Michigan Law Review

Volume 97 | Issue 6

1999

A New Economic Theory of Regulation: Rent Extraction Rather than Rent Creation

Douglas Ginsburg
United States Court of Appeals for the District of Columbia Circuit

Recommended Citation
Douglas Ginsburg, *A New Economic Theory of Regulation: Rent Extraction Rather than Rent Creation*, 97 MICH. L. REV. 1771 (1999).
Available at: https://repository.law.umich.edu/mlr/vol97/iss6/25

A NEW ECONOMIC THEORY OF REGULATION: RENT EXTRACTION RATHER THAN RENT CREATION

*Douglas Ginsburg**

MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION. By *Fred S. McChesney*. Cambridge: Harvard University Press. 1997. Pp. xi, 216. $35.

Once upon a time, people believed that the government regulated various industries in "the public interest." The idea was that certain conditions, such as "natural monopoly" or the ability to externalize significant costs, caused markets to fail and governments to step in to correct that failure.[1]

Economic regulation predicated upon market failure can be dated conveniently to the Interstate Commerce Act of 1887,[2] in which the Congress established the Interstate Commerce Commission to regulate railroads in the interests of shippers, principally farmers and small businesses.[3] The legal notion of "affectation with the public interest" dates back much further, of course;[4] and the concept of "market failure" was not introduced in those terms until a good deal later.[5] But it is a useful simplification to say that for roughly eighty years (1885-1965), the market failure story, couched in various terms, was widely accepted.[6]

Toward the end of that period, however, economists began to point out certain problems with the story. For example, some noted that there was no plausible claim of market failure in certain regulated industries, such as motor carriers and airlines, suggesting that regulation must be explained by some other factor.[7] And, in an industry in which the market failure story seemed facially plausible

* Judge, United States Court of Appeals for the District of Columbia Circuit. — Ed.

1. *See* STEPHEN BREYER, REGULATION AND ITS REFORM 15-28 (1982).

2. Interstate Commerce Act of 1887, ch. 104, 24 Stat. 379 (1887).

3. *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, at 132-33 (1991).

4. *See* Walton H. Hamilton, *Affectation with Public Interest,* 39 YALE L.J. 1089 (1930).

5. *See, e.g.,* A.C. PIGOU, WEALTH AND WELFARE (1912); A.C. PIGOU, THE ECONOMICS OF WELFARE 129-30 (4th ed. 1948).

6. *See* Francis M. Bator, *The Anatomy of Market Failure,* 72 Q.J. ECON. 351 (1958).

7. *See, e.g.,* GEORGE W. DOUGLAS & JAMES C. MILLER III, ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY 45 (1974); 2 ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 190-93 & nn.58-60 (1971).

— local distribution of electricity — George Stigler and Claire Friedland cast doubt upon the assumption that regulation had any appreciable effect upon price.[8] Indeed, by the early 1970s, alternative explanations for, or ways of understanding, economic regulation were emerging with some frequency.[9]

The new learning that emerged in the early 1970s as "the economic theory of regulation" can justly be attributed to George Stigler, which is not to say that important refinements were not added by others. It proceeds from the historical observation that regulation was in many instances sought by, rather than imposed upon, the regulated industry, which is fundamentally inconsistent with the public interest story.[10] In the new learning, regulation, whether sought by industry or imposed upon it, "is designed and operated primarily for [the regulated firms'] benefit,"[11] and to the consumers' detriment. Regulation generates rents for the regulated industry, paid for by consumers, of which the politicians get a portion in the form of contributions from the regulated firms.[12] In Fred McChesney's[13] succinct synopsis of the Stiglerian model: "If expected political rents net of the costs of organizing and procuring favorable regulation are positive, then producers will demand regulation. If payments sufficient to compensate politicians for the costs of creating regulation are forthcoming, they will supply it" (p. 9).

