extent of lobbying efforts were revealed to the legislature that regulatory reform proposals would go "all the way" to deregulation. Once the constraints were lifted on regulatory reformers, pushed by interest groups favoring deregulation, the pace of reform quickened.

If the subjective preferences (rather than interest group influence and the self-interest of politicians) of the legislature was a desire to increase efficiency in major industries, this did not manifest itself in the legislative process leading up to deregulation. A desire to carry airline deregulation as far as it finally went (i.e., eventual elimination of the CAB) did not occur until political disorganization revealed to politicians that the potential rents were too low relative to the costs of organizing which meant the value of legislation was low, measured by the lack of opposition to a bill. Since the regulated industry could not present organized opposition to legislation this indicated

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[70]This statement originates from an interview with James P. Bass, vice-president for governmental affairs, American Airlines, conducted by Derthcik and Quirk, September 14, 1981.

that their willingness to pay for legislation was low--or in McChesney's (1997) terminology there was little expected "surplus" expected from any new legislation and hence little benefit to the legislature from supplying it: "Since industry concessions were not made collectively or offered contingently--indeed, were often not even explicit--the reformers had no need to respond with concessions of their own." (Derthick and Quirk 1985, p. 161) That is, since the industry could not present itself as a viable political force, it was unable to have influence on new legislation, which gave advocates in the administrative agencies, Congress and the administration more ability to push reforms. "At the conference committee stage, with industry quiescence only deeper, the reformers went even further" (Ibid, p. 162).

No Deal

The legislative process that eventually produced the Airline Deregulation Act of 1978 is supportive of theories put forth by McChesney (1997) and Tullock (1989), that a lack of rents net of transaction costs will not generate the political cohesiveness necessary to affect legislation. There is evidence that had the airline industry been able to organize and articulate a preference for a regulatory structure that was in its best interest, economic regulation of the airline industry may have persisted to some degree. But the failure of the airline industry to present a united front and an inability to agree on what a new regulatory regime should entail gave license to virtually complete deregulation of pricing and entry restrictions. Without direction and forceful opposition from the industry deregulation proceeded to such an extent that even the pro-reform forces were shocked and surprised at the "unexpectedly drastic" pace of reform. "What Kahn did not foresee, however, was that industry opposition would collapse--as the result of which the CAB received a charter to deregulate completely and rapidly" (Derthick and Quirk 1985, p. 155). No one would have predicted, nor few advocated, at the outset of regulatory change (not even Alfred Kahn) that the CAB would have been eliminated.

The factors causing the regulatory agencies to begin defacto deregulation (outlined below), had an affect on the expected durability and profitability of a regulated regime. In addition to regulatory induced rent depletion, the behavior of the agencies created an environment of uncertainty for regulated firms: " . . . deregulation by the commissions forced industries to operate in environments of debilitating uncertainty; by comparison, the stability potentially afforded by legislative action offered a distinct advantage" (Derthick and Quirk 1985, p. 149). Planning for the future required some certainty as to the economic environment the airlines would be operating under. With the regulatory agencies supposedly instituting reforms at a pace quicker than Congress or the president desired, firms did not know how to plan for the future. Capital acquisition was difficult to coordinate because airlines did not know which routes would be available to them and hence could not plan on which nor how many aircraft to acquire, for example. Even American airlines, which had been one of the strongest opponents of deregulation "shifted gears" when Congress passed piecemeal deregulatory legislation in early 1978 and called for more complete economic deregulation (Vietor 1991, p. 35).

It's been suggested in a previous chapter that the sentiment for regulatory reform appeared to come from regulatory agencies and not from the presidential administrations nor from Congress. Even Alfred Kahn assured industry opponents of deregulation as late as March of 1978 that legislation would never go "all the way" to complete deregulation (Derthick and Quirk

1985, p. 155). The reason legislation went much further than nearly anyone (even economists) would have predicted was that industry opposition collapsed. Therefore, it's implied that had the airline industry supplied a cohesive response to regulatory change there was room to shape and affect legislation. One apparent reason the industry was unable to accomplish this, apart from declining rents, was the incentive for each firm to behave independently and competitively within the political sphere.

When presenting their concerns before Congress and the administrative agencies, no two airlines took completely similar positions. The legislature was willing to give the industry every opportunity to influence any new legislation contingent upon the lobbying and other efforts put forth. Such effort would depend on the value of any new regulation. The implication is that over time as the political process tested the resolve or "willingness to pay" for influence in writing the airline deregulation bill, individuals who favored reform became increasingly empowered and this is "[w]here the collapse of the industry's resistance accounts for most of the radicalism of the bill" (1985, p. 162). That is, Congress had to test the resolve of the industry to measure the amount of politically effective support it was willing to supply, as the political environment had made it more costly to supply economic regulation. With little effort by the airlines to organize and affect new legislation, the Congress went a step further in an attempt to elicit a collective response from the industry. Deregulation proposals had been for the most part relatively modest with none proposing elimination of the CAB.[71]

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[71]It was not until the legislation reached the conference committee stage the word "deregulation" was inserted into the title of the bill. The more cautious "regulatory reform" had previously been used in the title.

A development that occurred late in the legislative process was a "sunset" provision, which, if allowed to remain a part of proposed legislation, would eventually eliminate the CAB. Surprisingly, this provision was not proposed by ideological promoters of deregulation but by a legislator who was generally opposed to deregulation, Congressman Elliott Levitas. (In McChesney's (1997) fashion, this is further indication that politicians are not mere brokers standing idly by waiting to respond to interest group demands. When interest groups are inactive in a market, politicians will seek a response by initiating proposals that have an impact on their wealth.) According to Derthick and Quirk "the unstated implication was that Congress could repeal the provision and there might never be much deregulation" (Derthcik and Quirk 1985, p. 162). That is, since there was no general desire to "totally deregulate," the fear of an unfettered market would cause the regulatory reformers to moderate their positions. Therefore, due to its ambiguity, this provision could have either elicited a positive or a negative response from the airlines. Sunset did not elicit a strong response from "reformers" due to the fear it might "postpone genuine reform."[72] Neither did it elicit a response from the airlines. A strong response from the industry could have signaled the potential surplus and that maintaining some form of regulation was worth the lobbying effort but "none invested effort in lobbying for it" (Derthick and Quirk 1985, p. 163). Nor did any of the airlines lobby against the provision. There was no ideological commitment to eliminating the CAB. In summarizing the final bill, the committee stated that it "has by no means concluded that total deregulation is desirable" and that only reform required was "a moderate, controlled release of some regulatory fetters" (*Congressional Record,* Sept. 14,

[72]Even Mimi Cutler, of Ralph Nader's Aviation Consumer Action Project, denounced the sunset provision as a "farce." *New York Times,* April 24, 1978.

