Achieving Deregulation—A Public Choice Perspective

Gordon Tullock

ANY POLITICIAN will tell you that in order to achieve major governmental reform the minority in favor of change must be transformed into a cohesive majority. When some members of society would be injured as a result of a proposed change, it is often very difficult to bring about reform, since those likely to be injured will voice strong opposition *unless* they are compensated for their losses. Many of the recent proposals for regulatory reform are of this type—that is, some groups would gain because of the change and others would be injured (or *think* they would be injured). For example, consumers would gain from trucking deregulation, but some truckers would lose. Cable TV users and companies would gain from broadcast deregulation, but the "free" TV industry would lose. Many consumers and oil producers would gain from deregulation of oil and gas, but other consumers and the producers of competing energy supplies would suffer. The key to reform would appear to be the development of proposals that enable (or require) the gainers to compensate the losers, or at least ameliorate their plight. Here a relatively new field of inquiry called "public choice" may offer useful insights.

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This article is based on a paper presented at the AEI Conference on Regulation and Regulatory Reform, December 19, 1977.

Public Choice

Public choice was deliberately coined as the title for a new branch of study that applies economic reasoning to politics. Public choice scholars think that most people, most of the time, are motivated by self-interest—an assumption common in economic analysis but not so common in explaining the activities of public servants and other political figures. It is true that almost everyone at least occasionally is disinterested, charitable, and devoted to the group interest. But public choice analysis views that as the exception rather than the rule.

With respect to policy making, public choice analysis assumes that politicians are concerned less with the public interest than with getting reelected or perhaps moving on to higher office. Bureaucrats are assumed to seek not administrative efficiency but promotion and pay raises or, at the very least, security. The voter is assumed to choose among parties and candidates according to what he thinks best for him, not what he thinks would be best for the country as a whole—if not always, at least most of the time.

On the basis of these rather simple assumptions about motives, it is possible to develop quite an elaborate theory of political and bureaucratic behavior. It may be argued that this theory is, in essence, only an extended footnote in the war cry of William Marcy—"to the victor belong the spoils"—but it is at least a very extended footnote, and by applying the theory rigorously we may be able to explain behavior that is inexplicable according to other models. What is discussed below is an illustration (albeit almost entirely theoretical) of public choice reasoning. In order to make the discussion easier, I will use the airlines as an example, even though regulatory reform is fast making obsolete, not the analysis given here, but the state of the industry that it assumes.

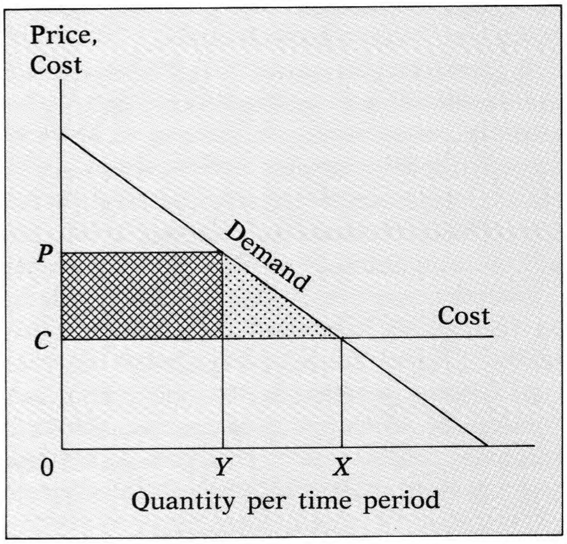
Gainers, Losers, and Compensation

Let us suppose that a government agency restrains competition in an industry such as the airlines, making the industry essentially monopolistic. In these circumstances, the amount of air service available to travelers falls, the price of tickets rises, and the firms that provide air service (producers) experience above-normal profits. *However,* it is simple to prove that the gain to airline firms in the form of excess profits is *less* than the loss to travelers (consumers) in the form of higher prices and foregone opportunities to fly (see the figure and accompanying discussion). If the restriction that raised prices occurred quite some time ago, then many of the present holders of airline stock would have acquired their stock at prices that took the profit into account. If the airlines were deregulated, those stockholders, along with the original holders of the stock, would suffer.

