

## A note on centralized regulatory review\*

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### 1. Introduction

Viewing the apparatus of the state as a vehicle through which regulators dispense wealth in return for political support, the well-known 'capture' theory implies that concentrated interests will generally prevail over more diffuse interests. In this note we argue that an important consideration in predicting regulatory outcomes in such a setting is the degree to which the overall administration of rent-seeking opportunities is centralized within a particular level of government.<sup>1</sup> If regulatory administration is decentralized, with rules issued piecemeal by a variety of independent agencies, then concentrated interests will typically be more successful in inducing regulators to fashion their decisions to benefit them. In contrast, a centralized review process makes this outcome less likely.

The major benefit of centralized regulatory oversight is its effect on the rate of return to lobbying, or the attempt to capture an agency. Creating a central location for the review of proposed rules effectively sums the welfare costs associated with the gamut of individual regulations. In consequence, the expected benefits of lobbying by diffuse interests are increased, and more efforts by them to influence regulatory outcomes are predicted, *ceteris paribus*. By contrast, while centralized regulatory review should have little influence on the benefits realized by concentrated interests in lobbying for regulatory gains, their lobbying costs will rise. The change in the relative rates of return would appear large, and we would expect centralization to introduce substantially more influence by diffuse interests into the regulatory process, even if the supply elasticity of such lobbying effort is relatively low.

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We use the term ‘lobbying’ in its most general sense. The additional influence of diffuse interests on regulatory outcomes will be manifest in a variety of ways, including speeches, articles, letters, telephone calls, and campaign contributions. We do not limit or even stress the possibilities of lobbying personal visits by professional advocates for the purpose of obtaining political favors.

## **2. Centralized v. decentralized administration**

The ‘capture’ theory of economic regulation is well known and has a venerable history in the literature, going back perhaps as far as Wickcell’s classic 1896 paper, ‘A New Principle of Just Taxation.’<sup>2</sup> Its presentation remained fairly inarticulate, however, until the appearance of Stigler’s seminal article, ‘The Theory of Economic Regulation,’ in 1971.<sup>3</sup> Stigler formalized the notion that coalitions of producers will find it in their self-interest to use the apparatus of the state for their own benefit. This follows because producer groups are small enough in number and their financial interests are sufficiently concentrated that the potential gains from lobbying for monopoly rights will often exceed the costs. On the other hand, the more diffuse nature of consumer interests leads such groups to face relatively high costs of organizing coalitions to oppose monopoly-enhancing regulations. As a consequence of its lobbying advantage, industry can often successfully mobilize the state’s coercive powers to secure for itself such favors as direct subsidies, control over the entry of new rivals, restrictions on the outputs and prices of complementary and substitute goods, and the legitimization of price-fixing schemes.

In the most important subsequent contribution to the theory of economic regulation, Peltzman posits a vote-maximizing regulator who faces a tradeoff between the gains conferred on producers and the costs imposed on consumers in setting a regulated price.<sup>4</sup> An important implication of Peltzman’s model is that industry does not receive all it wants from regulation, in the sense that the vote-maximizing price is less than the pure monopoly price.

The demand for regulation on the part of producers arises from the profit-enhancing effects created by regulatory restrictions. Firms will be willing to spend up to \$1 for every \$1 of obtainable rents. In return, industry coalitions offer political support for the regulators, and such mutually beneficial exchanges serve as the basis for an agency’s willingness to supply rulemaking activities.

In contrast, the groups that are harmed by regulation – frequently consumers who pay higher prices because of limitations on competition – have a lesser and more varied interest in the regulatory process. Every

dollar in rents received by concentrated interests is, with provisions for the cost of operating the wealth-brokering machinery, \$1 given up by the polity at large. However, while each dollar of regulatory gains will be divided among the relative handful of members in the concentrated-interest group, the loss suffered by each of those having diffuse interests will be trivial.

The public choice literature contains a great deal of discussion concerning the properties of the many possible voting rules for aggregating individual preferences.<sup>5</sup> Of relevance here is that one of the principal suggestions of this literature is that the time required for any coalition to reach a consensus increases with the size of the requisite majority. On the basis of sheer numbers alone, therefore, concentrated interests can be expected to dominate rulemaking proceedings because they can more readily reach agreement on what actions are in their best interest. The costs borne by diffuse interests will also be relatively higher if members display wide differences of opinion or if information about the effects of regulation is difficult to obtain. Moreover, because it costs something to initiate action, the many losers from regulation are less likely to organize than the few gainers.