1978, p. 29528). Because the sunset provision elicited no response, "total" deregulation of the airline industry was the ultimate result.

A Comparison with Trucking Deregulation

One manner in which to test the hypothesis that the extent of political organization represents the amount of surplus available, is to compare the deregulation of the trucking industry. An apparent anomaly in examining deregulation of trucking and airlines, is that one would expect with roughly 16,000 firms the prospects for political organization of this group would be highly problematic. Nevertheless, the American Trucking Association was able to organize effectively and have some influence on the legislation to deregulate the trucking industry. An explanation for this is that, in spite of the substantial transaction costs, trucking regulation, in contrast to airline regulation, had been relatively successful in maintaining rents.[73]

Regulation's ability to increase profits by limiting competition was apparently well known. As one member of the ATA noted, "If you can sit down and talk price with your competitors, even if you may be calling them sons-of-bitches and disagreeing frequently, you have something like a fraternity"(quoted in Derthick and Quirk 1985, p. 166). Trucking companys' rates were set by "rate bureaus" under the auspices of the ICC and were under the protection of anti-trust immunity. Thus the amount of surplus available from maintaining regulation was clear, contributing to cohesion in the industry. In contrast to the airline industry, the lobbying efforts of the trucking industry were pointed:

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[73]An analysis by Moore (1978) has shown that, in contrast to other regulated industries, trucking firms and members of the Teamster's union benefited substantially from economic regulation.

> By the fall of 1979 it was clear that something had to be done immediately if the forces of reform were to be stopped or reversed. A $2 million 'war chest' was created to fight deregulation(in reality reduced regulation). A public relations firm was hired and a blitz of personal calls on congressmen was launched (quoted from Noll and Owen 1983, p. 127).

The result of this "blitz" was an initial moratorium by the ICC on administrative deregulation at the behest of senator Howard Cannon.

Implicit then in the fact that deregulation of the trucking industry did not go as far as airline deregulation was the potential for rents. "It was the ATA that had eight or ten lobbyists and all the political contacts" and most firms within the industry ". . .considered the ATA the only significant spokesman for the trucking industry and felt confident that Congress also recognized the status"(quoted in Derthick and Quirk 1985, p. 167). Because of its cohesion as a group the trucking industry's lobbying group was able to have significant input into the writing of the final bills. Thus, the ATA was able to mobilize several hundred industry executives, "conveying the industry's views at every opportunity. . ." (Ibid, p. 172) As a result of this pressure the ATA staff was able to make "itself available to Congress for negotiations and worked behind the scenes with [Subcommittee chairman] Howard and his staff, helping him develop another bill" (Ibid, p.171). While not avoiding deregulation, the final bills that emerged were much less pro-competitive than would have occurred without political organization. The ICC's jurisdiction over motor carriers was not eliminated, and some regulations on entry were left "vague" so as to give possible leeway for the ICC to interpret the statutes to the industry's favor in the future. In any event, "The trucking industry alone . . . acted with unity in a firm yet calculating manner to oppose reform; and it alone secured legislative provisions that in any significant way limited deregulation and competition" (Ibid, p. 206).

Summary

During the period between the Kennedy hearings and new legislation, it's apparent that Congress had left ample political maneuvering room for the airlines to affect legislation on behalf of the industry as long as they could show a degree of unity and specify components of legislation that they favored. The fact that they were unable to organize politically to bring such influence to bear is significant evidence that the value associated with a regulated marketplace had declined and that regulation was about to "exit" the political arena. Derthick and Quirk concur on this point, that had the airlines been able to effectively organize to influence the 1978 legislation reform would not have "been so radical," and they agree that airlines' eventual acceptance of the Airline Deregulation Act was the result of the industry's "political disorganization"(1985, p. 152). [74] While the individual carriers were vocally opposed to deregulation this is an instance that supports the adage " action speaks louder than words." Had regulation held much value, that is if there had been substantial expected rents to be gained through regulation, it's likely that the ATA would have been able to overcome organizational costs to have their self-interest reflected in new legislation.[75]

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[74] Interestingly, they go on to explain the relative lack of opposition to deregulation by highlighting the lack of airline profitability under a regulatory umbrella and discuss regulatory induced cost increases. They cite TWA's chairman testifying before Congress, stating that the airline industry was the least profitable of all the major industries in 1975 (Derthick and Quirk 1985, p. 153).

[75] The airline industry still possessed a particularly important economic characteristic for influencing the political process. That is, it had seemingly low organizational costs (few firms), but it seemed to lack a significant stake in the outcome of any legislation. The benefits of regulation were probably as uncertain as a competitive market.

CHAPTER VI

INSTITUTIONAL CHANGES AND THE INCREASE IN RENT-SEEKING COSTS

Introduction

Potential changes in the costs and/or benefits associated with supplying rents can be measured only indirectly. Previous sections highlighted some possible ways in which the public became more informed about the political process and the effects of economic regulation on wealth. This would increase the probability that some groups will oppose regulation, while the decreased benefits to beneficiaries reduced the probability and level of support. Endogenous factors altered constraints and created an increased incentive for the political process to take consumer interests into account. In terms of the Peltzman/Stigler model the rising number of individuals harmed by airline regulation, the loss of rents and increased information made the probability of continued support for regulation less likely and increased the probability that those harmed would oppose. In addition, during the deregulatory period (the mid to late 1970s) there were a number of institutional changes that developed which can be at least partly attributable to those factors cited previously--the mis-trust of government, institutional behavior, loss of rents, etc--which affected the cost/benefit structure associated with supplying regulation. There is indirect evidence that the "endogenous interplay of self-interested forces" altered the supply/demand characteristics of economic regulation.

