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Rethinking Regulatory Capture

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Abstract
The capture theory of regulation concludes that regulatory agencies act in the interests of regulated firms rather than in the general public interest. Those benefits to regulated firms are transitory. In the long run, regulatory protections benefit legislators and regulators by making those who are regulated dependent on those who have the power to extend or terminate those regulatory protections. Regulated firms must continue to support the interests of the politicians on whose decisions their profitability depends. Ultimately, firms are captured by those who regulate them, rather than the other way around.

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The capture theory of regulation (Stigler 1971) concludes that regulatory agencies are captured by the firms they regulate and they act in the interests of those firms rather than in the general public interest.[1] This theory, while surely descriptive in many cases, is incomplete because it does not explain why legislators would approve regulatory institutions that serve to further the interest of the regulated. Some insight on this question comes from recognizing that the benefit from such regulation is transitory and erodes as the present value of future benefits is capitalized into assets owned by those who are regulated (Tullock 1975). The result is that regulated firms become dependent on the continuation of their regulatory protections, which allows legislators to extract payments from them to allow regulatory protections to continue (McChesney 1987, 1997; Schweizer 2012).

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[1] This conclusion is also reached by Kolko (1963), whose work predates Stigler's, and Rothbard (2017), among others. See Posner (1974) for a discussion of this theory contrasted with the public-interest and interest-group theories of regulation.

The capture theory, standing alone, makes politicians and regulators appear to be lured into creating and enforcing regulations that favor those who are regulated. A more reasonable way to view their behavior is that legislators and regulators create regulations that work in their own interests, and regulatory protections can do this by making those who are regulated continually dependent on the politicians and regulators who have the power to extend or terminate those regulatory protections. Those who are regulated receive a transitory benefit from the protection but, into the indefinite future, must continue to support the interests of the politicians on whose decisions their profitability depends.

I. The Demand for Regulation

The only reason to have regulations is either to require people to do things they otherwise would choose not to do or to prohibit people from doing things they otherwise would choose to do. The demand for regulation can originate from many different sources. The public-interest theory of regulation rests on the idea that in some situations people will choose actions that are not in the public interest, so they should either be required to act in the public interest or be prohibited from acting in ways contrary to the public interest. In this view, regulation guides people to act in the public interest. In keeping with the capture theory of regulation, firms might ask for regulations that further their own interests. Stigler (1971, p. 5) says, "Every industry or occupation that has enough political power to utilize the state will seek to control entry. In addition, the regulatory policy will often be so fashioned as to retard the growth of new firms." Firms seek regulations that provide differential advantages for themselves and that impose costs on their rivals. A third group that may demand regulation is legislators, who, as Schweizer (2013) explains, can extract payment from firms and industries that might be regulated in exchange for supporting regulation favorable to them or impeding regulations that might be harmful to them.

Often, as Yandle (1983) notes, regulation is supported from multiple sources. In his example of the bootleggers and Baptists who supported alcohol prohibition, the Baptists supported prohibition because they believed it was in the public interest, while the bootleggers supported prohibition because their incomes were generated from providing illegal alcoholic beverages. From his work as a regulator, Yandle saw that model as a general phenomenon. A clear example is the mandate that motor fuels contain ethanol. The public-interest arguments have been that ethanol is more environmentally friendly than petroleum and that domestic production of ethanol lessens dependence on foreign oil. Meanwhile, corn farmers and processors who produce most ethanol favor the mandate because it increases the demand for their products.

II. The Process of Regulatory Capture

The capture theory of regulation concludes that regulatory agencies are captured by those they regulate, so regulations further the interests of those who are regulated rather than the public interest. Ultimately, regulation balances the political pressures exerted by the various demanders of regulation, as Becker (1983) hypothesizes, so nobody is likely to get everything they demand. Despite an element of compromise, the regulatory process does favor the interests of those who are regulated over the general public interest for a number of reasons. One is that political processes tend to favor more concentrated interests over those that are less concentrated, as Olson (1965) argues. Small amounts transferred from each member of a large group to be divided among members of a small group mean the payoff to each member of the small group is much larger than the cost imposed on any member of the large group. With the ethanol mandate, for example, each purchaser of motor fuel pays a small amount to ethanol interests every time they buy motor fuel, resulting in much larger payoffs for each ethanol producer.

