RENT EXTRACTION AND RENT CREATION IN THE ECONOMIC THEORY OF REGULATION

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I. INTRODUCTION

THE economic theory of regulation has advanced considerably since Stigler's seminal piece explained government's ability to create rents by cartelizing private producers.[1] Because political action can redistribute wealth generally, it is now seen that private interest groups other than producers also have an incentive to organize, both to obtain the gains and to avoid the losses from a whole menu of government enactments.[2] The configuration of winners and losers depends on many factors, and it changes as the underlying demands for and costs of regulation shift. New technology, for example, may render existing government regulations undesirable to their prior beneficiaries or make current regulations useful to groups previously not benefited. Finally, "government" itself has come to be treated, not as a unit, but as a complicated network of individuals, each with an incentive to maximize his own interest.

The original economic theory of regulation thus has evolved into a more complex description of the various ways government regulatory power can be turned to private ends. Two limitations of the current economic

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[1] George J. Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. 3 (1971).

[2] Sam Peltzman, Toward a More General Theory of Regulation, 19 J. Law & Econ. 211 (1976); Gary S. Becker, A Theory of Competition among Pressure Groups for Political Influence, 98 Q. J. Econ. 371 (1983).

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model are noteworthy, however. First, despite the growing realization that "government" is not a monolith, the role of the politician has not been integrated satisfactorily into the model. The politician has remained a "mystery actor,"[3] a passive broker among competing private rent seekers.[4] Second, the economic theory, even in its post-Stiglerian form, remains one of rent creation. Observers note that creation of rents does not seem to explain many of the regulatory statutes that legislators have enacted.[5] But the opportunities for political gains from activities other than rent creation have not been considered.

This article focuses specifically on politicians. It views them, 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. The conceptual reversal of roles in turn forces consideration of the ways other than rent creation that politicians can gain from private parties. A model is developed to show how politicians reap returns first by threatening and then by forbearing from extracting private rents already in existence. These private rents, as opposed to politically created rents, represent returns to their owners' entrepreneurial ability and firm-specific private investments.[6]

Political office confers a property right, not just to legislate rents, but to impose costs. A politician can gain by forbearing from exercising his right to impose burdensome restrictions on private actors. The passage of sharply focused taxes and regulations will reduce the returns that private capital owners receive from their skills and investments. In order to protect these returns, private owners have an incentive to strike bargains with legislators, as long as the side payments to politicians are lower than

[3] Robert D. Tollison, Rent Seeking: A Survey, 35 Kyklos 575, 592 (1982).

[4] For example, Robert E. McCormick & Robert D. Tollison, Politicians, Legislation, and the Economy (1981).

[5] "The 'consumerist' measures of the last few years . . . are not an obvious product of interest group pressures, and the proponents of the economic theory of regulation have thus far largely ignored such measures." Richard A. Posner, Theories of Economic Regulation, 5 Bell J. Econ. 335 (1974). Migué also discusses regulations that are "difficult to reconcile with the economic theory of regulation." Jean-Luc Migué, Controls versus Subsidies in the Economic Theory of Regulation, 20 J. Law & Econ. 213, 214 (1977).

[6] Technically, some of the returns to private individuals are true economic rents (for example, the returns to entrepreneurial capacity), while others are more properly termed "quasi rents" (the returns to any fixed-cost investment). See Milton Friedman, Price Theory: A Provisional Text 115–18 (1962). Often, however, the differences are of little operational significance. See, for example, Donald N. McCloskey, The Applied Theory of Price 294 (1985) ("Producers' Surplus Is Economic Rent Is Quasi-Rent Is Supernormal Profit"). It is not the type of rent but its source that is of interest in this article. For expositional clarity, therefore, all profits created politically are described here as "political rents," while the returns to private capital are referred to as "private rents." Also, the term "capital" is used here to refer to both human (including entrepreneurial) and other types of capital.

the expected losses from compliance with the threatened law. (The payments need not be bribes; they might be contributions to political campaigns or in-kind donations of service and property, for example.)

A politician thus can gain by forbearing—for a price—from exercising his right to impose costs on private actors that would reduce rents from capital they have created or invested themselves. Though the strategy has not been recognized heretofore, one in fact observes private producers being compelled to pay legislators to prevent private rents from being extracted. In a static sense the payments might seem to be simple transfers. But the transfers required to protect returns to private investments create disincentives to invest in valuable specific capital in the first place. The short-run view ignores the longer-run adverse consequences of threatened rent extraction for overall levels of wealth. In the end, the article suggests, existing estimates of the welfare costs of government regulation overlook the costs of inducing government *not* to regulate.

II. Rent Extraction and the Economic Theory of Regulation

A. *Legislative Creation of Political Rents*

The original (Stiglerian) interpretation of regulation is the traditional cartel model, but one in which government imposes and enforces the anticompetitive restrictions. If expected political rents net of the costs of organizing and procuring favorable legislation are positive, then producers will demand—pay for—regulation. Deadweight consumer loss is measured by the welfare triangle. Producers stand to gain the rent rectangle, but political competition for it produces additional social loss from rent-seeking.[7]

Industry-wide cartelization is not the only way politicians can create rents. More recent theoretical[8] and empirical[9] contributions have noted

[7] Gordon Tullock, The Welfare Costs of Tariffs, Monopolies, and Theft, 5 W. Econ. J. 224 (1967); Richard A. Posner, The Social Costs of Monopoly and Regulation, 83 J. Pol. Econ. 807 (1975).