Economic theory suggests that there are constraints that influence the ability of politicians to supply rents. A comparison with mercantilism may shed light on how these changes influenced the supply of regulation in a modern context: "[T]o the extent that there is competition for positions of royal authority, the monarchy must expend resources to resist bids to take over the royal apparatus. As part of a cost-minimizing strategy for staying in power, it may be efficient for the king to take consumer interests in to account to some degree" (Ekelund and Tollison 1981, p. 24). That is, to avoid challenges to his authority the king benefited by allowing consumers to retain some of their surplus. Even the monarch was constrained in his ability to profit from rent-seeking by the need to expend resources to stay in power.

In a democratic setting, public perceptions and the influence of various interest groups are much more important in terms of maintaining power and influence. In terms of deregulation, the widespread knowledge that economic regulation benefited producers by imposing significant costs on consumers, and additional factors that affected the public's perception of government--brought challenges to the power of incumbent politicians during the deregulatory period of the mid 1970s, and made it increasingly costly to support the status-quo on regulatory issues.[76] All else equal, an increase in the challenges to incumbent politicians would require an increase in the amount of resources necessary to maintain power. There is considerable evidence that the political popularity of Congress declined during the period that coincided with deregulation, suggesting that the constraints on rent-seeking activity were altered. Endogenous and exogenous factors increased the costs of maintaining power, a contributing factor being a widespread belief that government worked contrary to the interests of the average citizen. Therefore, it may be inferred that economic regulation and its highly visible costs played a part in affecting potential "majorities" of the legislature.

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[76]A 1977 poll for *U.S. News and World Report* showed that 81 percent agreed and 8 percent disagreed with the statement "large companies have a major influence on the government agencies regulating them."

Evidence

Parker (1996) has compiled data on the popularity of Congress and the public's perception of "who runs the government." For example, in 1964 fewer than 30 percent of voters believed that a "few big interests" ran the government. However, by 1974 more than 60 percent of the public believed the government was run primarily at the whims of wealthy interest groups.[77] Parker's contention is that when the electorate hold the current legislature in relatively low esteem, this increases the probability that challengers will compete for congressional seats. With the competition for legislative office on the rise, the resources devoted to political activity must also increase. One implication is that, under these circumstances, the turnover of congressional seats should be greater with low popularity of Congress.

Parker (1996) again has demonstrated this relationship between the popularity of Congress and "novice" freshman entering office. On average from 1952 to 1972, with congressional popularity relatively high, novice freshman entering the House of Representatives comprised only 6 percent of the membership. However, from 1976 to 1990 the average jumped to 22 percent, with 36 percent of the incoming freshman legislators for the 1974 congressional elections having no prior public office experience (1996, p .83). As a consequence of greater competition for legislative power, it might be expected that the cost of obtaining election/reelection should increase as measured in receipts and expenditures in election campaigns.

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[77]Data are from the National Election Studies 1964-86 (quoted in Parker 1996, p. 71). The proportion of the public holding an "unfavorable" view of Congress went from roughly 25 percent in 1966 to approximately 65 percent in 1972 (Ibid, p. 86).

Jacobson (1980, p. 53) reports that inflation adjusted campaign expenditures for House seats increased 12 percent from 1972 to the 1976 elections. However, because of changes in campaign finance laws, this data may understate the level of competition in federal elections. It is clear that there was increased competition for legislative seats as measured by the reaction of incumbent politicians leading up to this period. Federal campaign finance laws were changed by the current legislatures of the period evidently for the purpose of limiting any potential challengers' chances of obtaining legislative seats. The Federal Election Campaign Act (FECA) of 1971 and its Amendments in 1974 were meant to put constraints on the ability of challengers to obtain public office and limit competition for congressional seats. Disclosure of the sources of campaign funds was one aspect of the legislation that was less appealing to politicians in general, but limits on campaign spending " . . . were the reforms Congress found most inviting" because evidence "showed clearly that challengers normally did well only if they spent a great deal of money . . . " (Ibid, p. 187)[78] By establishing limits on campaign spending, incumbents limited the ability for challengers to unseat them. However, a secondary effect of limiting campaign spending and the size of individual contributions was to increase the amount of time candidates needed to spend raising money from individuals:

> The 1976 congressional candidates reported spending more time than ever raising funds because of the present limits on the size of gifts. As much time and attention must be spent on contributors of $500 or $1000 as on people who gave ten times the amount previously, so the efficiency of fund raising necessarily diminishes and the time devoted to it increases (Ibid, p. 70).

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[78]Jacobson (1980) also has regression analysis indicating a highly significant connection between challenger campaign expenditures and voter recognition and no significance between expenditures and recognition for incumbents (p. 153).

One consequence of these campaign finance changes was the increased need to appeal to the sentiment of individual voters and hence voter ideology. This would certainly manifest itself in the desire of candidates to distance themselves from unpopular interest groups and appeal to groups with "broader" interests. In regard to raising funds under these new constraints Jacobson notes that, "The ideological and policy positions of the candidates are also relevant. Candidates can raise more money if they can attach themselves to emotional issues and causes . . . " (Ibid, p. 71).

The increase in the unpopularity of Congress, legislator turnover, campaign finance reform and the manner in which money was raised coincides with an increase in "citizen" lobbying groups. Berry (1997, p.20) cites data that indicates 25 percent of all Washington lobbying groups were established after 1970, with the majority of those being citizen or "public interest" groups. The increasing competition for political influence and the changing nature of the lobbying groups would no doubt influence the "price" previously influential groups would need to pay to achieve their political objectives.[79] This evidence raises the possibility that, for some interest groups, primarily producers seeking protection from competition, the price of influencing the political process had increased dramatically. With the number of available interest groups rising, and the increasingly costly nature of supplying rents, legislators may cater to "lower cost" groups, ones whose interests will not require expensive "mitigating" of opposition.