In other words, regulation is an item of trade, supplied by politicians who traffic in the state's monopoly on the use of force, and demanded by producers who can use regulation to extract rents from consumers. Regulation occurs because consumers, being nu-

---

8. *See* George J. Stigler & Claire Friedland, *What Can Regulators Regulate? The Case of Electricity,* 5 J.L. & ECON. 1 (1962).

9. *See, e.g.,* William S. Comanor & Bridger M. Mitchell, *The Costs of Planning: The FCC and Cable Television,* 15 J.L. & ECON. 177 (1972); Richard A. Posner, *Taxation by Regulation,* 2 BELL J. ECON. & MGMT. SCI. 22 (1971); George J. Stigler, *The Theory of Economic Regulation,* 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

10. *See* Stigler, *supra* note 9, at 3.

11. *Id.*

12. Regulation can create rents in two ways. First, regulation can create monopolies or stable cartels, which allow producers to lower output, increase price above marginal cost, and capture increased profits. "It is the state's ability to apply the force of law to any monopolizing arrangement that frequently makes regulation a superior mechanism for creating rents." P. 11. Second, regulation can create rents "inframarginally." As McChesney explains:

> [R]egulatory measures are identified that increase costs for all firms, but proportionately more for marginal firms . . . . A regulation increasing the cost of labor, for example, will affect firms with relatively large capital investments less than those using proportionately more labor than capital in production. Higher overall costs due to regulation mean higher prices to consumers, and so a lower quantity produced. Reduced quantities mean that rents earned on some existing production will be lost because of regulation. But for capital intensive producers, costs may rise less than prices do, creating new rents exceeding the old rents lost. To inframarginal, capital-intensive producers, regulation is advantageous . . . .

P. 15 (citations omitted).

13. Professor, Cornell Law School.

merous and each having a small stake in preventing it, are typically not organized as effectively as producers and hence systematically lose in the legislative struggle.

The economic theory of regulation is as familiar and obvious to lawyers and economists educated in the last twenty-five years as was the market failure story to the immediately preceding generation. Now comes Fred McChesney, in *Money for Nothing: Politicians, Rent Extraction, and Political Extortion,* to say that the rent-creation story cannot stand alone; it is but a part of a larger and more powerful economic theory of regulation based upon rent extraction.

McChesney demonstrates first that the rent-creation model of regulation is deficient in several respects (pp. 17-19). As an empirical matter, it is incapable of explaining the great wave of health, safety, environmental, and consumer-oriented regulation that began to emerge in the late 1960s and continues even now. In those instances, regulation simply did not create rents for the regulated industry — although it did benefit others, such as manufacturers of pollution control equipment, who may well have participated in the legislative process. Moreover, even well-organized industries were unable to resist the imposition of sometimes very costly measures while individuals, particularly in the case of environmental regulation, were able to organize effectively notwithstanding their large number and small stakes.

Second, and more fundamentally, the rent-creation model implicitly treats politicians as passive players: "they do not actively enter the market for rents with their own demands" (p. 17). This aspect of the model, no doubt a carryover from the "consumer-sovereignty model of private markets" (p. 17), closes off an area ripe for analysis. We all know that politicians need and actively seek out both votes and campaign contributions; economists can hardly ignore, therefore, the possibility that politicians seek out, or otherwise create, opportunities to use the legislative process in fulfillment of those needs. Finally, the model does not attend "to ways other than rent creation that a politician can obtain benefits from private individuals" (p. 18). Perhaps principal among those is the "ability of politicians to gain . . . by causing losses to others" (p. 19), or, alternatively, by threatening to do so but forbearing when appeased.

Thus does McChesney introduce his model of economic regulation, in which rent creation is but a special case of politicians seeking to maximize their benefits from the legislative process. His more general proposition is that politicians have the opportunity to gain whenever they can credibly threaten to extract existing rents from private hands, whether those of producers or of consumers.

When all goes well, the threat will not have to be exercised: the threatened party will pay the politician to forbear from regulating, handing over a portion of the rents rather than losing all of them. When regulation does occur, therefore, it is because this process of threat, appeasement, and forbearance has failed. Perhaps transaction costs were insurmountable, or one side or the other behaved opportunistically.

