Viewpoint

Bruce Yandle

Bootleggers and Baptists–The Education of a Regulatory Economist

THE SEARCH FOR regulatory relief is as young as the Reagan administration, and as old as man. When the American Medical Association chafes under Federal Trade Commission oversight, it feels the same frustration Adam must have felt at the menu regulations he faced in Eden. But often people want relief not from regulation but through the protections regulation can provide. Today, some airline executives want succor from the uncertainties they confront in a world without regulated (uniform) pricing. The London weavers felt that same way about their trade in the thirteenth century and obtained relief through a provision in the Magna Carta requiring all cloth woven in the realm to be of uniform dimensions—conforming to the London standard. Nothing is new under the sun.

Economists from Adam Smith on (and including Karl Marx) have realized that government regulation is a sword that cuts in both directions, and all have called for reforms to improve the good regulations and prune the bad. But desiring reform and achieving it are obviously two different things. What we want to find out here is under what circumstances they can coincide. When can we achieve regulatory reform?

Regulation and Murphy's Law

In my studies of the relationships between governments and business, my attention was first attracted to the unbelievably costly things that governments do when attempting to control businesses. It seemed, as Murphy might have said, that if there was a wrong way of doing something, the regulators would adopt it. I found countless cases where rules and regulations imposed tremendous costs while delivering little if any benefit.

- Freight rates for one class of shippers were subsidized by another class of shippers. As a result, factories were located on the basis of false signals, real costs were hidden, and goods were shipped great distances at lower fares to be processed in higher-cost plants.
- Catalytic converters were installed on automobiles for the purpose of reducing emissions. But, for the converters to operate properly, unleaded gas had to be used—and it is more expensive than regular. So cost-conscious drivers put leaded gas in their tanks, which turned the converters into so much junk and added more emissions to the environment than there would have been had engines been even slightly modified or some other plan introduced.
- Petrochemical plants were required to reduce emissions at each and every stack by the same percentage. If instead managers had been given plant-wide targets and left free to attain them efficiently, the same degree of pollution control could have been achieved at much lower cost.
- Petroleum companies that found oil on Alaska's North Slope and sought to bring it to the lower forty-eight states by way of the West Coast were barred from doing so by complex environmental rules. Logic would then have dictated that the oil be shipped to Japanese refineries, which could have returned the refined product to the United States. But that was against federal law too. Instead, the crude oil

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is being shipped from Alaska to Texas, where it is unloaded and refined, all at considerable extra cost.

• Precise fuel economy standards were prescribed for automakers, to prod them into building the kind of cars that probably would have been produced and purchased voluntarily if the price of gasoline had been higher. But the price of gasoline was regulated so it could not rise; and the automakers had to ration their larger cars, which U.S. buyers wanted, while forcing smaller cars into the market. Eventually, the price of gasoline was deregulated and the effects of the mandated fuel-economy scheme tended to evaporate—for the time being, at least.

The list could go on and on. Not only does government rarely accomplish its stated goals at lowest cost, but often its regulators seem dedicated to choosing the highest-cost approach they can find. Because of all this, I and others in academia became convinced years ago that a massive program in economic education was needed to save the world from regulation. If we economists could just teach the regulators a little supply and demand, countless billions of dollars would be saved.

Bootleggers and Baptists

My views began to change after I joined the Council on Wage and Price Stability in 1976. There my assignment was to review proposed regulations from the Environmental Protection Agency (EPA), the Federal Trade Commission (FTC), the Department of Transportation (DOT), and parts of the Department of Health, Education, and Welfare (HEW). The field was white unto the harvest, and I was ready to educate the regulators. But then I began to talk with some of them, and I began to hear from people in the industries affected by the rules. To my surprise, many regulators knew quite a bit about economics. Even more surprising was that industry representatives were not always opposed to the costly rules and occasionally were even fearful that we would succeed in getting rid of some of them. It was in considerable confusion that I returned later to my university post, still unable to explain what I had observed and square it with the economics I thought I understood.

That marked the beginning of a new approach to my research on regulation. First, instead of assuming that regulators really intended to minimize costs but somehow proceeded to make crazy mistakes, I began to assume that they were not trying to minimize costs at all—at least not the costs I had been concerned with. They were trying to minimize *their* costs, just as most sensible people do. And what are some of those costs that keep regulators from choosing efficient ways of, say, reducing emissions of hydrocarbons?

• *The cost of making a mistake.* Simple rules applied across the board require fewer decisions where mistakes can be made.

• *The cost of enforcement.* Again, simple rules requiring uniform behavior are easier to monitor and enforce than complex ones, and they also have a false ring of fairness.

• *Political costs.* A legislator is likely to be unhappy with regulators who fail to behave in politically prudent ways—who fail, in the legislator's view, to remember the industries and the workers in his area.

Second, I asked myself, what do industry and labor want from the regulators? They want protection from competition, from technological change, and from losses that threaten profits and jobs. A carefully constructed regulation can accomplish all kinds of anticompetitive goals of this sort, while giving the citizenry the impression that the only goal is to serve the public interest.