[8] For a diagrammatic presentation of the theory, see Fred S. McChesney, Commercial Speech in the Professions: The Supreme Court's Unanswered Questions and Questionable Answers, 134 U. Pa. L. Rev. 45, 74–100 (1985).

[9] For example, Howard P. Marvel, Factory Regulation: A Reinterpretation of Early English Experience, 20 J. Law & Econ. 379 (1977); R. H. Coase, Payola in Radio and Television Broadcasting, 22 J. Law & Econ. 269 (1979); Michael T. Maloney & Robert E. McCormick, A Positive Theory of Environmental Quality Regulation, 25 J. Law & Econ. 99 (1982); B. Peter Pashigian, The Effect of Environmental Regulation on Optimal Plant Size and Factor Shares, 27 J. Law & Econ. 1 (1984); Ann P. Bartel & Lacy Glenn Thomas, Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact, 28 J. Law & Econ. 1 (1985).

that regulation can create Ricardian (inframarginal) rents if it raises costs of some firms more than those of others. This "cost-predation" strategy differs from Stiglerian cartelization in that only some firms in the industry gain while others lose. Industry cooperation to obtain rents for all firms is replaced by rivalry among industry subgroups to benefit some firms at others' expense.

The cooperation and rivalry models of regulation are the same, however, in that both focus on private purchase of rents. Politician-brokers respond to private demands for rents with a supply of regulation but do not actively enter the market for rents with their own demands.[10] This is perhaps in keeping with the consumer-sovereignty model of private markets, but the applicability of that model to the political market is questionable. Clearly, a politician himself actively seeks votes, campaign contributions, and other forms of recompense, contracting to receive a supply of goods or services from private parties in response to his own demands.[11]

Modeled just as a broker among competing private demands, the politician has not been well integrated into the economic theory of regulation. His role thus far has been "subsumed,"[12] with little explicit consideration given to the ways in which the politician himself benefits from creating rents for private parties. More important, no attention has been paid to ways other than rent creation that a politician can obtain benefits from private individuals.

A politician has alternative ways to engage private parties in exchange. He may demand votes or money and offer the rent rectangle as consideration, as in the orthodox economic theory of regulation. But a politician may also make his demands on private parties, not by promising benefits, but by threatening to impose costs—a form of political blackmail. If the expected cost of the act threatened exceeds the value of the consideration that private parties must give up to avoid legislative action, they will surrender the tribute demanded of them. With constant marginal utility of wealth, a private citizen will be just as willing to pay legislators to have rents of $1 million created as he will to avoid imposition of $1 million in losses.

[10] "Regulation is . . . an instrument of wealth transfer—the extent of which is determined in a political market—where interest groups demand regulation and politician-regulators supply it." Migué, *supra* note 5, at 214.

[11] For one of the few models based on political demands being made of private individuals, see William P. Welch, The Economics of Campaign Funds, 17 Pub. Choice 83, 84 (1974) ("[t]he politician demands funds in exchange for political influence").

[12] Robert E. McCormick, The Strategic Use of Regulation: A Review of the Literature, in The Political Economy of Regulation: Private Interests in the Regulatory Process 14 (Robert A. Rogowsky & Bruce Yandle eds. 1984).

Once the politician is seen as an independent actor in the regulatory process, his objective function cannot be treated as single valued. He will maximize total returns to himself by equating at the margin the returns from votes, contributions, bribes, power, and other sources of personal gain. All these, in turn, are positive functions not only of private benefits he confers but also of private costs he agrees not to impose.

The political strategy of cost forbearance can assume several forms. Perhaps most obvious is the threat to deregulate an industry previously cartelized. Expected political rents created by earlier regulation are quickly capitalized into firm share prices. If politicians later breach their contract and vote unexpectedly to deregulate, shareholders suffer a wealth loss. Rather than suffer the costs of deregulation, shareholders will pay politicians a sum up to the amount of wealth threatened to have them refrain from deregulating. In fact, one routinely observes payments to politicians to protect previously enacted cartel measures.[13]

Subsequent payments to avoid postcontractual opportunism by politicians must be distinguished from contractual payments to guarantee rent permanence ex ante. Both politicians and rent recipients gain when the durability of regulation is increased by holding legislators to longer contracts. But new 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. Guaranteed rent durability is thus impossible. Among firm owners, subsequent purchasers of shares with expected rents capitalized into their prices are vulnerable to rent extraction on the part of opportunistic politicians. Payments to political newcomers to secure performance of previously negotiated contracts earn no rents. Rather, they protect against windfall losses that new legislators could otherwise impose.

B. Political Extraction of Private Rents

The durability problem for politically created rents has been discussed elsewhere[14] and is not the focus of this article. But recognition of the rent-

[13] Dairy interests pay handsomely for the continuation of congressional milk-price supports. Larry J. Sabato, PAC Power: Inside the World of Political Action Committees 133, 137 (1984). Physician and dentist "political action committees" (PACs) contribute large sums for continuation of self-regulation. *Id.* at 134–35.

[14] Since more durable rent contracts are in the interest of both private parties and politicians, the intervention of third-party institutions predictably would be sought to hold legislators to their deals. The judiciary, for example, may help guarantee congressional rent-creation contracts, since courts can overrule legislators' attempted revisions of earlier contracts by holding the changes unconstitutional. William M. Landes & Richard A. Posner,

extraction opportunities that capitalized cartel rents represent to politicians suggests that similar strategies may offer gains to politicians when other sorts of rents exist. In particular, it leads one to focus on the capital value of privately created rents and predictable political responses to their existence.