Clearly the opportunities for rent extraction abound, whereas the opportunities for rent creation are more limited. In any case, the relevant question, as McChesney poses it from the point of view of the legislator, is what strategy maximizes his revenue (pp. 22-23). Depending upon the particulars of the case, the most promising strategy may be offering to create rents for Industry A, threatening to extract rents from Industry B, or threatening to extract rents from Consumers C.

McChesney identifies two general methods for rent extraction. The first is to threaten producers with a price reduction (or what is functionally the same thing, withdrawal of a privilege or permit previously granted by the state) (pp. 26-28); the second is to threaten to raise the industry's cost by imposing upon it some regulatory burden (p. 29). For both types of legislative proposal, McChesney adopts the term "milker bills," used by California legislators to describe legislative proposals that are intended not to pass, but to elicit contributions from those who would like to make sure they do not pass (pp. 29-30). (In other state capitols, they are reportedly called "cash cows," "juice bills," and "fetchers.")

The phenomenon of legislation that is proposed for the purpose not of being enacted but of being bought off brings to mind a personal observation. In the mid-1980s, some members of Congress, borrowing an idea then current in the law reviews, proposed to amend the securities laws so as to require a federal rather than a state charter for some class of publicly owned corporations. The point of the proposal was nominally to assert federal control over various takeover tactics and defenses in the interest of preserving the integrity of the securities market. The intended effect was to insulate the managements of target companies from hostile takeovers, at the expense of both their shareholders and those of the acquiring companies. As the Reagan Administration's monitor of this legislation, I could only conclude at the time that, while the bills may not have been conceived as milker bills, they were surely pursued as such once the members realized how lucrative they could be. Publicly traded corporations on both sides of the issue, which is to say tender offerors and takeover targets, began furiously throwing favors at the relevant Congressmen for at least a few years while the threat (or promise) of legislation seemed credible. Then the idea dropped off the legislative agenda for no discernible reason. But I digress.

McChesney is quick to point out that rent extraction is socially costly, albeit perhaps less so than rent creation. "Even if politicians eventually allow themselves to be bought off, their minatory presence reduces the expected value of entrepreneurial ability and specific-capital investments" (p. 33). The results are to diminish the value of existing capital and reduce the incentive to invest; to induce an inefficient preference for investment in "politically more mobile" (meaning less firm-specific) forms of capital and in underground economic activity; and to incur the bargaining and other transaction costs of the extractive process (pp. 33-34). These include the costs of the legislative process (hearings, etc.) insofar as they are incurred solely to make legislative threats credible, and the time of lawyers, lobbyists, and legislators (assuming there is a socially positive opportunity cost for legislators' time) (p. 34).

McChesney elaborates the theory in several respects that we need not rehearse here. Suffice it to say, he analyzes the relative attraction of rent creation, as opposed to rent extraction, as a function of the elasticity of industry supply (pp. 34-36); explains how the legislative auction serves to elicit valuable information concerning the relative value of regulatory action versus inaction (pp. 36-37); examines the benefits of employing expert administrative agencies to extract rents from specialized industries (p. 37); and analyzes the problem of opportunistic behavior by politicians and their customers using the familiar heuristic of a game modeled upon the Prisoner's Dilemma (pp. 38-41). This leads him to the empirical question: "[D]o private actors in fact pay significant sums to induce government *not* to act?" (p. 42).

The foregoing describes Part I of the book. In Part II, "Demonstrations," McChesney offers such evidence as he can for the descriptive validity of the model. Chapters are devoted respectively to anecdotal evidence, empirical tests, and application of the model to changes in the rate at which the Internal Revenue Code is amended.