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[79]63 percent of corporate lobbying offices in Washington D.C. increased their staffs from 1975 to 1980. "General Motors went from a three-person office in 1968 to a staff of 28 in 1978" (Berry 1997, p. 20). However, this probably understates the real resources and the monetary expense of lobbying. The number of lawyers operating in Washington D.C. increased from around 11,000 in 1972 to about 35, 000 in 1980 and currently they number about 60, 000 (Ibid, p. 24).

Greater turnover in Congress and challenges to incumbency had additional consequences for supplying rents. With more "non-career" politicians entering Congress and greater challenges to authority in the legislature, there was pressure to dilute the power and influence of those remaining "career" politicians. Beside campaign finance reform, "changes of the committee system introduced by House Democrats in the mid-1970s had the effect of increasing the number of players and of decreasing the [committee] chairman's control" (McChesney 1997, p. 104). These changes increased the number of legislators needed to support a bill and get it through Congress.[80] Institutional changes not only increased the number of legislators needed to pass legislation, but the diffusion of power also increased the number of congressional staff members from fewer than 400 during the 1940s to more than 3000 by 1980, as relatively junior members of the legislature wished to have similar access to resources as did the senior members, with the majority of the increase in staff occurring during the 1970s (Ibid, p.105). This made it increasingly difficult to gain access to those ultimately responsible for legislation, and the number of bills introduced into committee. The ultimate effect of these changes is an increase in the number of "issues" brought before the legislature, more floor votes and the need for interest groups to "lobby the staff" as well as politicians (Ibid). Therefore, institutional changes worked to increase transaction costs and reduce the durability of any potential legislation. "The decline in legislator tenure and the proliferation of internal congressional changes in the 1970s necessarily created doubt about the

[80]One lobbyist is quoted during the 1980s that "[t]here used to be two to five guys on each side[of the legislature] who had absolute control over any category of bills you might want. All you had to do was get to them. Now getting the top guys is no guarantee. You have to lobby every member of every relevant subcommittee and even the membership at large" (quoted in McChesney 1997, p. 105).

likelihood that legislators would perform on longer-term contracts" (Ibid, p. 106).

The election law changes during the mid 1970s also increased the amount of money channeled through political action committees (PACs). During the 1970s when these changes were instituted--allowing corporations and other groups to set up committees to solicit voluntary contributions--it created the possibility that previously unorganized interests would have the resources to influence legislation. "To a politician contemplating deals with private interests that are binding into the future, a principal disadvantage [of the PAC system] is the possibility that other interests will later emerge and offer more money for a conflicting deal" (Ibid).

It is evident that greater turnover in the legislature and institutional changes increased transaction costs. These increased costs coincided with the decline in "traditional" economic regulation. A decline in durability and increased lobbying costs were two of the principle reasons put forth by Ekelund and Tollison(1981) for a decline of English mercantilism during the eighteenth century. It is suggested, therefore, that economic regulation itself (the behavior of regulators), along with exogenous events altered the constraints faced by producers and regulators, with unintended consequences. In response to declining popularity of governmental institutions and incumbent politicians, institutional changes reduced the benefits and increased the cost of obtaining traditional economic regulation.

Much of the economic theory of regulation is predicated on the notion that politicians are faced with an implicit tradeoff: providing benefits to interest groups at the expense of a diffuse and rationally ignorant majority while also acquiring votes sufficient to be reelected. The legislators objective would be to maximize votes while also maintaining the willingness of interest groups to pay for the services of politicians. A dilemma faced by politicians during the deregulatory period was how to reduce the political costs (and to elicit favorable votes) associated with the previously established regulation while also maintaining the value of their services. That is, declining rents and changing public opinion were not conditions sufficient to enlighten politicians on the inefficiencies and inequities of regulation through revealed wisdom and then produce a legislative outcome. Politicians did not wish to appear as though they were acting in bad faith and would over time "test the market," attempting to see which interest groups had sufficient resources and what, if any, regulatory changes rent-seekers were willing to pay for. Therefore, much of the observed behavior of politicians and regulators during this period may be explained by the desire of legislators to sell their abiding preference for the public interest, while simultaneously maintaining their ability to cater to (or extract wealth from) interest groups.

Judicial Rulings

Inadvertently, as a result of its own actions outlined above, the CAB eventually brought careful scrutiny upon itself from a number of institutions, which, under the theory of bureaucratic behavior, they would have an incentive to avoid. Prior to legislative scrutiny the federal courts began to question the CAB's anti-competitive decisions. The Circuit Court of Appeals for the District of Columbia, said to be the single most important reviewer of regulatory rulings, became highly critical of the anti-competitive behavior of the CAB and ultimately took a dim view of the behavior of regulatory agencies in general, which seemed to be a reversal of its previous stance on regulatory issues. In *Moss vs. CAB,* in a decision that Derthick and Quirk describe as a "shock" to the regulators, the court ruled that the CAB was "unduly" ruling in favor of the airline industry when determining airfares rather than considering the public interest, which, in the court's words, "it was designed to protect."[81] Other similar rulings followed. In a 1975 ruling the Circuit Court of Appeals for the District of Columbia stated that the CAB is to "foster competition as a means of enhancing the development and improvement of air transportation service on routes generating sufficient traffic to support common carriers."[82] These rulings followed and were a direct consequence of the behavior of the airlines and the regulators as they responded to the inability to maintain the cartel and further influenced the decisions of regulatory agencies.

Given the nature of the relationship between the courts and the legislature, it is evident that the value of legislation depends to a large degree on the perception that it is enacted in the public interest (Tullock 1989), which manifests itself in cross-subsidizing certain groups of consumers.[83] In terms of Peltzman's (1976) model regulators increase their utility by not allowing firms to "maximize profits," but distribute some of the rents to particular groups of consumers. Given the increased visibility of regulatory agencies, ruling in favor of the regulatory agency decisions and the protected industries in light of technological change and egregious rent-seeking behavior, as displayed by the airline industry and regulators, may have undermined the court's desired image of being independent, and in turn undermined the stature of the courts and the respectability of judges. In the

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[81]430 F.2d 891 (D.C. Cir. 1970) This was a case that brought into dispute the agency's procedures for determining airfares.