1. The Model

Figure 1 depicts an industry in which producers have differing amounts of entrepreneurial capacity or some firm-specific, fixed-cost asset. The industry supply curve in the absence of regulation (S_0) thus is upward sloping. Returns to entrepreneurship and specific assets come as rents out of producers' surplus, $0AD$. Regulatory measures could be identified that would increase costs for all firms, but more for marginal firms, moving the industry supply curve to S_1.[15] To inframarginal producers regulation is advantageous (that is, they would pay politicians to effect it) as long as there is a net increase in rents. In Figure 1, area I is greater than area II ($CDEF > ABC$): the gains from higher prices exceed the losses due to fewer sales. The capitalized value of the increased rent flow defines the maximum payment producers would make to politicians in return for regulation.[16]

But rent creation by a governmentally mandated shift from S_0 to S_1 is not the only option open to politicians. *Existing* private rents rewarding specific assets are greater than the rents that can be created by regulation: $0AD > CDEF$ (area I). Regulatory measures can also be identified that

The Independent Judiciary in an Interest-Group Perspective, 18 J. Law & Econ. 875 (1975); Robert D. Tollison & W. Mark Crain, Constitutional Change in an Interest-Group Perspective, 8 J. Legal Stud. 165 (1979). Executive veto of attempted changes in legislative deals is another way to increase the amounts private parties would spend for rent creation. W. Mark Crain & Robert D. Tollison, The Executive Branch in the Interest-Group Theory of Government, 8 J. Legal Stud. 555 (1979). But neither guarantee system is perfect "since there will be some expectation that an independent judiciary will not support all past legislative contracts," Tollison & Crain, *supra*, at 167, and because newcomers to both the legislature and the executive office have less stake in continuing bargains made by their predecessors, Crain & Tollison, *supra*, at 561–66.

[15] For an empirical demonstration of the harm to marginal firms from minimum-wage and union-pay increases, for example, see David E. Kaun, Minimum Wages, Factor Substitution and the Marginal Producer, 79 Q. J. Econ. 478 (1965); and Oliver E. Williamson, Wage Rates as a Barrier to Entry: The Pennington Case in Perspective, 82 Q. J. Econ. 85 (1968). For discussion of other regulatory measures with different effects on firms, see the sources cited in note 9 *supra*.

[16] Maximizing payments to politicians would require, inter alia, that all producer beneficiaries be induced to pay and that consumer-voters exert no counterinfluence on the amount of regulation imposed. Relaxing these assumptions would not alter the fundamental implications of the rent-extraction model proposed here. See, for example, Becker, *supra* note 2; and Peltzman, *supra* note 2.

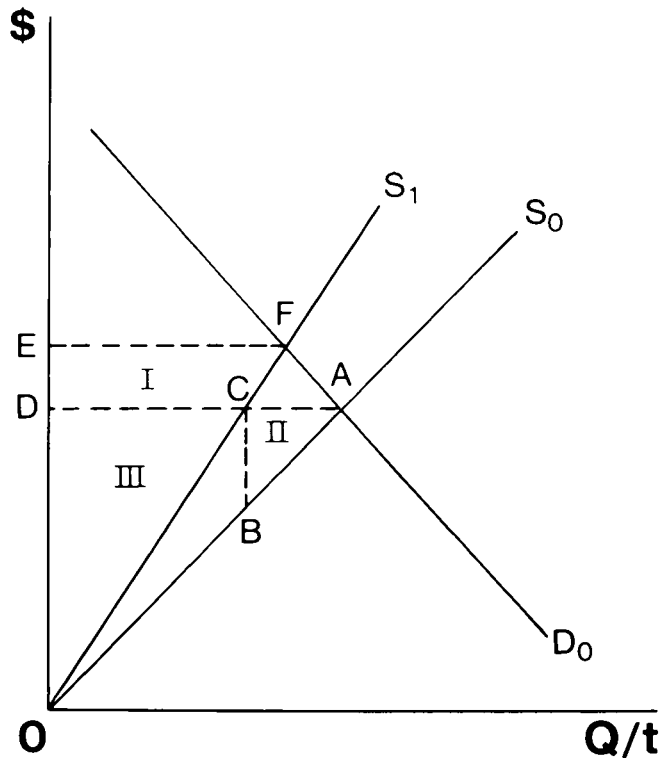

FIGURE 1

would expropriate the producers' surplus, as explained below. Once such regulation is threatened, the price that producers would pay politicians in return for governmental nonaction would exceed any payment for rent-creating regulation.

