

Regulatory Capture

BY BETTY JOYCE NASH

In the early days of flight, airlines couldn't provide air service profitably so the government stepped in with support. Airlines began to carry mail, paid for by airmail contracts. By 1933, four carriers collected 94 percent of airmail service subsidies. Later, the Civil Aeronautics Board (CAB) set fares, subsidies, and mail rates. Airlines were permitted profits, based on reported operating ratios. That provided an incentive for airlines to overinvest and generate higher operating costs. Profitable routes also subsidized unprofitable ones, justified by the CAB, which contended small cities would otherwise lose air service. By 1978, airlines were largely deregulated, but for decades government intervention was exploited to serve the interests of various stakeholders — including the regulated firms. This is an example of regulatory capture.

Capture can take various forms: subsidies, control of entry by competitors, and price-setting, among others. Economist George Stigler, who did much to develop the theory of regulatory capture and to identify prominent cases, concluded that “as a general rule, regulation is acquired by the industry and is designed and operated for its benefit.” Stigler’s work built on earlier research on political utility maximization. He applied those theories to regulation, and helped pave the way for the deregulation wave that began in the late 1970s.

Regulation is typically a response to a perceived market failure, ostensibly to serve the public interest. But as the airline industry example demonstrates, regulatory capture can pose problems for policymakers who want to implement regulation that improves the general welfare. Last spring, people questioned the conduct of the government regulator overseeing offshore drilling. But it's unclear, until the case is unraveled, whether regulatory capture or simple ineptitude contributed to the accident.

A significant insight emerging from capture theory is that a regulator may act, either intentionally or unintentionally, in a way that results in personal or institutional gain. This can be fostered through a close relationship between industries and regulatory agencies. Regulating agencies may have incentive to hire from regulated firms to acquire expertise, and firms may rely on industry-supplied knowledge.

An early federal regulatory effort was the Interstate Commerce Act of 1887. Railroads supported the creation of the Interstate Commerce Commission (ICC) because its rules would strengthen the existing cartel. Previously,

railroads had competed for business through price wars, secret rebates, and price concessions. The ICC is now regarded as a classic example of regulatory capture, in which regulators enact rules in favor of the regulated industry. For example, in the Transportation Act of 1920, Congress allowed the ICC to regulate minimum, not just maximum, shipping rates. The Act also controlled entry into and exit from the industry. Stigler also cited the regulation of long-distance trucking as an example of capture. As roads and vehicles improved, by 1930 trucks posed competition for railroads in long-distance hauling. The railroads then sought state-imposed weight limits on trucks. Soon all states regulated truck weight and dimensions. Stigler noted that Texas and Louisiana limited trucks serving (in competition with) two or more railroad stations to 7,000 pounds. But trucks that served (did not compete with) one station were allowed

twice the weight, 14,000 pounds. In 1935 the Motor Carrier Act gave the ICC the power to control permits, approve routes, and set tariffs. That discouraged new entrants. Ultimately, Congress deregulated the industry over industry and union opposition, but it took a long time, until 1980.

Regulatory capture also can become institutionalized. For example, local and state citizen boards may be comprised of those who work in a profession or industry, creating a potential conflict of interest. In some states practitioners of law, medicine, dentistry, cosmetology and others may draft laws that determine the qualifications of those eligible to enter their occupation.

The extent of regulatory capture depends to some degree on the intensity of interest among those affected. Regulated firms may have much

at stake in regulatory activity. Consumers, though, will have a small or diffused stake in the outcome. Environmental regulation is a classic case where regulated firms have concentrated interests, but individual interest is diffuse. Environmental organizations act as intermediaries, ostensibly promoting the public interest through lobbying and other efforts.

An essential insight of Stigler and other economists who followed his lead was that all players in the regulatory regime — firms, bureaucrats, interest groups, and legislators — act as economic agents who have the interest and opportunity to advance strategic actions. Although public service may motivate players, Stigler pointed out that these are not the only incentives at work.



RF

ILLUSTRATION: TIMOTHY COOK