[82]*Continental Airlines vs. CAB.* 519 F.2d 944(D.C. Cir. 1975)

[83]This could assist in explaining the profligation of environmental and social regulation. It is now easier to rationalize as being in the public interest and obfuscate the fact that it benefits special interests.

court's view the regulated industries and the regulators strayed too far from the perceived legislative "deal" of the original legislation, due partly to endogenous regulatory induced depletion of rents and exogenous factors, such as technological change.[84] Subsequently, in light of this readily available information, and without sufficient wealth to redistribute to selected groups of consumers, the courts began to take a procompetitive stance, further affecting the durability and value of regulation to the regulated industries. Court approval, as well as public approval of economic regulation, requires the perception that such legislation serves the public interest. When rulings overturning regulatory decisions emanated from a court (The Washington D.C. Court of Appeals) that was considered "the single most important reviewer of regulatory agency action" and the "supreme court" for regulation(Derthick and Quirk 1985, p. 67) there would conceivably be changes in the choice set faced by the regulators (and firms). The fact that deregulatory efforts began within the regulatory agencies themselves is at least indirect evidence that regulators and firms were affected by these rulings and faced different constraints as a result. These rulings would further erode the value of

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[84]This analysis sheds some light on the manner in which new technology and changing cost structures had an effect on promoting deregulation. These changes did not effect the regulatory process directly through the legislature but made it more likely that regulatory rulings would receive challenges in the courts. Therefore, even though potential competitors could not exert a great deal of influence on legislators, and, therefore, did not appear to have a great deal of influence on legislative outcomes, they did pursue their interests in the most efficient manner they could--by bringing these issues before the courts. Derthick and quirk assert, for example, that potential competitors to AT&T "had no independent political power in the 1960's but when the FCC attempted to stifle MCI's foray into long-distance telephone service "MCI successfully appealed to the courts"(1985 p. 23). Upstart airlines, trucking companies and airlines brought challenges to regulatory rulings before the court--challenges that would not have received a hearing in many cases were it not for technological change and other economic factors that made competition more viable.

regulation by creating uncertainty as to the durability of rulings put forth by the agency.[85]

Summary

Sellers will virtually always prefer to operate with less competition, and would certainly prefer that regulators could maintain an effective cartel. But the changing attitude of the courts toward regulation increased the uncertainty faced by regulated industries with regard to regulatory rulings. Even if industry could persuade regulators to rule in their favor, the probability was increasing that such rulings, possibly at the initiative of potential competitors, would be struck down by the courts, just as producers in mercantile England faced uncertainty from crown granted monopoly rights--the high probability of being overruled by the common law courts.

Just as "the fall of mercantilism must be found in the changing cost-benefit structure facing potential rent-seekers" (Baysinger et al. 1980, p. 244), there are similar (though less dramatic) changes in the modern context: Greater turnover in the legislature increases the uncertainty that legislation will be durable; a larger number of individuals who must be influenced to get

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[85]Challenges to anti competitive rulings did not apply only to the airline industry. The D.C. Court of Appeals also ruled in 1977 that the ICC could no longer deny, as they had previously, an application to a trucking firm exclusively on the grounds that it had failed to show that current service was inadequate, but that it was required to consider the benefits of increased competition on its own merit (*P.C. White Truck Line vs. ICC.* 551 F.2d1326 D.C. Cir. 1977). Also in 1977, (*MCI Telecommunications Corp. vs. FCC.* 561 F.2d365 D.C. Cir. 1977), in a case involving the telecommunications industry, the court stated that, "[the FCC] must be ever mindful that, just as it is not free to create competition for competitions sake, it is not free to propagate monopoly for monopoly's sake" This was a step in the opposite direction from the landmark Supreme Court case that had previously given a nod of approval to anti-competitive regulation by the agencies. These decisions all shared the common feature of being the result of challenges brought by potential competitors in each of the major regulated industries.

legislation passed increases transaction costs; and an increase in judicial activism and a change in legal precedent are all factors that would reduce the demand for economic regulation. Court rulings created uncertainty as to whether profit-enhancing decisions by regulators would withstand challenges in the courts. The rise of democratic rule in mercantile England produced in effect a similar result. An increase in the number of decision-makers due to the rise of democratic rule, and an increase in judicial activism, created uncertainty and increased transaction costs. " For these and other reasons, the costs of lobbying to rent seekers will rise under representative democracy, and we would expect to see a decline of government interference in the economy because of these higher costs" (Ibid).

CHAPTER VII

AN ECONOMIC EVALUATION OF DEREGULATION OF TELECOMMUNICATIONS AND TRUCKING

Introduction

As noted in a previous chapter, airlines are a clear case where endogenous and exogenous factors reduced rents prior to deregulation. However, reduced rents prior to deregulation were not precursors to deregulation in the trucking and telecommunications industries. In the telecommunications industry technological advance had clearly worked to maintain and even increase rents (Peltzman 1989; Keeler 1984). Moreover, there was never the regulatory problems experienced by the airlines. Within the industry "regulatory harmony was easy to maintain because scale economies and technological change continually drove costs downward" (Derthick and Quirk 1985, p.178)[86].

The trucking case shares more in common with the airline industry than does telecommunications. Both trucking and airlines were affected by exogenous events--inflation, recession and oil embargoes. However, while there were some regulatory induced cost increases in the trucking industry, these were not as dramatic as the airline case. Moore (1978) has estimated that regulation depleted no more than 25 percent of the total rents available and that most of the rents accrued to members of the Teamsters union. That there were still rents available is supported by the fact that operating rights that had value prior to deregulation became worthless after deregulation (Peltzman

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[86]It should be noted, however, that in some respects the telecommunications industry experienced some of the same regulatory difficulties as other industries. Namely, in an inflationary environment, state utility regulators not allowing rate increases to match cost increases (MacAvoy 1979).

1989, p. 25). Also, as noted previously, the trucking industry and its unions mounted a vigorous, unified lobbying campaign against deregulation.