Faced, then, with a choice between the two strategies, a regulator would maximize the benefits to himself by threatening to expropriate the existing private rents rather than by creating new political rents.[17] As with threatened deregulation of government cartels, payments must be made to protect rents. But unlike the cartel case, where rents were created by government itself, a legislator threatening to expropriate private rents is paid to let firms earn returns on capital they have created or invested for themselves. "Milker bills" is one term used by politicians to describe legislative proposals intended only to squeeze private producers for pay-

[17] The conditions under which rent extraction is politically preferable to rent creation are explored further below.

ments not to pass the rent-extracting legislation. "Early on in my association with the California legislature, I came across the concept of 'milker bills'—proposed legislation which had nothing to do with milk to drink and much to do with money, the 'mother's milk of politics.' . . . Representative Sam, in need of campaign contributions, has a bill introduced which excites some constituency to urge Sam to work hard for its defeat (easily achieved), pouring funds into his campaign coffers and 'forever' endearing Sam to his constituency for his effectiveness."[18] Milked victims describe the process simply as blackmail and extortion.[19] The threats are made quite openly. One reads, for example, that "House Republican leaders are sending a vaguely threatening message to business political action committees: Give us more, or we may do something rash."[20]

The producers' surplus compensating firm-specific capital is inframarginal, but this does not mean that its potential expropriation by politicians has no allocative consequences. Even if politicians eventually allow themselves to be bought off, their minatory presence reduces the expected value of entrepreneurial ability and specific-capital investments. The possibility that government may reduce returns to their capital unless paid off reduces firms' incentives to invest in the first place. It also induces inefficient shifts to investment in more mobile or salvageable (that is, less firm specific) forms of capital as insurance against expropriation. In either event, the allocative losses from politicians' ability to extract the returns from private capital are measured by investments that are never made in the industry threatened.

In effect, an important similarity between capital expropriations in less-developed countries and "mere" regulation in developed nations has been overlooked. In both cases the very presence of a threatening government will reduce private investment.[21] The resulting welfare losses would be measured by the value of specific capital and other investments that firms would have made, but for the fear of subsequent expropriation and

[18] W. Craig Stubblebine, On the Political Economy of Tax Reform 1, 2 (paper presented at the meeting of the Western Economic Ass'n 1985).

[19] One PAC director describes congressional "invitations" to purchase tickets to political receptions as "nothing but blackmail." Sabato, *supra* note 13, at 86. Likewise, "[t]he 1972 reelection effort for President Richard Nixon included practices bordering on extortion, in which corporations and their executives were, in essence, 'shaken down' for cash donations." *Id.* at 5.

[20] Brooks Jackson, "House Republicans Are Pressing PACs for Contributions," Wall St. J., June 27, 1985, at 36, col. 2. Further instances of how politicians pressure PACs for money are given in Sabato, *supra* note 13, at 111–14.

[21] The effects of Third World government expropriations of private capital in diminishing the amount of investment made are analyzed in Jonathan Eaton & Mark Gersovitz, A Theory of Expropriation and Deviations from Perfect Capital Mobility, 94 Econ. J. 16 (1984).

the cost of purchasing protection from politicians. The consequences are like those of ordinary theft: "One way of minimizing loss by theft is to have little or nothing to steal. In a world in which theft was legal we could expect this fact to lead to a reduction in productive activities."[22]

Rent extraction can succeed only to the extent that threats to expropriate private rents are credible. With any given firm or industry, producers and politicians may be locked in a "chicken" game: since legislators seemingly gain nothing if they actually destroy private capital, capital owners may be tempted to call politicians' bluff by refusing to pay. But a politician's demonstrated willingness actually to expropriate private rents in one situation provides a lesson for other firms or industries that will induce them to pay in their turn. To make credible expected later threats to destroy others' capital, politicians may sometimes have to enact legislation extracting private rents whose owners do not pay.[23] (And as discussed below, legislators can always enact statutes now and sell repeal later.)

The credibility and thus the political attraction of rent-extraction strategies also depend on the strength of constitutional rules that protect private property and contract rights against governmental taking. Legislative threats to expropriate returns to private capital will elicit fewer payments to politicians the more likely it is that capital owners later can have any legislation voided constitutionally in the courts. The level of constitutional scrutiny of legislative expropriations involving private contract and property rights has declined throughout the twentieth century.[24] The scope for credible legislative threats against private capital has expanded apace. In effect, as courts have retreated from affording constitutional protection against legislative takings, potential private victims have been forced to employ more self-help remedies by buying off politicians rather than submit to rent-extracting regulation.

2. Private Rent Extraction versus Political Rent Creation

Extraction of private rents and creation of political rents need not be mutually exclusive; maximum gains to politicians may involve a combina-

[22] Tullock, *supra* note 7, at 229 n.11.

[23] The situation is thus a form of the "Samaritan's dilemma," in which a politician must convince private producers that he is willing to suffer losses in the short run in order to reap longer-run gains whose present value exceeds that of any immediate losses. See James M. Buchanan, The Samaritan's Dilemma, in Altruism, Morality, and Economic Theory 71 (Edmund S. Phelps ed. 1975). Of course, to the extent that the political threats are convincing, private parties are more likely not to call a legislator's bluff, and he therefore will not actually suffer any short-run loss.

[24] Richard A. Epstein, Takings: Private Property and the Power of Eminent Domain (1985); Terry L. Anderson & P. J. Hill, The Birth of a Transfer Society (1980).

tion of the two. In Figure 1, for example, politicians could create rents in area I (*CDEF*) by imposing regulation while threatening at the same time to expropriate the remaining producers' surplus in area III (0*DC*). The maximum private payment forthcoming from this combined tactic, I + III (0*EF*), would exceed that from merely threatening rent expropriation without regulation (0*AD*). But a combined strategy of rent creation and rent extraction is not necessarily optimal to politicians. Political rent creation (of either the Stiglerian or the inframarginal sort) requires restriction of output, which itself reduces the current stock of expropriable producers' surplus. Ceteris paribus, greater rent creation therefore means more forgone rent extraction. Particularly because the political processes of creating or extracting rents are not costless to legislators, the gains may justify using only one or the other strategy in a particular market.