The differential payoffs cause most people to be rationally ignorant of any regulatory details, following Downs (1957). Most people have little incentive to be informed about the regulatory process because they have relatively little at stake, whereas the regulated firms have much at stake and so have an incentive to be informed and to engage regulators to try to influence their policies. Add to this a revolving door in which people who work for regulatory agencies tend to move to jobs in the industries they once regulated and people who work in regulated industries tend to move to jobs at regulatory agencies, and the information and incentives on both sides lead to regulated firms' disproportionately large influence over the regulations they face.

Regulated firms also have an advantage in their knowledge about the operation of their own businesses. The general public will be largely ignorant of the specifics, and the regulators will tend to get information about the firms they regulate from the firms themselves. These aspects of the regulatory process have been generally recognized and lay the foundation for the capture theory of regulation.

III. The Missing Element: The Incentives of Regulators

The element that has been most conspicuously absent from the literature on regulatory capture is the interests of those who create the regulations. One can understand why regulated firms would want regulation that favors their interests, but this does not explain why legislatures and regulatory agencies would create such regulations. Setting aside the (unlikely) possibility that they are duped time after time, Holcombe (2017) notes that regulations must benefit those who created them, or they would not have been created. Regulations are the result of a negotiating process between those who create them and those who are covered by them.

Wagner (2016) concludes that public policy determination tends to involve three parties: the parties that negotiate for their own advantages, and a third party that bears the costs of the bargains struck by the other two. In this case, bargains are struck between regulated firms and those in government—legislators and regulators—and the third party that bears the cost is the general public, which tends to be rationally ignorant.

Regulated firms seek regulation that creates barriers to entry for rivals, subsidies, tax breaks, guaranteed prices for their outputs, cartelization of incumbent firms, and more. The literature on regulatory capture has recognized these regulatory benefits. In return, legislators get campaign contributions, political support, and other benefits, as Schweizer (2013) documents. A complete capture theory of regulation must recognize not only the benefits of this political exchange to regulated firms but also the benefits to those who create the regulations.

IV. The Dynamics of Regulatory Capture

Regulatory benefits can be limited by applying regulations to specific firms or industries. Those within the regulated group get the benefits, shifting the costs to others. A good example is farm price supports, which guarantee farmers above-market prices for their products.[2] The benefit from the supports goes only to those who own farmland. Similarly, New York City regulates the number of taxis on its streets

[2] This simplifies government programs that aid farmers, sometimes through guaranteed purchases, sometimes through acreage allotments that restrict how much can be grown, and sometimes by paying owners of farmland to not grow anything on their land. The simplification does not alter the overall example since to benefit from these programs requires the ownership of farmland. Indeed, for some programs, owners of specific parcels qualify while owners of similar farmland do not.

by requiring that all taxis own medallions and display them on their hoods, and the number of medallions is limited, creating a barrier to entry. As Tullock (1975) says, the benefits from these regulations go only to those who own specific types of capital—in these examples, farmland and taxi medallions. That creates a barrier to entry.

Legislators do not simply legislate regulations to benefit regulated firms, and regulatory agencies do not simply favor those firms. Those regulations are created through a bargaining process that benefits legislators in exchange for providing regulatory benefits to firms. The exchange process must benefit both parties for the exchange to take place. Weingast and Moran (1983) provide evidence that such exchanges do take place. They find that Federal Trade Commission actions systematically favor the policy preferences of legislators who are on regulatory oversight committees.

After the regulatory bargaining, Tullock (1975) notes, the expected present value of the regulatory benefits becomes capitalized in the value of the assets required to gain the regulatory benefits. The expected present value of farm price supports raises the value of farmland, so the future rents from the regulation are capitalized in the value of the land. After entry into the New York taxi market is restricted by the medallion requirement, the future rents that flow to taxi operators are capitalized in the value of the medallions. The result is that those who are protected by the regulations ultimately receive only a normal market rate of return.

The regulation produces a transitory gain, which ends up being dissipated as the benefit becomes capitalized into the asset required to get those rents. As Krueger (1974) notes, resources may be inefficiently invested to obtain the capital required to obtain rents, and Dawson (2021) provides empirical evidence of inefficiency because regulation alters the mix of inputs used by firms. The rent from regulatory capture provides a temporary increase in firm profit that dissipates as it becomes capitalized in the regulated firm's assets.