The fact that regulators so easily admitted competition when there were still substantial rents to be had does not, according to Peltzman, bode well for an economic explanation. "Accordingly, if one had to choose between [an economic] explanation and [the public interest theory]--that deregulation follows the demise of natural monopoly conditions--the latter is simpler and thus more appealing" (Peltzman 1989. p. 31). Therefore, from a rent-seeking perspective, these observations appear inconsistent with an economic explanation of deregulation in telecommunications. However, some useful insights into the deregulation of trucking and telecommunication industries may be gleaned from the preceding analysis of the airline industry. In terms of rent-seeking, it's not rents at a particular point in time, but the prospects for future rents that are important. Factors that reduce the durability of regulation and increases in lobbying "costs" will reduce the value of regulation.

Rent-Seeking Factors

It is evident that technological advance and the prospect for competition had made the reduction of rents a distinct possibility in the long-distance telephone market. Peltzman (1989, p.30) notes that, while there was in the late 1960s and early 1970s no actual dissipation of rents, the profits built into long-distance telephone communication, provided a strong incentive "for actual competition" and from AT&T's and the regulator's perspective "the threat was obvious." In 1968 the FCC allowed MCI to offer private long-distance microwave service to large users (see note p.93) with the potential of siphoning profits from AT&T. Within a short time MCI applied for and received permission to provide public long-distance service by connecting to local networks. Therefore, the resourcefulness and influence of potential competitors should not be dismissed as a potential real factor to consider. While dismissing the political influence of potential competitors to AT&T, Derthick and Quirk nevertheless note how MCI was able to create competition in long-distance service by going beyond what the FCC had authorized them to do. "The FCC in its *Specialized Common Carrier* decision(1971) intended to restrict the new long-distance offering to private line service, but MCI proceeded to offer, with Execunet, what was in effect public service" (1985, p.24). They go on to note that when the FCC attempted to halt Execunet service after they realized their error, "MCI successfully appealed to the courts" (Ibid). It seems rather unlikely that there were not potential political gains to be made from allowing large business users of long-distance service to benefit from competition, particularly when those interests had been a loser in the regulatory process. Even Derthick and Quirk note (consistent with the airline case) that this was an instance where "the irrationalities of regulation became more visible" (Ibid). An economic interpretation of this political observation would be that deadweight losses from regulation long-distance telecommunications were rising.

In the trucking industry, it was the liberalized rulings of the ICC that increased competition. This occurred undoubtedly in response to the airline demonstration. "One cannot know for sure how the deregulation of the airlines affected perception and thinking in other agencies, but at a minimum it got people's attention at the ICC" (Noll and Owen 1983, p.128; see note p. 97; also court rulings in previous chapter). By allowing more competition the regulators created an uncertain operating environment for the firms within the trucking industry. Appearing before Congress, the president of the

American Trucking Association stated that " . . . the motor carrier industry is now operating under an intolerable burden of uncertainty. From one week to the next we do not know what the rules will be."[87]

The increased presence and potential for competition in the telecommunications and trucking industry, due to technological change and regulatory change respectively, implies that rent-seekers will have to expend more resources to maintain their monopoly. The monopoly right becomes less durable. "Therefore, the more an interest group has to spend to maintain its monopoly (holding constant the monopoly rents) the greater the gain from deregulation and the more likely deregulation will occur" (McCormick et al 1984, p. 1079). The presence of potential competitors, not only reduces the prospects for future rents, it increases the expenditures needed to maintain monopoly status.

The timing and strength of deregulation in trucking and telecommunications also tends to suggest an interpretation consistent with the preceding economic analysis. Derthick and Quirk imply that deregulation bills of both the telecommunications industry and the trucking industry "required" the consent of both (1985, p. 188), indicating that, unlike the airline industry, these industries yet had substantial political influence. The influence of AT&T remained formidable. "As late as the end of 1981, it still had been taken for granted that Congress could pass no significant telecommunications bill without Bell's *imprimatur*" (Ibid, p. 202). However, its slowly evolving acquiescence to deregulation may have come about because institutional changes and the prospect of competition reduced the present value of regulation--that is, that monopoly rights must be durable to have value to

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[87] See *Economic Regulation of the Trucking Industry,* Hearings before the Senate Committee on Transportation, 96 Congress, 1 session. Government Printing Office, 1979. pt1, p. 80.

rent-seekers. These factors also increased lobbying costs making it likely that rent-seekers would expend fewer resources in the rent-seeking process. Nonetheless, one might argue that the slow (still on-going) process of telecommunications deregulation could be attributable to the persistence of rents and the relative lack of regulatory "failure." Relative to the airline industry, the less swift and less dramatic deregulation of trucking (the ICC was not eliminated nor was the regulation of trucking by the individual states) could be explained by the relative lack of endogenous factors and the available rents. However, resorting once again to broader theories of how incentives influence political behavior may shed additional light on the deregulation of these two industries.

The Role of Political Entrepreneurship and Rational Ignorance

Noll, in attempting to reconcile economic theories with the exit of regulation in the presence of rents, believes that Peltzman takes too narrow a focus of the economic theory. "In one sense [Peltzman's theory] is narrower than the economic theory of politics, for it either ignores or only partly incorporates several other important contributions to the economics of political behavior" (Noll's comments to Peltzman [1989], p. 48). A focus on the supply side of rent-seeking may also be applicable in these two case--specifically, focusing on political entrepreneurs and the rational ignorance of voters.

As noted above, exogenous factors reduced the value of and also increased the costs of maintaining the original agreement. During the 1970s inflation (besides indirectly reducing profitability in the airline industry through increasing fuel prices) was becoming a serious economic, social and political problem and policy makers were looking for a place to put the blame and were groping for potential solutions. Political entrepreneurs[88] seized upon regulation as a culprit. President Ford was particularly inclined to claim regulation as a cause of inflation and to exploit it politically, and, as Derthick and Quirk claim, without this issue Ford would likely not have supported deregulation (1985, p. 47).