The relative gains from the two strategies, and thus the optimal political mix of created and extracted rents, will depend on industry supply and demand conditions. The more inelastic industry demand is, the greater the relative attraction of political rent creation. Likewise, if industry supply is perfectly elastic, there is no producers' surplus and so no opportunity for rent extraction. On the other hand, when industry demand is perfectly elastic, extraction of private rents is the only plausible political strategy. Similarly, a large stock of specific (nonsalvageable) capital increases the relative attraction to politicians of private rent extraction. Of course, producers themselves would rather buy new rents than pay to protect their own existing rents. But in some markets, rent-creation opportunities may be slight as compared to the opportunities for extraction of returns to entrepreneurship and private capital. For example, ease of new entry into an industry may make rent-creating cartelization futile. At the same time, the presence of large specific-capital stocks would make the same industry vulnerable to rent extraction.

Information concerning demand and supply elasticities, entry costs, and the size and mobility of capital stocks is costly to politicians. The specter of rent extraction naturally will induce private owners of expropriable capital to try to hide the size of their capital stocks, which increases the costs to politicians of discovering how much producers would pay to avoid expropriation.[25] But political threats to act have the effect of instituting an auction market among private parties. "[L]egislatures work on the presence or absence of opposition. Legislation for which the claim can be made that some group will benefit, if only modestly, and which induces no opposition is almost certain to pass. Thus, introduction of a

[25] See J. Patrick Gunning, Jr., Towards a Theory of the Evolution of Government, in Explorations in the Theory of Anarchy 22 (Gordon Tullock ed. 1972).

milker bill which does not generate the expected opposition to its passage, as evidenced by resources devoted to lobbying for its defeat, indeed will pass. By contrast, milker bills which generate the anticipated opposition will fail. Contrasting these outcomes usually makes an effective case for generating the lobbying resources."[26] An auction not only drives competitive bids for legislative favors higher but also reveals which firms stand to gain and which to lose and the magnitude of the respective effects.

The auction thus provides valuable information whether regulatory action or inaction will be more lucrative to politicians themselves; it helps to identify the likely payors and to set the amounts of the compensation to be paid. Particularly since legislators may not know the size of the rents potentially expropriable, they may prefer to make good their threat in order to elicit bids revealing the true size of the private capital stock. Actual enactment of legislation raises to unity the probability of rent-destroying measures being imposed, unless firms buy legislative repeal. Legislation that would destroy rents can be enacted with a delayed effective date to allow firms to mobilize and bid to remove or alter the statute.[27]

Because the maximum gains to legislators depend on knowledge of elasticities and the size of private rents, there may also be gains from specialization in identifying industries with expropriable producers' surplus and in determining how best to extract it. If so, legislators predictably would delegate cost-imposing functions to specialized bureaucratic agencies. By threatening or actually imposing costs, these outside agents create a demand for politicians to mitigate the costs. Use of specialized agencies to impose costs has a second advantage to politicians. While they may act at the behest of elected officials, bureaucrats will be perceived by at least some rationally ignorant voters as independent. Information about the regulatory process is costly to obtain, and so it may appear that misguided agencies rather than politicians themselves are responsible for the costs threatened.[28] Designation of institutions like the

[26] Stubblebine, *supra* note 18, at 2.

[27] This was the pattern observed, for example, with the amendments to the Clean Air Act in the early 1970s, when the Department of Transportation repeatedly delayed and altered standards on auto emissions in response to auto-firm lobbying.

[28] The rent-extraction model thus sheds light on the recurring controversy whether bureaucratic agencies "run amuck," free of congressional or other constraints. The most recent study of the Federal Trade Commission (FTC), for example, concludes that "the Commission remains largely unconstrained from without." Kenneth W. Clarkson & Timothy J. Muris, Commission Performance, Incentives and Behavior, in The Federal Trade Commission since 1970: Economic Regulation and Bureaucratic Behavior 282 (1981). But Weingast and Moran present evidence of systematic congressional influence over FTC actions. Barry R. Weingast & Mark J. Moran, Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission, 91 J. Pol. Econ. 765 (1983). The rent-extraction model suggests that neither view may fully capture the essence

Federal Trade Commission (FTC) and the Securities and Exchange Commission as "independent agencies" may further the perception in some voters' eyes that politicians are less responsible for their activities.[29]

C. *Methods of Extracting Private Rents*

Having located private capital stocks whose returns will come out of producers' surplus, how can legislators extract that surplus? Two general strategies represent threats to private producers: reductions in price and increases in cost.[30]

1. Legislative Threats to Reduce Prices

Consider, for example, firms' fixed-cost investments in brand-name capital or reputation.[31] All firms may produce otherwise equivalent products, but some will have incurred greater costs in past periods (for example, by advertising) to make their names and quality familiar to consumers. Advertising creates a capital stock, returns from which are taken over time.[32] Once created, the capital is specific to the firm and enables the firm in a later period to incur lower costs to guarantee the quality of the goods or services that it sells. Rival firms without brand-name capital must incur higher costs in that same period to make their names and product quality as well-known and trustworthy to consumers.