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Indeed, the pages of history are full of episodes best explained by a theory of regulation I call "bootleggers and Baptists." Bootleggers, you will remember, support Sunday closing laws that shut down all the local bars and liquor stores. Baptists support the same laws and lobby vigorously for them. Both parties gain, while the regulators are content because the law is easy to administer. Of course, this theory is not new. In a democratic society, eco-

nomic forces will always play through the political mechanism in ways determined by the voting mechanism employed. Politicians need resources in order to get elected. Selected members of the public can gain resources through the political process, and highly organized groups can do that quite handily. The most successful ventures of this sort occur where there is an overarching public concern to be addressed (like the problem of alcohol) whose "solution" allows resources to be distributed from the public purse to particular groups or from one group to another (as from bartenders to bootleggers).

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What all this implies is that the challenges of regulatory reform are institutional. Regulation is relief for some and a burden for others, so that reform is a burden for some and a relief for others. The fact that a regulation has come into being as a result of a costly political exchange means that reform can hardly be gained easily. This is not to suggest that all is for naught, that there are no opportunities for reducing net (overall) regulatory costs or removing the protective regulatory cocoons woven so tightly and carefully around this activity and that. But it is to say that we can scarcely expect full-scale deregulation to occur often. Not when the Baptists and the bootleggers vote together.

Shocking the System: Pareto-Paperwork

Let us accept for the moment the proposition that all regulation produced in a given period has value at least sufficient to justify the direct costs borne by those supporting it. Since those who opposed a given regulation most probably fought it, rather than allowing it to proceed by default, we will *not* assume that the value of the regulation exceeds the total costs incurred by the winners, losers, and regulators.

Now consider an equilibrium state in which the political-economic market has produced a given quantity of regulation and will continue to maintain it unless there is an outside shock to the system. Imagine that you are regulatory czar, subject to all the economic forces at play in the system (other activities and actions being held constant) and with a free rein to reform the regulatory process. Finally, to make the situation more interesting (and more illuminating), imagine also that you are a long-suffering student of the regulatory system, with a long list of regulations you are convinced cannot be justified at all, or at least not in their present form. What would you do?

Regulatory paperwork would likely be your best candidate for reform—for it is an area where you might be able to reduce costs for both the regulated and the regulators (making both better off, no one worse off, in a kind of Pareto move), without disturbing the equilibrium state established by the interplay of rules and regulations. Of course, reducing paperwork is not nearly so dramatic as deregulating the airlines, speeding up new drug approvals, or removing import quotas (supposing any of these appealed to you). Still, it would not be a minor accomplishment. The cumulative savings from paperwork reduction for the years 1981 through 1983 are expected to reach 300 million hours. If you managed that as czar, we might well rise up and call your name blessed.

Unfortunately, other reforms would be much more difficult. Remember that you must act within the existing political forces, that the actors in the drama are all well-informed, and that the existing equilibrium is the product of a massive struggle.

Changes in the Demand for Regulation. So, let us ask, how might you upset that equilibrium by creating new players or causing the current players to acquire an interest in deregulation. Put differently, what factors might shift the demand for regulation?

- *Technological change.* A technology protected or even induced by regulation can nonetheless become obsolete, and the regulated businesses can find themselves hamstrung by the very rules that protected them.
- *Demographic change.* With migration and population growth, patterns of production and distribution supported by regulation can

become so costly over time that the producer chooses to throw back the protective blanket.

• *Significant changes in factor costs.* Regulated firms generally seek regulations that fit production arrangements based on predicted prices for labor, materials, and capital—which means that unpredicted changes in those prices can alter the amount and incidence of the benefits of regulation.

• *New information.* With increasing scholarly and press attention to regulatory issues, voter/taxpayer/consumer groups might discover that their benefits from regulation are less than their costs.

Looking down the roster of successful regulatory reforms, it is not difficult to find cases that can be explained in part or as a whole by some combination of the above factors. For example, take the impact of technological change on the AT&T monopoly. Microwave, computer, and satellite technology outstripped the basic "hard-wire" systems used in Bell's telephone operations, creating competitive opportunities and weakening the demand for monopoly privilege. The field of action that had been created partly by inventions of the major telephone companies, yet barred to them, came to offer greater opportunities for growth and profit than the older regulated field. Technological change was also a crucial factor in banking and finance. The electronic transmission of funds, coupled with the Federal Reserve Board's dominant position in the check-clearing process, contributed significantly to a new technical base for financial institutions. This development, along with the unexpectedly high interest rates that commercial banks and savings and loans were barred from paying, made the old regulatory structure obsolete.

Changes in two other demand factors arguably undermined the traditional regulatory framework in trucking and other surface transportation. The unexpected increase in the price of energy magnified the costs associated with circuitous routes and empty backhauls, and changing population patterns made old route structures less desirable. Both developments fueled the demand for reform. Finally, take airline deregulation. In this case, it was rising energy prices, changing patterns of equipment utilization, and population shifts—combined with the development of new aircraft and intensive reporting of research on the effects of these changes—that shifted the demand for regulation.