Economics teaches us that in circumstances like this it is possible (at least in theory) to go from this monopoly situation to a competitive situation without injuring anyone. In other words, it is possible to compensate the owners of a monopoly out of benefits gained by consumers. The reason this is possible is that there are consumers who would have flown at the lower price but who do not fly at the higher price. In theory, the benefit these consumers would receive from a cut in price can in part be used to compensate the owners for the abolition of the monopoly. Unfortunately, the administrative problems are generally difficult, and therefore a direct payment of this sort is usually impossible.

Some will argue that monopolists are perverse or wicked and should not be compensated for their monopoly, even if those who own the monopoly firms (the stockholders) turn out to be women and children—"widows and orphans"—who bought stock on the advice of their bankers long after the monopoly was established. Policy makers, and especially reformers, should realize that it is a good deal easier to get a program through the political process if they do not try to impose severe losses on anyone. Hence, if deregulation is the goal, we would probably be wiser to forgive the "monopolists," forget their past monopoly profits, and buy them off, rather than engage in a political struggle to take their money away from them. Note the "probably" in the above statement: there are cases in which the political process has been used to despoil people of either ill-gotten or well-gotten gains, but these cases are few and far between.

The figure shows a conventional demand and supply diagram. Price (and cost) is on the left axis, and the quantity sold per time period is at the bottom. The amount that can be sold increases as the price is reduced—this being, of course, shown by the demand line. For simplicity, we assume that the commodity in question can be produced in any quantity for the same unit cost (including profit as part of the cost).



In a competitive market, quantity X would be produced and sold at price C. Let us suppose that a government agency creates a monopolistic restriction in this market, reducing the amount bought and sold from X to Y and raising the price from C to P. Although consumers would be paying P, the cost would only be C, and the cross-hatched rectangle would go to the owners of the industry as excess profit.

If this market were deregulated (causing price to fall to P and output to increase to X), the industry would lose the excess profit shown in the cross-hatched rectangle. But consumers would gain this amount (in lower price) *plus* the amount shown in the dotted triangle. In other words, consumers shut out of the market at price P would come into the market at price C, and the amount by which the value they put on the output between Y and X exceeds the price they pay is the net gain from deregulation.

In short, the gain (to consumers) from deregulation (the cross-hatched area *plus* the dotted area) exceeds the loss to producers (the cross-hatched area) by the amount shown in the dotted area.

Let me reiterate that the problem of actually making compensation may be administratively difficult—indeed, perhaps administratively impossible. Part of the difficulty is that compensation might involve charging different prices to different consumers—in which case we would have to find out how much each individual consumer would be willing to pay for additional usage and then charge him a little less than that amount. If this problem cannot be solved, it would probably be necessary to take on the monopolists directly.

Fortunately, in most real-world cases in which government restrictions have raised prices, the problem does not have to be faced. Almost without exception, government regulation not only reduces quantity and raises prices, but also leads producers to engage in wasteful production techniques—with the result that producers' costs are higher under regulation than those they would face in a competitive market. Typically, then, regulation is more wasteful than granting a monopoly franchise.

In a way, of course, it is much easier to reform a situation where there is waste than where monopoly (or any regulated system) merely transfers wealth from one group to another. It is easier to get out of a mess when not many people will be hurt and a great many will be helped. For example, suppose that the regulated price for air service is a great deal above the competitive price. The airlines, at least on routes where they compete, improve their service because, with prices fixed, that is the only way they have to attract passengers. (I will pass over the question whether this is really an example of monopoly in action—it is certainly an example of regulated and reduced competition.) But air travelers are paying much more for this improved service than it is worth to them—that is, while they prefer the improved service at the regulated price to stripped-down service at the same regulated price, they would prefer a lower price to both.

In this case, the administrative problems are relatively easy. Since the restriction produces no large gains, little compensation is necessary for it to be eliminated. The principal effect of changing the restriction is not to lower the return to the airline owners but to lead them to bring their production techniques more into accord with the wishes of consumers.