The relative lobbying disadvantage for opponents of rent-creating regulation exists on an agency-by-agency basis and *a fortiori* for rulemaking as a whole. Even if a coalition of those having diverse interests could organize and successfully defeat a regulation that, for example, awards a monopoly franchise to supply the market with one good, it is unlikely that the same group could repeat its performance on a second issue, such as tariff protection for some other commodity, unless there is a substantial intersection of interests between the buyers of the two products. The large numbers and varying preferences of consumers are generally incompatible with sustained lobbying efforts.<sup>6</sup>

On the other hand, the small numbers and concentrated financial interests of supporters of rent-creating regulation make it worthwhile for them to contribute funds for the establishment of trade associations or other permanent lobbying coalitions. Such coalitions can continually monitor the regulatory process and through personal contact with agency employees respond rapidly to regulatory initiatives that appear contrary to the group's well-being. The permanent lobbying organizations are also advantageously placed to deal with the Congress and with the encroachment of, or the possibility of obtaining favors from, regulatory agencies normally outside the purview of the particular coalition.

All of this goes toward saying that rent-seeking concentrated interests have the willingness and ability to form coalitions that have relatively low costs of supplying additional lobbying effort. Such is generally not the case for diffuse interests, including consumers.<sup>7</sup>

When regulation is decentralized, efforts at reform are subject to the same asymmetries as the original rulemaking proceedings. Diffuse interests

are as unlikely to be successful in eliminating regulation as they are in opposing its introduction. As Buchanan suggests, piecemeal attempts to eliminate rent-seeking opportunities are likely to founder: 'those persons and groups who have established what they consider to be entitlements in the positive gains that have been artificially created will not agree to change, and those persons and groups who suffer losses will not willingly pay off what they consider to be immoral gainers, (p. 365).'<sup>8</sup>

### 3. Changing the rate of return to lobbying

In this section we argue that centralizing regulatory oversight concentrates and raises the expected benefits of lobbying efforts by diffuse interests. To see how this mechanism operates, consider the familiar effects of imposing a price-entry regulation on a previously competitive market.

Assume a competitive industry with constant costs in zero-profit long-run equilibrium. Now suppose that a rule is proposed that would artificially raise market price and generate the transfer to producers and deadweight loss characteristic of monopoly. Assume further that the regulation restricts new entry so that the rents are not dissipated by resource reallocations.

Prior to centralized regulatory oversight, the lobbying advantage of producers is likely to lead to the adoption of the proposed rule. Although the total gain to the industry, the transfer, is smaller than the loss to consumers, transfer plus deadweight loss, the relatively larger per capita gain (and lower organization costs) for industry members will lead producers to expend relatively more resources in order to achieve their desired outcome.

The effect of centralized review can be grasped by generalizing the above argument to regulation in the large. Centralization introduces an additional step to the regulatory process and therefore increases the lobbying costs of proponents of regulation. Moreover, since the establishment of the oversight process does not change the expected size of the wealth transfer to concentrated interests, their prospective gain from lobbying is unchanged. Finally, oversight may dilute further the influence of concentrated-interest coalitions since there is no reason to believe that the reviewers will be captured by a particular industry; indeed, the reviewers must deal with a multitude of industries.

In contrast, centralized oversight enables diffuse interests to focus their lobbying against rent-creating regulation on one location rather than splitting those efforts among a variety of regulatory agencies. In effect, centralization sums the individual welfare losses created by the regulatory bodies subject to its jurisdiction. When one considers the prevalence of regulatory intervention in the economy, the overall cost to diffuse interests

is likely to be quite substantial. Summing the individual welfare losses from rulemaking activities that create rents raises the rate of return to lobbying against such regulation. Accordingly, more opposition will be forthcoming.