This is shown in Figure 2 for two representative firms. Industry supply

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of Congress-agency relations. A politician has less incentive to monitor specialized agencies ex ante while they consider and adopt cost-imposing measures more cheaply than Congress itself could. There is more incentive for legislative surveillance of agency action ex post, in order to locate opportunities for alleviating those costs (for a fee). For a discussion and evidence of politicians' intervention to remove the costs imposed by bureaucrats' antitrust investigations and prosecutions, see Roger L. Faith, Donald R. Leavens, and Robert D. Tollison, Antitrust Pork Barrel, 25 J. Law & Econ. 329 (1982).

[29] Further, the appearance may not be purely illusory. Congressional monitoring of agencies is costly. See Isaac Ehrlich & Richard A. Posner, An Economic Analysis of Legal Rulemaking, 3 J. Legal Stud. 257 (1974). Some of what agencies do, therefore, will not be known to a legislator until constituents bring it to his attention.

[30] The purpose here is to illustrate how politicians acting collectively can induce private payments not to extract rents. This admittedly leaves unaddressed public-choice problems of achieving collective political action: how to assemble political coalitions when each politician maximizes his own interest, how to divide the gains from rent extraction among individual politicians, the role of the committee system in rent extraction, and so forth.

[31] Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. Pol. Econ. 615 (1981); L. G. Telser, A Theory of Self-enforcing Agreements, 53 J. Bus. 27 (1980).

[32] See, for example, Yoram Peles, Rates of Amortization of Advertising Expenditures, 79 J. Pol. Econ. 1032 (1971); Robert Ayanian, Advertising and Rate of Return, 18 J. Law & Econ. 479 (1975).

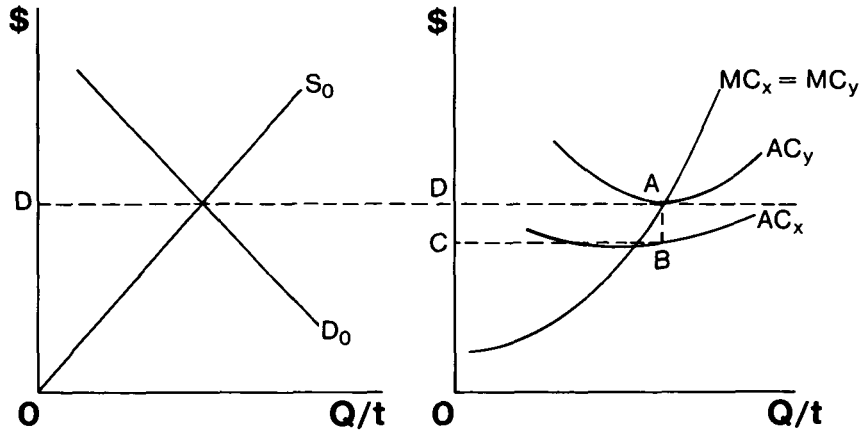

FIGURE 2

and demand (from Figure 1) establish the equilibrium price, 0*D*. Firm X has been in business and advertised for years; firm Y has just started business. Both firms provide identical products of equivalent quality at the same production cost ($MC_X = MC_Y$). But customers cannot evaluate product quality prior to purchase; hence there is uncertainty. Both firms guarantee quality, but in different ways. Firm X relies on its investment in brand-name capital in prior periods, its customers paying a premium for the credible guarantee of quality that the reputation capital provides. To offer an equivalent guarantee, firm Y must incur other fixed costs in the current period, such as having an independent laboratory test its product quality and publicize the fact that it is just as good as X's, making its average costs higher ($AC_Y > AC_X$). The premium (*AB*) that firm X's customers pay for the reputational guarantee earns rents (*ABCD*).

But X's rents can be reduced or destroyed by government intervention. Politicians can pass legislation to have administrative agencies guarantee quality or truthful information by imposing minimum quality standards or mandatory information-disclosure regulations. Government agents then would police the market for quality and truth, substituting both for the brand-name capital invested earlier by firm X and for the current testing that firm Y would have commissioned to guarantee quality. To the extent it substitutes for private reputation capital, government regulation destroys the premium value of firm X's private capital while relieving the nonreputational firm, Y, of the need to incur new costs to warrant its own quality.

The threatened government intervention would lower price and increase the elasticity of industry supply, eradicating the producers' surplus

available to compensate firms for their earlier fixed-cost investments. Rather than have politicians depreciate their capital stock, firm X would pay up to *ABCD* per period for nonintervention in the market. Even if regulation "only" substitutes for activities currently provided privately, it reduces the expected returns to private-reputation investments and so over time the amount of investment. Note also that in the new equilibrium firm Y would earn no rents from the regulation and so would offer politicians nothing for it. The only gains to politicians in this case come from threatening to extract X's rents.

The history of the FTC's "Used Car Rule" provides an example of the gain to politicians from threatening this type of regulation and later removing the threat for a fee. In 1975, Congress statutorily ordered the FTC to initiate a rulemaking to regulate used-car dealers' warranties.[33] The FTC promulgated a rule imposing costly warranty and auto-defect disclosure requirements, creating the opportunity for legislators to extract concessions from dealers to void the burdensome measures. In the meantime, in fact, Congress had legislated for itself a veto over FTC actions.[34] On promulgation of the rule, used-car dealers and their trade association descended on Congress, spending large sums of money for relief from the proposed rule's costs.[35] When the concessions were forthcoming, Congress vetoed the very rule it had ordered.[36]

It is noteworthy that conditions in the used-car industry conform closely to those hypothesized as conducive to a strategy of rent extrac-

[33] The Magnuson-Moss Warranty–Federal Trade Commission Improvement Act of 1975 included an order to the FTC to initiate within one year "a rulemaking proceeding dealing with warranties and warranty practices in connection with the sale of used motor vehicles." 15 U.S.C. § 2309(b). For the FTC's initial rule, see 16 C.F.R. § 455 (1982).