But let us suppose that we do want to give the airline owners some compensation. One possibility would be to put a modest excise tax on all airline tickets and give the revenues from that tax to the owners. While this may look simple, it would not be simple in the real world. The reason is not that collecting this small tax and paying out the benefit are inherently difficult, but rather that it is hard to identify the people who are to be benefited. Indeed, it is fairly obvious that we would end up with some kind of approximate solution. This might be acceptable, however, if the gains from deregulation were great. If some "vested interests" were overcompensated, the social cost would be minor compared to the social profit from abolishing the restrictive arrangements.

One basic reason why airline deregulation will not hurt very many people very much is that, if prices should fall to the competitive level, passenger traffic will rise enough so that current equipment will still be fully employed and the industry's demand for new aircraft will be about as great as before—if not greater. It is true that different types of aircraft may then become optimal but presumably the adjustment to the new types will be gradual (given the cost of new aircraft). Similarly, it seems likely that there will be no falloff in the demand for pilots, flight attendants, mechanics, agents, and other employees, since there will be more passengers to handle. It is quite possible that, in all of these areas, returns will rise because of an increase in demand. (In fact, we have already seen evidence of this. In 1978, airline profits have risen to extraordinarily high levels by historical standards as regulatory restraints on airline operations have been eased.)

This does not mean that no one *could* lose as a result of airline deregulation: there are, after all, a good many people whose livelihood depends on the regulatory activity. While not *everyone* puts his or her own occupation above the public interest, it is nevertheless true that those likely to be injured by change are apt to object. So compensation for the injured may be a sensible step.

One of the groups that might lose from total deregulation of air service is made up of the employees of the Civil Aeronautics Board (CAB). Here we might consider a previous case. In the early nineteenth century, the English sought to improve government efficiency through a series of drastic reforms sometimes called the Benthamite reforms. As part of this effort, a number of governmental sinecures were abolished, but the laws abolishing them provided that the actual positions were not to be eliminated until the current incumbents died. Although this meant that salaries continued to be paid to these incumbents for quite a number of years, the savings eventually came, and there was no political opposition to the reform. Those who drafted the new airline reform legislation have done something rather similar. At least in the short run, according to some projections, the demand for regulatory personnel will increase because of the gradual phasing out of regulatory controls and the CAB's role in this transition. As a result, no civil servant's job will be especially threatened.

Other groups might also lose from *total* deregulation of the airlines. First, there are the professional lawyers and consultants who are specialized in CAB procedures, though I presume most of them can switch over to something else without much difficulty. Second, there are those high-level airline executives who have adjusted to the present nature of the industry and might have difficulty in a more competitive environment. For example, the vice president who knows eighty-one congressmen but who is just a little uncertain as to exactly why an airplane flies may be invaluable to an airline today but will be of much less use in a more competitive environment. But these people, too, undoubtedly have talents that are transferable.

Another group that is at least apprehensive about deregulation is made up of the citizens of a number of small towns. Actually, it appears there will be few cities that will lose air service as a result of deregulation, because there are practically no cities that are now served at a loss. Nevertheless, the provisions in the new law that ensure continuing service make a number of people happy and do not cost very much.

Efficiency, Equity, and Achieving Reform

So far, we have been discussing the public choice approach to the abolition of government regulation in an area where compensation of the losers would be fairly easy. It should be pointed out, however, that complete compensation is not necessary, however preferable it might be. Even in a democracy it is possible to impose quite substantial losses on certain people if a suitable political coalition to impose those losses can be designed. Owners of American oil and gas wells have learned this in the last four or five years.

Many readers may think that they have been reading not the latest in the economic approach to political problems but (as my earlier comment on the victor and the spoils may have indicated) a discussion of pork-barrel politics from the 1830s. But just as modern economists have in many cases refined the work of Adam Smith, it is possible for us to refine earlier political doctrines. Interestingly, the public choice approach to politics has led to the realization that some of the old-fashioned techniques (spoils, pork barrels, logrolling) not only work but also can serve the public interest as well as the "corrupt interests." In fact, in many cases the latter are not particularly corrupt. Rarely are the special interest groups wholeheartedly concerned with ethics and/or with maximizing the public interest, but then neither is anyone else. In pushing for their own interests, they, on occasion, benefit society—"private vices," as the eighteenth-century philosopher had it, produce "publick benefits."