Inflation was a (if not the most) serious economic and social problem during the Ford administration. Ford campaigned heavily promoting deregulation as a cure for inflation in spite of the fact that no one in the administration seriously believed economic regulation was a significant cause of inflation.[89] Inflation then hurt the regulatory regime in two ways. It reduced profitability in regulated industries by not allowing price increases to keep up with increases in cost, and as an exogenous event which, used by politicians, brought further scrutiny upon the regulatory apparatus, creating additional uncertainty about the durability of regulation. Deregulation was a vehicle which political entrepreneurs used to gain voter support. "In the second half of 1974, with the presidency weakened, with the world economic order destabilized after the first oil shock and the demise of fixed exchange rates, and with the domestic economy sliding into a high-inflation recession,

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[88] Noll (comments to Peltzman [1989], p. 50-51) states that "A political entrepreneur is a person who invents a way to undo structure-induced stability. He or she discovers how to take advantage of the fundamental instability of majority rule within the constraints imposed by the institutional arrangements designed to induce stability."

[89] In their account Derthick and Quirk characterize this stance by the Ford administration as an example of a political figure willing to take on powerful interests at political expense. Ford's support of a trucking deregulation bill had angered the trucking industry and the Teamsters union. However, they also note the political gain Ford achieved by this stance: "A policy stance that promised to reduce government activity therefore had some potential for mass appeal (and some potential utility for a president who would soon be asking the national electorate to return him to office). (1985, p. 47) Ford evidently believed the potential benefits exceeded the costs from a political standpoint and supporting deregulation was in his interests.

the time for reform, and for political entrepreneurship was ripe" (Vietor 1991, p. 32). The expediency of blaming inflation on economic regulation implies greater costs in terms of "mitigating" opposition to price and entry controls, making it more likely that economic regulation will exit the political arena:

> Politicians can take advantage of salient issues by being the source of information free to voters on an important issue of the moment. An example from the early and middle 1970s was stagflation; the free information was inefficiency in regulated industries. Indeed a fairly common complaint was that "excessive regulation" was undermining business performance. Rationally ignorant voters, concerned about macroeconomic performance, could be expected to respond to this information by favoring economic deregulation, even though a fully informed analysis might conclude that regulation had only a trivial effect on national economic performance. Moreover, the simplicity of the point with respect to economic regulation--"prices are too high"--may explain why regulatory reform was far more successful in that area than in many other areas where it was proposed, such as drug regulation, environmental regulation, and workplace safety and health regulation (Noll's comments to Peltzman [1989], p. 52).

While Derthick and Quirk note that no economists seriously believed that regulation had any significant impact on inflation (1985, p. 56), the Kennedy hearings and President Ford's campaign against inflation were in this genre, actions that provided "cheap information" to voters clearly in response to the public's concern over macroeconomic conditions. Political entrepreneurs used these events--regulatory failure and inflation--as a means to cater to voters who had concerns over macroeconomic conditions could easily buy into the idea that deregulation would "whip inflation now."

The High Cost of Supplying Rents

In addition, the implications of the role played by political entrepreneurs is consistent with previous observations that, given exogenous and exogenous factors that affected institutional change, politicians would avoid catering to particular "high cost" interest groups. The interests of the politician/supplier were no longer well-served by supplying economic rents in such a manner. The simplicity of the argument--that regulation implies poor economic performance--meant that it must have a universal application and that any regulated industry where there were controls on entry and price must be a culprit. To paraphrase Tullock (1980, p. 219), a law that provided a direct transfer to an interest group (e.g., trucking firms) would be less likely to pass muster with voters. The public's perception of regulation must certainly have evolved to the point where it was viewed as a direct transfer. Given that politicians claimed that regulation caused prices to be "too high," this once again made virtually all industries "high cost" interest groups for politicians to supply political benefits, given the drama played out within the airline industry and the exogenous events of the period. Therefore, even though rents were yet available in telecommunications and trucking, rents were unable to generate the support necessary to maintain regulation in its traditional form. Peltzman (1989, p. 20) points out that, given the political environment, incumbent producers may yet support regulation, in spite of its shortcomings, because it promises the possibility of some rents, but the rents are too small to produce politically effective support. Requests for a "cheap lunch," he argues, will not be granted. The rational ignorance/political entrepreneur theory is casually supported by the evidence. Deregulation within the agencies began roughly at the start of the inflation, oil embargo and recessionary periods of the 1970s.[90] Noll, once again in his comments on Peltzman's (1989, p. 57) work, notes that "Moreover, the steam seems to have run out of the regulatory reform movement roughly coincidentally with the

[90] For example, the ICC began to police rate bureaus in 1973 in an attempt to ensure that rate setting by trucking firms were more competitive (Noll and Owen 1983, pp. 125-6).

end of the stagflation period, late in the first half of the Reagan administration."

Since acquiring votes are the ultimate objective of politicians, cheaply acquiring them from exploiting rational ignorance will be attractive under particular circumstances--potentially reducing the influence of particular interest groups. Therefore, in light of the airline experience, where the inefficiencies were obvious and dramatic, no other industry benefiting from controls on entry and price could go unscathed. Political entrepreneurs seeking votes used regulatory failure as a vehicle to promote their interests and inadvertently produced institutional change that altered the incentives of rent-seekers. In seizing airline regulation as a vehicle by which to enhance "political utility" legislators may have instigated institutional changes that altered the cost-benefit structure of supplying rents to other industries. Congressional action, court rulings and presidential input upset the status-quo.

VIII. CONCLUSION

In a broad context, a goal of this study has been to explain what forces drive social and economic change. It is common for scholars of all eras to resort to ideas or ideology as a primary cause of social, economic and political change. While interest group explanations for the establishment of economic regulation have gained credence with scholars, economic explanations for *the exit of regulation from the political marketplace* have not been well-received nor well explored. Derthick and Quirk note rather ironically that the criticism of regulation "was grounded on both microeconomic theory--which is generally held to be the most powerful body of theory in the social sciences--and empirical research" (1985, p. 246). The implication is that economic criticisms of regulation were founded on an understanding of the incentives underlying its development and implementation. It seems implausible that those "powerful" explanations would not also be useful in explaining its demise.