The results of our analysis apply equally to social regulation represented by environmental, health, or safety rulemaking. As before, regulatory outcomes are in large part dominated by the relative lobbying advantage of concentrated interests. Three general cases can be distinguished. First, the diffuse interests of those adversely affected by, say, pollution are overridden by the concentrated interests of producers and consumers of products which generate social costs; “too little” regulation results. Second, rent-seeking producers having concentrated interests can affect the kinds of regulations that are adopted by overriding the diffuse interests of competitors.<sup>9</sup> Third, the concentrated interests of labor and professional consumerists encourage agencies to promulgate “too much” regulation, dominating the more diffuse interests of producers and consumers of their products.<sup>10</sup>

Our interpretation of centralized regulatory administration suggests that its implementation will change the rate of return to social regulation lobbying in much the same way as it raises the relative return to lobbying against rent-creating price-entry rulemaking. Such lobbying efforts will be directed at the form as well as the level of social regulatory initiatives.

Given the increase in expected lobbying benefits for diffuse groups, we predict that centralization will evoke a substantial increase in lobbying activities, even if the supply of such lobbying is very inelastic. In consequence, centralization will result in more speeches being made against rent-creating rulemaking, more articles written on the subject of regulatory reform, more letters and telephone calls to Congress from concerned consumers, more campaign contributions to politicians advocating deregulation in the economic area (and more and improved regulation in the social area), more consumer lobbying groups being formed, and so forth.

The argument we have presented is applicable to any situation in which rent-seeking opportunities exist within a decentralized administrative framework. Centralization alters the relative rates of return to lobbying for various coalitions, generally in favor of groups having diffuse interests. Two examples of our argument are found in a recent executive order and in international tariff policy. Executive Order 12291 gives the Presidential Task Force on Regulatory Relief and the Office of Management and Budget authority to approve or disapprove rules issued by Executive Branch agencies. Such a centralized review process enables diffuse interests to focus their lobbying on those engaged in oversight rather than splitting those efforts among a variety of regulatory agencies.

Similarly, Thomas Willett has stressed that concentrated interests are

more likely to secure protectionist outcomes under a system where tariffs are set good-by-good than if tariffs are negotiated within a framework which centralizes control over the average level of tariffs.<sup>11</sup> If tariffs are set on a piecemeal basis, surely few consumers would find it worthwhile to oppose import duties on, for instance, nails. In contrast, greater influence from diffuse interests will be forthcoming if tariffs are negotiated under a GATT-type system where an increase in one tariff must be offset to hold the average level of tariffs constant.

#### NOTES

1. That is, we do not use centralization in the sense of transfer of authority from the state to the federal level.
2. Knut Wicksell, 'A new principle of just taxation,' *Finanztheoretische Untersuchungen*, Jena, 1896.
3. George J. Stigler, 'The theory of economic regulation,' *Bell Journal of Economics* 2(Spring 1971): 3–21.
4. Sam Peltzman, 'Toward a more general theory of regulation,' *Journal of Law and Economics* 2(August 1976): 211–240.
5. For an extensive review, see Dennis Mueller, 'Public choice: A survey,' *Journal of Economic Literature* 14(June 1976): 395–433.
6. To some extent, diffuse interests, including consumers, have also formed permanent lobbying coalitions. However, most 'public-interest' groups can hardly be viewed as representatives of the majority of those harmed by regulatory intervention.
7. Although we have to some extent followed the Stigler – Peltzman terminology in couching our argument in terms of concentrated producer interests versus diffuse consumer interests, the capture theory is in reality much more general.
8. James Buchanan, 'Reform in the rent-seeking society,' in James Buchanan, Robert Tollison, and Gordon Tullock, (Eds.), *Toward a theory of the rent-seeking society*, College Station: Texas A&M University Press, 1980.
9. See Michael Maloney and Robert McCormick, 'A positive theory of environmental quality regulation,' *Journal of Law and Economics* 25(April 1982): 99–123.
10. For example, Miller has shown that the support given OSHA by labor unions is consistent with the rent-seeking theory. See James C. Miller III, 'Is organized labor rational in supporting OSHA?,' unpublished paper, 1982.
11. Willett's argument is outlined in Ryan C. Amacher, Robert Tollison, and Thomas Willett's, 'The divergence between international trade theory and practice,' in *Tariffs, quotas, and trade: The politics of protectionism*, San Francisco: Institute for Contemporary Studies, 1979, pp. 55–66.