This article suggests that the various groups of people who would be hurt by a regulatory reform be compensated. Whether this is a good thing or a bad thing depends, to a large extent, on the language used. If one calls compensation "payoffs," most people would say it was bad. If one calls it, instead, paying people for rights they had but which are being taken by the government for the public interest, most people would call it good. But not much is gained by considering terminological problems of this sort.

There are in fact a number of sound arguments for compensating the people who would be injured. The first is simply that compensation tells us whether the change we are making is desirable. Suppose there is a governmental "reform" that benefits some people and injures others. We would usually regard a policy as undesirable if the total of its benefits were less than the total of the injury, and as desirable if the benefits were greater than the injury. Thus one way to find out whether the new policy is desirable is simply to pay those who are injured out of the profits of the change, and see if there is something left over. This is a purely mechanical efficiency argument brought over from economics into politics.

There are, however, other reasons for compensation. Ethically, regulatory reform in fact inflicts injury on some people in order to serve the public interest. These are generally not wicked people who are enjoying the ill-gotten gains of previous crimes but simply people who have adjusted their lives or investments to a set of government policies. Perhaps more important, as we have already said, compensation of the injured parties makes it much easier to get our reform enacted. This latter point is probably of more interest to practical men than to scholars, but the coincidence of an "efficiency" argument, an ethical argument, and an eminently practical argument, all pointing the same way, seems worth noting.

In addition to talking about actual payments to those who are actually injured, there is something to be said for providing a kind of guarantee for those who will not be injured but who worry that they will. Most people are disturbed by the prospect of a radical change in the economic circumstances they are familiar with. An elaborate argument pointing out that they will not be injured is, too often, not understood, not believed, or both. In these circumstances, a formal guarantee against injury should greatly reduce their political opposition to reform.

That, of course, is the practical reason for the kinds of guarantees that the airline regulatory reform bill offers to airline employees. There are also ethical and efficiency arguments. Ethically, it is at least undesirable that the government subject people to unnecessary trauma and worry; and, if we are seeking efficiency, surely it is desirable to raise the satisfaction of this group of people at no cost to the government: someone is benefited—although in this case the benefit is entirely psychological—and no one is injured. Thus, once again, we have a coincidence of efficiency, ethical, and practical arguments, all pointing toward the same action.

All of this may seem too good to be true. That St. Francis of Assisi, Boss Tweed, and a board composed of the last three winners of the Nobel prize in economics would all advise the same course of action is difficult to believe. But in this case it is both good *and* true. ■

(Continued from page 12)

ernment should ban the sale of products shown in any laboratory tests to have caused cancer in animals," while only 37 percent disagreed. But after Canadian tests had shown that saccharin can cause cancer in rats, a July 1977 Harris poll found almost a seven-to-one majority (82 percent to 12 percent) supporting the idea of attaching warning labels to products containing saccharin rather than banning it. A huge majority of respondents in another 1977 Harris poll implied that they believe the FDA should screen drugs on the basis of safety alone, rather than safety *and* effectiveness: 78 percent agreed and only 9 percent disagreed that "since we don't know how to cure cancer, if laetrile is harmless, people ought to be able to buy it if they want to use it." The FDA's efforts against saccharin and laetrile no doubt contributed to a 1977 Harris finding that, by a plurality of 44 percent to 39 percent, the public believes, "there is too much government regulation of consumer products, and the [FDA] is just overprotecting the public."

Polling data on the formation of a new federal consumer protection agency reflect substantial uncertainty and even ambivalence in the public's attitudes toward regulatory reform. In a February 1978 Harris poll, 58 percent favored the idea of creating the agency, with only 28 percent opposed. Among the reasons for public support of the agency was the argument, with which 67 percent agreed and 18 percent disagreed, that "the consumer will continue to be shortchanged on products and services" unless consumer advocacy in the government is improved. But at the same time, 52 percent agreed and only 29 percent disagreed that "adding another government bureaucracy, no matter how well intentioned, will lead to more red tape and spending more money, and it won't give the consumer more protection."

Conclusion. Overall, this very preliminary survey of polling results reveals considerable support for regulation, but much discontent with present performance and some ambivalence about what types of reform are needed. This ambivalence—a sense of wanting something better but wondering if it will turn out to be worthless after all—highlights the public's attitudes toward regulation.