The Chapter on anecdotal evidence, entitled "Observing Extortion: The Practice of Rent Extraction" (pp. 45-68), is not particularly satisfying. It consists of alternately pointing out the ways in which politicians can legally profit personally from campaign contributions, honoraria for speaking engagements, and in-kind benefits; and providing accounts of some instances in which threats to lower prices or increase costs were made, to the great consternation of the affected industries, but later abandoned. There is little attempt to gather "testimony" from those who have firsthand knowledge of what intervened between the threat and the forbearance. One can only sympathize with the author's plight, however; such evidence is inherently difficult to come by, notwithstanding the lawfulness of the transactions. (How many miles of unexplored caves are there?)

Perhaps the most suggestive alternative to the direct evidence upon which McChesney draws (pp. 66-68) is the analogy to underdeveloped countries, in which rent extraction is practiced more openly, whether by the ruling individuals acting upon their own behalf, or by the government acting as their agent. While there is no confusing a violent and corrupt environment in which foreign investors must pay to avoid everything from strikes to nationalization, and a highly developed country in which rents are extracted lawfully and without violence, it is hard to believe that people who occupy positions of power do not exploit them in similar ways, though by different means, the world over.

The Chapter entitled "Validating the Model: Empirical Tests of Rent Extraction" (pp. 69-85), is only slightly more satisfying. Here McChesney reports the results of studies looking at the wealth effect generated by the cycle of threat and forbearance. In particular, he recounts a study of Canadian firms that were the subjects of adverse legislative threats later abandoned (pp. 73-77). The results are "consistent with the strongest form of the rent extraction model" (p. 76). Although announcement of the threat depressed the prices of the affected firms' shares, retraction of the threats did not cause the firms' shares to recover their lost market value. "The implication is either that politicians were correctly expected to extract nearly all the rents, or that failure to negotiate a payoff was considered to be a remote possibility" (p. 77).

Relatedly, McChesney examines the effect that the Clinton Administration's health care proposals had upon the value of shares in pharmaceutical companies (pp. 77-78). "It is particularly interesting that the November 1994 Republican electoral victory did not restore to pharmaceutical firms the wealth they had lost. In the end, the threatened firms had paid good money for nothing: their wealth was diminished, and no legislation was passed" (p. 78). In other words, the threat was raised, the wealth was shared, and the threat was abandoned, leaving the nominally unregulated firms poorer if not wiser.

Event studies of this sort are unavoidably subject to certain criticisms and qualifications, the significance of which can be diminished only if enough subsequent studies turn up similar results. What McChesney has already done, however, is sufficiently suggestive to warrant those further studies.

Finally, in Part III, "Extensions," McChesney takes up the implications of his work for various fields of inquiry. In particular, he devotes chapters to optimal taxation (pp. 113-32), interest group organization (pp. 133-55), and the prospects for improving the model and addressing additional issues (pp. 156-70). The chapter on optimal taxation is full of interesting insights. For instance, McChesney explains why government services subject to user fees, such as grazing rights on federal lands and USDA meat and poultry inspections, are chronically underpriced (pp. 120-24). Underpricing causes governments to deliver services to the few at a loss borne by the many (all taxpayers), but enables politicians to threaten the few with an increase in user charges. McChesney also analyzes tax funds that are "earmarked" for a specific purpose (pp. 124-31). The supposed beneficiaries have no enforceable property rights in the funds and must compete, by conferring the usual emoluments, to get politicians to release the money for its intended purpose. Examples abound, but perhaps the most familiar in recent years has been the difficulty that airport authorities have had getting access to the "trust fund" established to finance airport construction.

On the costs and benefits of interest group organization, McChesney's analysis is particularly intriguing. He points out that being organized itself has costs and benefits. Only the organized can effectively fork over the payment necessary to obtain regulation — or to avoid it.

> Organization increases the ability to add to the group's surplus by becoming a transferee of others' surplus. Though once organized, a particular group will always offer more to keep its own surplus than competing groups will pay to have it transferred; organizing therefore gives politicians greater incentives to threaten a group's existing surplus. [pp. 151-52]

There is much more on the subject of interest group organization, but the foregoing point is enough to illustrate the productivity of McChesney's thesis; everywhere he looks with the aid of his model, he sees things in a new light.