This study has attempted to close a gap in the explanation of one aspect social change by juxtaposing economic explanations (in a broad context) with the ideological explanations for deregulation as developed by others and thereby provide further evidence as to how incentives affect social process. The intent was not to show that ideological explanations are mistaken, but rather incomplete. For example, it has been argued that institutional changes and increased transaction costs in obtaining legislative access coincided with the deregulatory period. Derthick and Quirk make a similar (if unintentional) point. They note that during the 1970s,

> [There was an increase in] the growth of analytical staffs in both legislative and executive branches, and the decentralization and democratization of power in Congress. These changes have altered the conditions, opportunities, and definitions of success in

> political careers: they encouraged officeholders to rely on themselves, rather than political parties . . . "(Ibid, p. 254).

One can argue, therefore, that there is a similarity between the decline of eighteenth century English mercantilism and the deregulation of major twentieth century industry: A greater number of decision-makers to persuade would make it increasingly difficult to gain influence to the political process by increasing transaction costs. Given these increased costs and the conflagration of interest groups that developed during the period, this would create an environment whereby the political process would produce less traditional economic regulation.

To support an economic argument for social change, it has been argued that a confluence of factors (many of them endogenous) altered the cost/benefit structure of economic regulation, creating pressures on political institutions to change policy. These "forces" for change are consistent with the Peltzman (1976) Stigler (1971) and Becker (1983) theories of political behavior. These pressures, exacerbated by exogenous events such as inflation and recession, provided a ripe environment for political entrepreneurs to actively pursue deregulation in an effort to gain political benefits, which efforts in turn played a role in reducing the value of traditional economic regulation. It has been demonstrated that, as interest group pressures (or more precisely, any factor that serves the interests of politicians) change, politicians have an effective mechanism to signal those changes to those who administer the law. This allows them to "market test" policy change and also to avoid the appearance of "political opportunism." The process of market-testing deregulation also had the effect of creating uncertainty and higher costs to rent-seekers.

The airline case provided a clear example of the process by which economic factors affect political change. For the airline industry, the expected net benefits of maintaining regulation were not positive. Non-price competition eroded rents along with recession, inflation and rising fuel costs. Gradually, they withdrew resources from lobbying for price and entry restrictions. The Kennedy hearings were an entrepreneurial event meant to signal that, from a constituency standpoint, regulation was functioning poorly. The failure of individual firms to organize as a politically effective group was an indication to the suppliers of regulation that the expected net benefits of regulation were low. Once regulators began promoting competition (in a limited fashion), this allowed Congress to conduct a market test of deregulation and also hide the opportunistic aspects of deregulation. In response to the endogenous and exogenous factors, institutional changes (partially due to previous institutional behavior) were enacted which unintentionally affected the cost/benefit structure in the regulatory process. In the political marketplace, the airline case had demonstrated the inefficiencies of regulation and also the possibilities of the benefits of deregulation.

> As long as deregulation benefits some part of the relevant coalition, it cannot be ruled out as a viable policy option. When the deregulation benefits become large relative to the associated losses, the probability that the option will be exercised rises. This situation is more likely to occur if the regulation itself has generated inefficiencies, so that shedding the inefficiency through deregulation provides a potential source of benefits (Peltzman 1989, p. 38).

Technological change, regulatory behavior, court rulings and political entrepreneurs, as Noll (1989) observed, created new interest groups and divided old interest groups, all apart from the relevant ideology. Therefore, ideas or intellectual insight would not necessarily have been the major factor that contributed to deregulation.

"Economists had begun making the bullets of procompetitive regulatory reform fifteen years before politicians found them to be usable in particular battles they wished to fight"(Derthick and Quirk 1985, p. 56). The principal question is what determines the "battles" that politicians chose to fight and are they driven by ideas or economic behavior? This study has attempted to show that real variables drive social change. In this instance, it's quite possible that the forces of self-interest would have been sufficient to drive social change apart from ideological influences. Ideas played a role but a role no more important than a host of other variables.

In relating ideas to policy change, Ekelund and Tollison (1997, p. 17) note that the importance of ideas (in the case of mercantilism) was subordinate to and supportive of interest groups able to influence the political process. This dissertation backs up that perspective. Ideas were the vehicles by which politicians and interest groups promoted their own interests. It was generally after the cost/benefit structure of regulation had changed that individuals supportive of "free markets" were brought into the policy process (e.g., Alfred Kahn to head the CAB). A loss of rents, the highly visible harm to consumers from regulation and the potential, demonstrated gains in political benefits from deregulation were the primary forces that instigated policy change, not merely ideas.

In exploring further how ideas influence social change Ekelund and Tollison note that "ideas, like technological advance, changes in transaction costs, and innovations, are 'shocks' to a given system composed of particular institutions. These 'shocks' must work through institutions that are established and evolve through markets guided by self-interested activity"(Ibid, p. 23).

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Scope and Method of Study: An economic analysis of the deregulation of major industries is developed using a methodology applied to the rise and decline of eighteenth century English mercantilism. Theories of rent-seeking and the economics of regulation are applied to the deregulatory period and contrasted with ideological explanations.

Findings and Conclusions: The analysis reveals that deregulation of airlines, trucking and telecommunications can be reconciled with economic theory. A decline in economic rents along with uncertainty regarding the durability of rents and regulation and the rising costs of rent-seeking contributed to the removal of price and entry restrictions in these industries.

ADVISOR'S APPROVAL: ____

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INSTITUTIONAL REVIEW BOARD

DATE: 11-03-97 **IRB #: BU-98-009A**

Proposal Title: DEREGULATION: ECONOMICS OR IDEOLOGY

Principal Investigator(s): E.O. Price, III, Gary McDonnell

Reviewed and Processed as: Continuation

Approval Status Recommended by Reviewer(s): Approved

Signature: Carol Olson (s80) Date: November 12, 1998

Carol Olson, Director of University Research Compliance
cc: Gary McDonnell

Approvals are valid for one calendar year, after which time a request for continuation must be submitted. Any modification to the research project approved by the IRB must be submitted for approval. Approved projects are subject to monitoring by the IRB. Expedited and exempt projects may be reviewed by the full Institutional Review Board.