[34] Since Congress has always been able to annul any agency rule or regulation statutorily, the question arises why it would want a veto. Statutes to change agency action require the president's signature. If the president must sign the statute, he then is able to exact payment for his participation in rent-protecting legislation, lowering the payments available to Congress. In eliminating the executive role, the legislative veto is hardly a check on agency action. It is an attempt to avoid splitting fees with the executive. Indeed, if Congress has a veto, it then has an incentive to fund even more rent-threatening activities by independent agencies, ceteris paribus.

[35] One study, cited in Sabato, *supra* note 13, at 134, found that, "[o]f the 251 legislators who supported the veto resolution and ran again in 1982, 89 percent received contributions from NADA [National Auto Dealers Association], which averaged over $2,300. This total included 66 legislators who had not been backed by NADA at all in 1980, before the veto resolution vote. Just 22 percent of the 125 congressmen who voted against NADA received 1982 money, and they averaged only about $1,000 apiece."

[36] See the FTC announcement of the veto published at 47 Fed. Reg. 24542 (June 7, 1982). When the Supreme Court later invalidated the legislative veto, INS v. Chadha, 462 U.S. 919 (1983), and thus Congress's overruling of the FTC's rule, Process Gas Consumers Group v. Consumer Energy Council, 463 U.S. 1216 (1983), the FTC recalled its proposed rule and essentially gutted it. See 16 C.F.R. § 455 (1985).

tion. As Stigler himself notes,[37] cartelization of the used-car industry would be difficult: start-up costs are low; there are no entry barriers (for example, licensing requirements); and units of the product have different qualities, making enforcement of cartel pricing difficult. By comparison, the industry is susceptible to a strategy of rent extraction. Quality uncertainty (the risk of getting Akerlof's "lemon")[38] is a problem, leading sellers to invest in reputation capital.[39] By requiring and policing seller disclosure of warranty and defect information, government would have substituted for sellers' investments in quality-assuring reputation. Rather than suffer the capital losses that regulation would entail, firms predictably would—and did—compensate legislators not to intervene.

2. Legislative Threats to Raise Costs

Just as proposals to institute price-lowering regulation imperil private rents, so do regulations that threaten to increase costs. Consider the situation portrayed in Figure 3, in which legislators threaten to impose an excise tax or other per-unit cost of $0C$. Rather than suffer a net loss in producers' surplus, area I − area II ($0AEC - BDFE$), firms earning rents will offer to compensate legislators to refrain from imposing the costs.

There are many examples of payments to politicians to purchase governmental inactivity in taxation.[40] Recently, the excise tax on beer has generated substantial revenue for legislators in return for their inactiv-

[37] Stigler, *supra* note 1, at 9–10.

[38] George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).

[39] "Both intuition and empirical data suggest that the used-car market attracts lemons. . . . A number of market mechanisms serve to alleviate these problems. The most visible solutions take the form of dealer guarantees and warranties, which recently have been beefed up with extended coverage backed by national insurers. Indirectly, dealers invest in brand-name maintenance (local television ads, for instance), which makes it more costly for them to renege on a reputation for quality. The reputation of the parent automakers is also laid on the line. All four domestic car manufacturers have certified the quality of the better used cars sold by their dealers. Two generations of Chevrolet dealers, for example, have designated better used cars with an 'OK' stamp of the dealer's confidence in the car's marketability." Can Regulation Sweeten the Automotive Lemon? Reg., September/December 1984, at 7, 8.

[40] "[M]embers of the tax-writing committees nearly tripled their take from political action committees during the first six months of this year, to $3.6 million, compared to the like period in the past two-year election cycle. . . . [T]he money is pouring in from . . . insurance companies that want to preserve tax-free appreciation of life insurance policy earnings, from horse breeders who want to keep rapid depreciation of thoroughbreds, from drug companies seeking to keep a tax haven in Puerto Rico, and from military contractors seeking to retain favorable tax treatment of earnings from multiyear contracts." Brooks Jackson, Tax-Revision Proposals Bring Big Contributions from PACs to Congressional Campaign Coffers, Wall St. J., August 9, 1985, at 32, col. 1.