While the benefit from regulatory capture dissipates over time, if the regulation were to be eliminated, those protected by the regulation would suffer a capital loss. If farm price supports were repealed, the value of farmland would fall, and if the regulation requiring taxis to have medallions were repealed, those who own medallions would suffer a capital loss.[3] Regulated firms become dependent on the regulations that protect them.

This dependency means that the legislators and regulators who create the regulatory environment have the ability to extract payment from those who are regulated by threatening to eliminate the regulatory protections if those who are regulated do not pay up. McChesney (1987, 1997) calls this rent extraction. Schweizer (2013) is more blunt and refers to this as extortion. Legislators have the upper hand in this process. If regulated firms do not pay up, legislators can eliminate regulatory protections and move on to other victims. An occasional show of force can demonstrate the threat that regulated firms face if they do not compensate those who maintain the regulatory protections. The regulated firms themselves face losses and possible bankruptcy if they do not continue to pay.

Schweizer (2013) gives examples of the lobbying process, noting that many observers liken lobbying to bribery: lobbyists bribe legislators to get regulatory benefits. Schweizer says the process is more like extortion than bribery. He notes a fine line between bribery and extortion but says that it is common for legislators to hold up legislation favorable to firms and industries unless payment is made and that legislators often will threaten to impose costly regulations on firms with the expectation that those firms will pay up to avoid having costs imposed on them.

The standard concept of regulatory capture misrepresents who is actually captured. Regulated firms can receive a transitory gain from protective regulation, but that gain dissipates over time and regulated firms become dependent on the regulation for their profits. As a result, they must continue to pay those on whom the continuation of the regulation depends, or they risk losing their regulatory protections. Ultimately, it is the legislature and regulators who capture the regulated firms, rather than the other way around.

V. An Example: Electric-Utility Regulation

The primary reason economists give for regulating electric utilities is that the production and distribution of electricity is a natural monopoly. Larger firms have cost advantages that allow them to underprice smaller rivals and put them out of business, until eventually

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[3] The argument here applies to new entrants, but the same idea holds for the original owners of farmland and medallions. They could sell their land or their medallions to realize the capital gain due to regulation, so they too receive only a normal rate of return on their now more highly valued asset.

only one firm remains. Thus, regulation is in the public interest. In fact, this process is not descriptive of the way that utility regulation emerged. Jarrell (1978) describes the history of electric-utility regulation to show that in the early twentieth century the industry was very competitive, with many electric utilities coexisting in large cities. In fact, the utilities themselves approached their state governments and, complaining about ruinous competition, asked to be allowed to combine and be run as a monopoly under state regulation.

Electric utilities were not entirely free of regulation prior to a major wave of state regulation from 1907 to 1914. States granted charters for electric utilities to operate, whereas municipalities granted franchises that allowed utilities to access public rights-of-way to run their transmission wires. But, as Jarrell (1978, p. 273) notes, "municipal regulators fostered excessively competitive conditions with their profligate franchise-granting activities. . . . All municipalities issued many blatantly duplicative franchises." The result was a very competitive market, which Jarrell concludes kept prices for consumers low.

Jarrell (1978, p. 293) notes that when state regulation of electric utilities began in New York and Wisconsin in 1907, "some public utilities campaigned vigorously to head off state regulation. . . . this early hostility from some private utilities gave way to widespread support for state regulation so that, by 1912, just before the wave of enabling legislation, utilities were the main champions of the movement." Following Yandle's (1983) bootleggers-and-Baptists story, the move to regulate electric utilities began with a public-interest view toward protecting consumers and evolved into a move to allow competing utilities to consolidate and monopolize the supply of electricity. The electric utility that serves New York City is Consolidated Edison. Consolidated out of what? The many competing electric utilities that were in that market prior to being allowed to consolidate.

The natural-monopoly theory of electric-utility regulation does not correspond with the facts. Competing utilities were allowed to consolidate into monopolies that were guaranteed a rate of return on their capital. Jarrell's (1978, p. 293) empirical work points toward the conclusion "that state regulation of electric utilities was primarily a pro-producer policy. . . . Consistent with the proproducer interpretation, prices and profits rose (between 1912 and 1917) upon the establishment of state commissions in early-regulated states." Electric-utility regulation allowed a competitive industry to become monopolized with government-enforced barriers to entry. Electric-utility rates and profitability are controlled by state public service commissions.

