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Toward a More General Theory of Regulation

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## COMMENT

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**T**HE economic approach to political behavior has frequently been said to imply that producers rather than consumers gain from legislation, that legislation does not promote the “general welfare” because it is “captured” by producers. As a result of the emphasis on “capture,” several studies have tried to determine when firms in an industry can act collectively to promote their interests.

Although the “capture” theory is sometimes attributed to Stigler, and he has made a few of these studies and encouraged others, he has also argued that rigid adherence to a “capture” theory is not consistent with the spirit of the economic approach.<sup>1</sup> Analytically, economics is a theory of balance, not of all-or-nothing, as implied by the “capture” of legislation. Empirically, even small but vocal minorities often have to be appeased: minority opposition is not automatically muted simply because the majority has 51 or 75 per cent of the vote. In other words, the concept of a “minimum winning coalition” advocated by Riker and others<sup>2</sup> conflicts with the economist’s view of balance at the margin.

In this important and stimulating paper, Peltzman<sup>3</sup> builds on and significantly extends these arguments of Stigler. He assumes that the aim of politicians is to maximize what he calls “votes”—he could equally well call it “wealth” or “power”—and shows that maximization implies that the votes gained from an action are balanced at the margin by those lost. He analyzes how optimal (that is, maximizing) behavior is affected by changes in different parameters, such as cost or demand conditions in a regulated industry. Therefore, he provides a way of explaining and testing the economic approach that is richer and more promising than the direction provided by the capture theory.

He explores in detail a simple model with

$$V = V(\Pi, D), \quad (1)$$

where  $V$  is the number of votes,  $\Pi$  the benefit to those favored, and  $D$  the

<sup>1</sup> George J. Stigler, *The Theory of Economic Regulation*, 2 *Bell J. Econ. & Man. Sci.* 3 (1971).

<sup>2</sup> See, for example, William A. Riker, *The Theory of Political Coalitions* (1962).

<sup>3</sup> Sam Peltzman, *Toward a More General Theory of Regulation*, 19 *J. LAW & ECON.* 211 (1976).

waste or dead weight loss, all from a particular policy. If voters are rational, and are aware of the effects of the policy,

$$\frac{\partial V}{\partial D} < 0 \quad (2)$$

since no one benefits from dead weight loss. The sign of  $\partial V/\partial \Pi$  is less clear a priori, for it is positive to those benefiting and negative to those harmed by the policy. If, however,  $D > 0$  (if there is dead weight loss) then *in equilibrium*,

$$\frac{\partial V}{\partial \Pi} > 0; \quad (3)$$

otherwise, votes could be increased by reducing  $\Pi$  since presumably  $D$  would be reduced also. Peltzman derives surprisingly many implications from this simple and attractive formulation.

It is not immediately obvious, however, why  $D$  would be positive. For example, if cash were transferred to some persons, and if cash transfers had no dead weight loss, then  $D = 0$ , and necessarily, in equilibrium,

$$\frac{\partial V}{\partial \Pi} = 0.$$

The richness of Peltzman's analyses would then largely vanish because it requires a positive dead weight loss. In the context of cash transfers to industries—and the airline, shipping, education and many other industries have all received cash transfers—his formulation would then lead to a discussion of which industries can organize effectively to obtain political power. The emphasis would be on concentration ratios, geographical dispersion, number of workers, and the like, and his formulation would be almost indistinguishable from the capture theory.

The empirical relevance of his more general formulation is based on the frequency of price controls, entry restrictions, tariffs, quotas, and other policies with obvious dead weight loss. Yet why are they used instead of cash transfers? One common answer<sup>4</sup> is that voters are fooled into underestimating the loss caused by quotas and these other policies. If so, the inequality in equation (2) and Peltzman's whole approach would be suspect.

I find it difficult to believe that most voters are systematically fooled about the effects of policies like quotas and tariffs that have persisted for a long time. I prefer instead to assume that voters have unbiased expectations, at least of policies that have persisted. They may overestimate the dead weight loss from some policies, and underestimate it from others, but on the average they have a correct perception. This assumption is consistent with the recent

<sup>4</sup> Phillip Nelson, *Political Information*, 19 J. LAW & ECON. 315 (1976).

emphasis on “rational” expectations. In the interest of brevity and a more forceful presentation of the argument to follow, I make an even stronger assumption; namely, that voters perceive correctly the gains and losses from all policies.

With this assumption and Peltzman’s formulation, one is driven to the conclusion that cash transfers are not exclusively used because they do have a dead weight loss. For example, if new firms are prevented from entering an industry in order that cash transfers only go to designated firms, the entry restrictions are a social cost; or if resources are spent to insure that cash transfers are used appropriately, these resources are social “waste.” Indeed, the statement that cash transfers were not used because it was “difficult” to use them can only mean that the dead weight loss would have been sizeable.

Consequently, if quotas are used instead of cash, the dead weight loss from cash must *exceed* that from quotas; otherwise, the number of votes would not be maximized, and could be increased by replacing the quotas by cash. Or if price supports and cash transfers are both used, the *marginal* dead weight losses from an increase in price and in the cash transfer must be equal; otherwise, votes could be increased by greater use of the socially cheaper method. In other words, with this approach, the size of the dead weight loss, not the ignorance of voters, explains when cash transfers are used.

Therefore, Peltzman’s simple model of dead weight loss and benefits to those favored by legislation need not be limited to the regulation of industries, and is equally applicable to unemployment compensation, aid to mothers with dependent children (AFDC), social security, progressive income taxation, and other policies involving cash transfers. The dead weight loss is as obvious here as in industrial regulation—for example, the AFDC program raises fertility, encourages marital instability, and discourages labor force participation. Votes would be maximized by trading off the dead weight loss and the cash transfers to recipients, and the analysis would consider how the trade off is affected by changes in various parameters—for example, how benefits or eligibility requirements for the AFDC program are affected by a secular growth in income.

This analysis of cash transfers also suggests that industries are regulated not only because political advocacy is often easier on an industrial basis, but also because industrial regulation may be a *relatively* efficient rather than inefficient way of transferring benefits to specified groups. To be sure, quotas, entry restrictions, price controls, and so forth, cause sizeable dead weight losses, but are they less, per dollar redistributed, than the dead weight losses caused by unemployment compensation, AFDC, social security, divorce laws, and other policies? Moreover, presumably actual policies tend to transfer benefits with less dead weight loss than the thousands of potential policies that never muster enough votes. Indeed, I would suggest that the traditional emphasis on the waste caused by industrial regulations

be reversed: regulations that survive the keen competition for votes tend to be *relatively* efficient ways to redistribute resources.

One final and related point: Peltzman's approach and my elaboration imply that usually the most efficient methods are used for any *given* redistribution of resources, whether to welfare mothers, petroleum refiners, or wheat producers. Economists are no more able to discover better ways to redistribute than they are able to discover better ways to produce the products of business. Although the dead weight loss from, say, the oil quota system is undeniably large, so too is the cost of frequent automobile model changes. There is not much more reason for believing that the redistribution achieved by the quotas could be accomplished more efficiently than for believing that consumer preferences for automobiles would be better satisfied with less frequent model changes.

That is to say, the methods used to accomplish any given end tend to be the most efficient available, in the public as well as the market sector, and the efficiency of methods should not be confused with the attractiveness of the ends themselves, whether they are large and fancy new cars, or government aid to particular oil firms. Although this approach leaves little room for economists to suggest improved methods in the public sector, it gives them potentially a much enhanced role in the positive analysis of the laws of operation of this sector.