As for future reforms, what might we predict on this same basis? Two come to mind. First, like AT&T, the U.S. Postal Service has stuck to an obsolete technology. With electronic transmission of messages, arguments about natural monopoly status have lost any credibility they may have once had and, for that reason among others, the statutes barring competition in the delivery of first class mail are under increasing fire. Energy regulation is another likely candidate for reform. Technical change and rapidly shifting relative prices have placed enormous pressures on existing regulatory structures, so that producers and consumers are now seeking greater flexibility than the present "public utility" status of much of the industry will allow. For example, the need for appropriate incentives to increase the amount of natural gas delivered to the market is widely recognized, and alternative systems for pricing and arranging the distribution of electricity are being explored. (Here, at least, we may have found one beneficial aftereffect of OPEC and its works.)

Changes in the Supply of Regulation. The supply side of regulation, like the demand side, helps determine the quantity of regulation produced in political-economic markets. Among the variables here are the bureaucracy and the electoral and legislative process.

• *Bureaucratic incentives and structure.* If lawyers and economists can improve their expected lifetime earnings by filing enforcement actions against specific industries, for example, those actions will tend to be filed. More broadly, how agencies are organized (whether they are independent commissions or headed by a single administrator), what voting rules are applied in making decisions, to what extent the agency specializes in an industry or product, and whether there is competition from other agencies for jurisdiction are traditionally thought to affect the supply of regulation.

• *Congressional oversight.* The legislative component of the supply side is closely related to demand, since elected officials also represent special interests who seek regulatory benefits. But, even so, the competition among legislators, their voting rules, and their committee organization are supply characteristics.

Assuming that demand is held constant, to what extent will changes in these supply-side characteristics affect the quantity or quality of regulations produced? For example, will a reduction in the number of commissioners (as is happening now at the FCC), or a shift in the party mix of agency oversight committees, cause regulation to change?

Empirical research suggests strongly that the supply side matters. For example, Barry Weingast and Mark Moran report that, contrary to some opinions, the FTC's regulatory behavior mirrors the conservative-liberal makeup of the agency's key congressional committees: in other words, the agency is hardly ever "out of control" (*Regulation*, May/June 1982). Roger Faith, Donald R. Leavens, and Robert Tollison find that the FTC has been less likely to take actions against firms headquartered in the districts of congressmen who sit on the FTC's congressional committees than against firms not so favorably situated (*Journal of Law and Economics*, October 1982). My recent research on the FTC suggests that the agency's behavior is influenced not only by shifts in the chairmanship from a Democrat to a Republican and vice versa, but also by shifts in how the chairman is chosen (in 1950 the method was changed from rotation to presidential designation).

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Putting all this together, we may say that there are strong possibilities for regulatory reform when the institutions involved are changing for other reasons anyway. Such changes would help explain the flurry of deregulation initiatives at the FCC, especially those dealing with broadcasting, as well as the shift away from industry-wide rulemaking and structural antitrust investigations at the FTC. Moreover, the cautious attitude now shown by the Justice Department and the FTC when considering price discrimination, resale price maintenance, and vertical combinations, along with the probing economic analysis applied in such investigations, reflect new learning in law and economics and changes in the structure of the two agencies. Indeed, the significant overall reduction in new regulatory initiatives across the entire federal government reflects a coordinated effort that draws on each of the items mentioned.

Other Agents of Change

So far I have hardly mentioned yet another interest group: those who gain special satisfaction from participating in the regulatory process in ways that will improve economic efficiency. While some might conclude that students of the process can only observe, record, and analyze, I have a more sanguine view: simply put, people and their ideas do make a difference.

Some individuals, for example, make a difference by continuing to raise questions about grand principles—overall social efficiency, the appropriate role of government, economic freedom, the virtues of the price system. The more articulate and informed of these point out the compromises being made by the rest of us. Of equal importance are those whose goal is to understand how the regulatory process works, what interests are driving it, and how its outcome might be predicted. These are the academic researchers, the public policy analysts, the economists with private firms and in government, who struggle to bring about marginal adjustments. Their task is the creative application of economic logic. At yet a third level, there is active participation in decision making itself. When I observed the effect of an Alfred Kahn at the CAB, a Darius Gaskins at the ICC, and a James Miller at the FTC—to say nothing of the less visible but nonetheless significant work performed by scores of others in the arena where decisions are made—I must believe they make a difference, a very great difference.

Finally, one should not expect to see sudden and widespread transformation in regulation. Like all market processes, the market for regulation is relatively stable, the result of thousands of transactions and years of institutional development. Yet, also like other markets, the forces of supply and demand do change, and the agents for change can and do have marginal but significant impact on political demand and regulatory supply. Bootleggers and Baptists may have been agitating for a century or more, but the saloon is still with us—and usually on Sundays, too. ■