That history, consistent with the capture theory of regulation, only tells the beginning of the story. Electric utilities are now dependent on state legislators and regulators for their continued profitability. Utilities receive a state-determined rate of return on their capital, but both the rate they receive and what constitutes capital on which they can earn a return are subject to negotiation (Averch and Johnson 1962), and, perhaps more significantly, utilities are looking to the state for continuing barriers to entry that bar competitors.[4] The regulated utilities have been captured by the governments that regulate them.

VI. An Example: The Civil Aeronautics Board

The Civil Aeronautics Board, created in 1938, regulated commercial airline routes and rates. An airline was required to get permission from the board to fly routes and was required to get permission to change its airfares. The board would grant permission to fly a route only if the applying airline could show that there was a need for additional capacity on that route. Airlines already flying a route would maintain excess capacity to keep out competitors, as Tullock (1975) notes. If a competitor applied to duplicate an airline's route, the airline flying that route would demonstrate that there was already sufficient capacity on that route. Readers of a certain vintage will recall that during the Civil Aeronautics Board era it was rare indeed for flights to be sold out.

The excess capacity in the industry was the result of the incentives embodied in the regulations that required airlines to show a need for additional service to add a route. Incumbent airlines had the incentive to fly with empty seats to demonstrate that there was no need for additional capacity on their routes. That excess capacity in the industry was one factor that led to higher costs in the industry, along with other factors related to regulatory incentives.[5]

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[4] This need not mean opening the market to competing utilities. Wood-processing plants can generate electricity by burning scrap, which could then be sold back to the grid, and increasingly, businesses with their own solar panels want to sell back to the grid when they are generating more electricity than they are using.

[5] For example, airlines were quick to settle disputes with unionized pilots to avoid service disruptions from strikes. They were able to pass higher costs on to passengers by asking for fare increases. Regulated fares also allowed them to frequently upgrade equipment to make their airlines look good when compared to their competition, and meals were served on all but the shortest flights.

Along the same lines, the Civil Aeronautics Board would routinely grant airlines permission to raise their fares but not to lower them. The board kept airfares high and restricted the routes that airlines were allowed to fly. Cartels are groups of firms that conspire to act like a monopoly by restricting output to charge higher prices, but cartel agreements are difficult to enforce because with higher prices, individual firms want to sell more, not less, so cartels tend to break down. The board provided government enforcement for the airline cartel by mandating higher prices and restricted output.

The Civil Aeronautics Board fits the theory of regulatory capture well, furthering the interests of the regulated firms over the interests of the consumers those firms served, but again, that is only part of the story. Those airlines were then dependent on the regulatory protections of the state for their profitability.

The Civil Aeronautics Board provides an especially interesting example because its regulatory authority over rates and routes was repealed by the Airline Deregulation Act of 1978 and the agency was disbanded in 1985. Much credit for airline deregulation goes to Alfred Kahn, an adviser to President Jimmy Carter who urged airline deregulation. However, interest group theory (Olson 1965) suggests that a concentrated interest such as the airline industry should be able to continue to maintain regulation in its favor over the diffused interests of airline passengers. One factor that undermined the airlines' hold on the regulatory process was that Ted Kennedy, a powerful senator from Massachusetts, was won over on the merits of deregulation.

Kennedy noted that airfares from Boston to Washington, DC, were significantly higher than from San Francisco to Los Angeles—flights of similar distances. One difference was that the Civil Aeronautics Board regulated interstate commerce, so flights from Boston to Washington were regulated, but not intrastate commerce, so the board had no authority over flights from San Francisco to Los Angeles. Kennedy perceived the higher airfares his constituents were paying, not just on that route but on all routes, and favored deregulation to lower airfares for his constituents. Many factors were at work to lead to airline deregulation, and the political influence of a powerful senator was one of them.

The deregulation of airlines illustrates the dependence that those who are regulated have on the continuation of regulation. As Tullock (1975) notes, there is a transitional gain when the regulation begins, but the gain is dissipated over time, and if the regulation is terminated, those who are regulated will suffer transitional losses. As the capture theory would predict, after airline deregulation, airfares fell, resulting in an increase in the demand for air travel. Even as the industry expanded, many of the firms that had been protected by the regulation failed. For decades, a stable group of airlines had been protected by the board—Braniff, Trans World Airlines, Eastern Airlines, Continental Airlines, and others—but suffered transitional losses and went out of business as a result of deregulation.