Not the least interesting is the observation with which he closes the chapter on interest group organization:

> *In the absence of transaction costs, all regulatory activity would be rent extraction.* Existing owners of rights to future capital flows or present wealth will always pay at least as much, and usually more, to keep what they have rather than have it transferred away. Regulation ensues only when the transaction costs of avoiding expropriation — of achieving a rent-extraction contract — prove prohibitive.
>
> . . . To say that regulation occurred is to say that someone who valued the resources more — their owner in the current period — failed to acquire them for the subsequent period. In other words, regulation is proof of failure in the market for political contracts. That regulation represents political market failure is terribly ironic; not so long ago economists were analyzing regulation as a result of *private* market failure. [pp. 154-55]

The irony is terrible and delicious, especially for those of us who have long believed that market failure is a rare beast indeed.[14]

In his final chapter, McChesney identifies outstanding issues to which he has no present answers. For example, why are the rents of some groups and not of others extracted (pp. 159-61)? Why do we sometimes see parties on both sides of a rent transfer issue paying politicians when only one side can win (pp. 161-62)? And perhaps most intriguing of all, why is it that "politicians' returns from rent extraction are so small, relative to the expropriable wealth threatened" (p. 162)? One prior study estimated that politicians skimmed only about five percent of the wealth they transferred (p. 163). The situation reminds McChesney of the relative gains to bidding and target firms in corporate takeovers; bidding firms drive up the premium paid for the shares of the target and in the end realize only modest profits themselves. Perhaps a more suggestive analogy is to spies, who typically receive payments that are very modest relative to the value of the secrets they transfer. Are politicians, like spies, constrained by the need not to live too well, lest they attract unwanted attention — in this case from voters? Or is the relevant constraint imposed by voters not upon how they live, for most of the proceeds go into campaign expenditures, but upon how much they collect from any one industry?

Alternatively, perhaps the relatively low level of rents extracted merely reflects competition at work. Legislators must compete among themselves for the available rents. (Even a small legislative body has too many members to form an effective cartel.) In a chamber of 100, for example, in order to prevail a purchaser need accumulate only fifty-one votes, which may be had on the cheap if the opposing interest is not organized and actively acquiring votes in opposition to the proposal. The result may be fairly low prices except where a matter is hotly contested between two (or more) private interests. I am aware of no literature on the subject, but my impression is that legislators raise more money, other things being equal, from issues in which there are contending industries involved (such as banks versus insurance agents) than from those in which a single industry is seeking legislation without encountering significant opposition.

Curiously, McChesney does not develop the implications of his theory for relationships among legislators. Consider: if Legislator A puts forward a milker bill, the gains from those who contribute to make it go away will accrue not only to A, but to others on the relevant committee and to anyone else that may be able to suppress the bill. In other words, the author of the milker bill cannot secure

14. *See* Steven N.S. Cheung, *The Fable of the Bees: An Economic Investigation,* 16 J.L. & ECON. 11 (1973).

the full benefits that it generates (which is not to suggest there is an inefficiently small number of milker bills as a result). Viewed the other way around, Legislator A's bill is an opportunity for Legislator B, who can profit from opposing or supporting it, whichever is more lucrative. Indeed, how can A be sure a bill will fetch significant returns to him rather than to his colleagues?

Questions like these will no doubt command the attention of a phalanx of public choice theorists for some time to come. Indeed, McChesney has in his book dictated an important research agenda for the future. Lawyers, economists, and especially doctoral students should be duly grateful. Which reminds me of another story, one that I heard when I was still teaching law. A colleague in the mathematics department had brought back as a graduate student a young prodigy he had encountered during a sabbatical abroad. A couple of years later, when asked how his protégé was doing, the professor replied somewhat gloomily, "Well, he has solved several problems that hadn't been solved before, but he just isn't asking questions that no one can answer." McChesney is doing both.