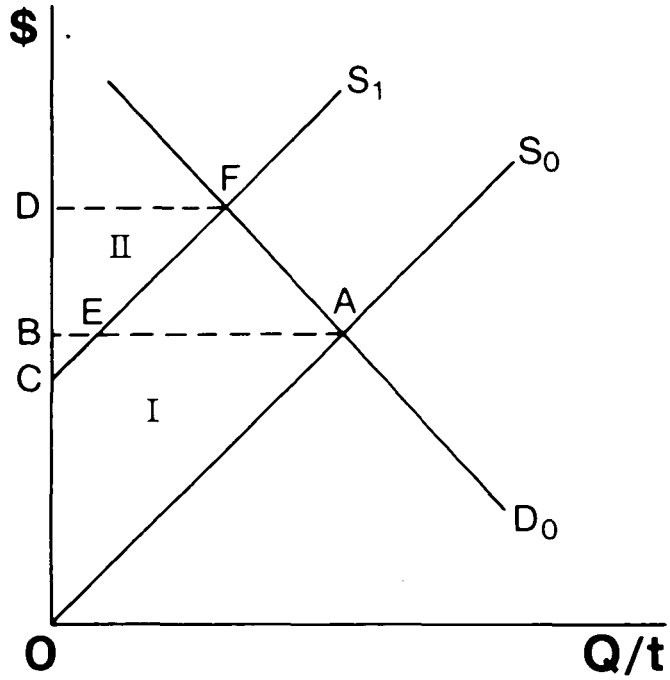

FIGURE 3

ity.[41] Of course, excise taxes are just one cost that politicians can threaten to impose on private firms. Other recent threats include proposals to require financial institutions to start costly reporting and withholding of taxes from depositors' interest and dividends (a measure that was passed and then repealed) and proposals to impose "unisex" premiums and benefit payments on insurance firms. Both episodes are difficult to explain using the standard economic model, as they consumed considerable political time but ended with no regulation at all being imposed. But even if the regulation was never actually imposed, each measure would be attractive politically as a device that might ultimately elicit private payments to

[41] One report notes that "there hasn't been an increase in the 65-cent-a-case federal tax on beer since the Korean War, and nobody is seriously proposing one right now." Yet the industry has organized a coalition of brewers and wholesalers to compensate key members of Congress anyway: "Members of House and Senate tax-writing committees regularly drop by the coalition's monthly meetings to talk about budget and tax trends, [and] pick up $2,000 appearance fees." Though new beer taxes "haven't . . . generated much interest in Congress," the president of the brewers' trade association says they "want to be prepared." Brooks Jackson, Brewing Industry Organizes Lobbying Coalition to Head off Any Increase in U.S. Tax on Beer, Wall St. J., July 11, 1985, at 48 col. 1.

legislators *not* to impose the threatened costs—which in fact each one did.[42]

III. Conclusion

This article extends the economic theory of regulation to include the gains available to elected politicians from alleviating costs threatened or actually imposed on private actors by legislators themselves and by specialized bureaucratic agencies. Status as a legislator confers a property right not only to create political rents but also to impose costs that would destroy private rents. Their ability to impose costs enables politicians credibly to demand payments not to do so. Even when politicians eventually eschew intervention, the mere threat and the payments required to remove it distort private investment decisions.

The model of rent extraction set out here in no way undermines the orthodox model of rent-creating regulation; rather it supplements it by recognizing alternative sources of political gains. Indeed, Stigler's original article foreshadowed a complementary rent-extraction model: "The state—the machinery and power of the state—is a potential resource *or threat* to every industry in the society. With its power to prohibit or compel, *to take* or give money, the state can and does selectively help *or hurt* a vast number of industries. . . . Regulation may be actively sought by an industry, *or it may be thrust upon it*" (emphasis added).[43] Conditions that make political rent creation relatively unattractive to politicians make private rent extraction more attractive. The relative attraction of rent extraction has also increased as constitutional protection of private rights has diminished.

Many of the insights from the rent-creation model of regulation will doubtless prove useful in further explorations of rent extraction. For example, the problem of double-dealing by opportunistic politicians that was discussed above in connection with deregulation raises equivalent issues for contracts with legislators not to extract private rents. As with rent creation, the rent-extraction model will be enriched by consideration of the need to assemble coalitions to obtain rent protection, the problems created by changes in coalitions' composition and power, and similar

[42] The banking industry contributed millions of dollars to politicians in 1982 to obtain repeal of the statutory provision requiring banks to withhold taxes on interest and dividends. There are no precise figures on contributions to politicians to stop legislation banning gender-based insurance-rate and benefit schedules, but their magnitude may be inferred from the American Council of Life Insurance's media budget of nearly $2 million in 1983 and 1984 to defeat the legislation. Sabato, *supra* note 13, at 125.

[43] Stigler, *supra* note 1, at 3.

issues that arise once "government" is recognized as a collectivity of rational, maximizing individuals.

For the moment, however, it is sufficient to note that the problems of political opportunism and the imperfections in private-capital protection create disincentives for capital owners to buy off legislators. Yet several instances have been presented here in which private actors in fact have paid significant sums to induce government not to impose costs. Despite the political impediments to contract, then, the evident willingness of capital owners to purchase protection indicates that appreciable capital stocks are credibly imperiled by regulations that are never actually enacted.

If so, one cost of government regulation has been missed. Heretofore, the economic model has identified several different costs of government regulation: deadweight consumer loss, resources expended as private parties seek rents,[44] costs of compliance with regulation,[45] and diversion of resources to less valuable but unregulated uses.[46] To these should be added the costs of protecting private capital even when politicians ultimately are persuaded not to regulate. There is no such thing as a free market.

[44] Posner, *supra* note 7. See also Franklin M. Fisher, The Social Cost of Monopoly and Regulation: Posner Reconsidered, 93 J. Pol. Econ. 410 (1985); W. P. Rogerson, The Social Costs of Monopoly and Regulation: A Game-theoretic Analysis, 13 Bell J. Econ. 391 (1982).

[45] Tullock, *supra* note 7.

[46] James Alm, The Welfare Cost of the Underground Economy, 24 Econ. Inquiry 243 (1985).