On the surface, it appears that those who are regulated capture the agencies that regulate them, but recognizing the dependence regulated firms have on continuing regulation, over time regulated firms increasingly become captured by the regulatory agencies and legislatures that they depend on for continued regulatory protection. Regulated firms must continue to maintain the favor of those who control the regulatory process, allowing regulators and legislators to engage in what McChesney (1987, 1997) calls rent extraction. Those firms must continue to pay up or suffer the same fate the airlines did when they lost their regulatory protection.

VII. Implications

A number of broader implications can be drawn from this more nuanced view of regulatory capture. As the regulatory state expands, the profitability of firms becomes increasingly dependent on political connections rather than on creating value for consumers, as Holcombe (2018) describes. The developing relationship between regulated interests and the legislators that support them leads toward what Olson (1982) calls the decline of nations. As Benson (2004) explains, resources that are devoted to rent seeking have an unobserved opportunity cost: they could have been productively employed elsewhere. The regulatory process pushes businesses to focus their entrepreneurial activities more on maintaining their political connections and less on bringing innovations to market.

This cooperation of political and economic actors for their mutual benefit sheds light not only on government's expanding regulatory activities but also on the more general increasing scope of government. As Tullock (1975) notes, regulatory protections for businesses, once put in place, are difficult to repeal, so new regulations continue to be adopted, adding to the size of the regulatory state. The growth of the regulatory state does not replace private sector activity with public sector activity but rather is a cooperative endeavor that leaves private sector firms intact, although increasingly dependent on political connections for their survival. A similar phenomenon exists with the budgetary state. In many cases, government does not nationalize private firms but rather, through government contracting, becomes the customer of those firms. Those firms then become dependent on government contracts, and in exchange they support the political elite on whom they depend for their continued profitability.

Proponents of free markets, at least as far back as Hayek (1944) and Schumpeter (1947), have depicted socialism as the looming threat to capitalism. Meanwhile, capitalism is being eroded from within by an expanding regulatory state that increasingly makes business profitability dependent on political connections. By focusing on the threat of socialism, capitalism's proponents are distracted from seeing that the more imminent threat to capitalism is this cronyism. Capitalists themselves, through their rent-seeking actions to capture the regulatory process, undermine capitalist institutions. Market capitalism become displaced by political capitalism.

VIII. Conclusion

The capture theory, as generally understood, goes only partway toward describing the regulatory process. It is naive to think that legislators would approve regulations and that regulators would enforce them unless there was some benefit to the creators and enforcers of regulation. The reason those regulations are put in place to begin with is that the legislators who approve them are able to leverage them in the future to extract benefits for themselves from those who are regulated. Initially, regulation can create a transitional gain to those who are regulated, but that gain dissipates over time. Ultimately the regulators capture those they regulate, rather than the other way around. Those they regulate become dependent on the continuation of those regulations and must continue to pay off the politicians or risk losing their regulatory advantages.

In exchange for regulatory protection, firms have an ongoing debt to the legislators who maintain the legislation that protects them. There is a political exchange in which legislators continue regulatory protections and in return the regulated firms contribute campaign contributions, political support, and other benefits to legislators, as Schweizer (2013) describes.

The building blocks for this revised theory of regulatory capture, which have been in the academic literature for decades, produce a clearer vision of regulatory capture when combined. Stigler (1971) proposed the capture theory without discussing the advantage of regulatory capture to the regulators. Tullock (1975) noted the existence of transitional gains but attributed them to errors on the part of policy makers rather than recognizing the advantages policy makers could gain by creating them. McChesney (1987, 1997) described the process of rent extraction but did not link it to the transitional gains created by the regulatory process. Linking these insightful ideas provides even greater insight into the regulatory process.

Formaini (1999) makes an argument that in light of the complexity of economic systems, regulators should be given discretion in their actions, but this recommendation ignores the incentives regulators and legislators have to use the regulatory process to their advantage. Shughart and McChesney (2010) note the influence of special interests over the regulatory process, and Weingast and Moran (1983) show that regulators tend to yield to legislative demands when designing regulations. Regulatory discretion leads to regulations that benefit narrow interests.

Stigler's (1971) capture theory of regulation depicts regulators as acting in the interests of those they regulate, but this is misleading because it tells only half the story. The gain to those who are regulated is transitory, as Tullock (1975) notes, but regulation makes regulated firms dependent on continued regulatory protection for their survival. That ongoing dependence enables legislators to continually extract rents from those who are regulated. Ultimately, it is the regulated firms that are captured, not the regulators.

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