2 Capture theory and antitrust

The basic tenets and insights of public choice

Public choice theory contributes to social science research and policy analysis with some straightforward, profound tenets. First, public choice applies economic theory to collective action, primarily government and politics. Second, public choices are made when A's decision is also a decision for B, and/or vice versa. Third, as is typical in economics, public choice theorists argue that people are self-interested in all choices, including public choices. Fourth, while retaining neoclassical economic tenets of individual welfare maximization in the analysis of public choices, public choice derives far different hypotheses than otherwise. Public choice begins with the neoclassical axiom of subjective individual wealth maximization, but it departs from the neoclassical tradition by endogenizing government or, more generally, collective action, as a means to increase or decrease wealth. Hence, what remains is a rivalrous or even a dichotomous means for achieving well-being.[8]

[8] This summary paragraph was adapted from a pair of email messages by Edward Lopez (August 28th and September 4th 1996) in which he summarizes public choice. Ed completed his public choice related dissertation at George Mason University in 1997.

Building on these tenets, the major public choice insight became *the logic of concentrated benefits and dispersed costs*, which demonstrates the conflict between good politics and good economics. Thus, the myopic bias in policy making is highlighted. Policy makers prefer short term and easily identifiable benefits at the expense of long term and largely hidden benefits. They also prefer costs that are long term and/or not easy to identify, e.g., deficit finance, inflation, "takings," etc.).

Mitchell and Simmons point out that government regulation is not all that it is cracked up to be by mainstream social scientists, planners, and policy analysts. They contend that free markets are the best means to attain socially-beneficial ends.

> [W]elfare economists see government as merely a means to achieving the normal ends of consumption and utility maximization. That is, it facilitates the allocation of resources desired by consumers…The solution to these perceived ills [caused by corporate manipulations and "incorrect" values generated by the market against the common interest]…is the expansion of government… [However], government is not the frictionless plug welfare economists blindly propose as a means of stopping the losses caused by markets…Instead of being "government by the people," politics is often an intense competition for power to benefit particularized interests at the cost of wider society. Instead of politics ennobling participants, it promotes myth making, suppression and distortion of information, stimulation of hatred, and legitimation of envy…The solution from the Left and the Right is straightforward—elect, appoint, or hire honest, well-trained people and government will function smoothly, efficiently, and fairly. Our analysis is entirely different. It exposes the problems of government as be-

> ing far greater than those that might be caused by incompetent or grasping political actors. A government and polity composed entirely of saints would produce results approximating those we currently get from admittedly imperfect political participants. These problems will continue unless the rules of the game are changed… Recognizing the failures of government to promote widely shared values must be accompanied by a renewed acceptance of markets, property rights, and prices (Mitchell and Simmons 1994, pp. 211, 212, 213).

Public choice analysis of monopoly and antitrust

Public choice insights naturally led to a new understanding of monopoly creation. Tollison and Wagner argue that monopoly can be either "accidental" or "intentional," although they mainly use the former as a heuristic contrivance. They suggest that most (if not all) monopoly is "something that people seek intentionally, as through investing in legislative favors" (Tollison and Wagner 1991, p. 58) Indeed, beginning with Tullock, economists have treated monopoly as intentional, "in that it results from people trying to acquire monopoly positions" (Tollison and Wagner 1991, p. 61) via rent seeking.

Tollison argues that antitrust theory has a weak foundation because it "rests on the public interest theory of government" and "judges and antitrust bureaucrats are assumed to operate in the public interest" (Tollison 1985, p. 905). In order to correct this deficiency, he tries to "achieve a positive understanding about how antitrust decision makers behave" (Tollison 1985, p. 906). In the end, he embraces a very different perspective than policy scholars and planning models traditionally provided. Tollison describes the impact of public choice in policy research.

> "Public choice" refers to a revolution in the way government is analyzed. Before public choice, government was treated as exogenous to the economy, a benign corrector of the market economy when it faltered. After public choice, the role of government in the economy became something to be explained, not assumed. As a result of the public choice revolution, economists now place government failure alongside market failure as a useful category of analysis. What is public choice? I advance my own particular answer to the question. Public choice is an expansion of the explanatory domain of economic theory. Traditional economic analysis uses the apparatus of economic theory to explain the behavior of individuals in private settings. Public choice represents the use of standard economic tools (demand and supply) to explain behavior in nonmarket environments, such as government. This expansion of economic theory is based on a simple idea. Individuals are the same people whether they are behaving in a market or nonmarket context (Tollison 1985, p. 906).

The hypothesis is simply that individuals promote their self-interest in all environments or circumstances. Thus, the idea that markets are guided by private interest while government is guided by public interest is merely a fantasy (Tollison 1985, p. 907).

Table 2.1 Monopoly problems

Monopoly power arises by two means:
(a) *accidentally* or from market failures, and/or
(b) *intentionally* or from government failures.
Monopoly can be either short term (normal and beneficial) or long term (abnormal and damaging)

With respect to antitrust cases, Tollison wondered why antitrust bureaucrats repeatedly prosecute the same firms

(about 25% of all antitrust action is for repeat offenses). Perhaps the bureaucrats are minimizing costs, or maybe offenders find it worthwhile to violate repeatedly. He noted that in studying the organizational behavior of antitrust branches of the U.S. government, Katzman found "that the desire to gain trial experience biases FTC lawyers toward shorter and less complicated initiatives as opposed to the FTC economists" who want longer and more complex ones (Tollison 1985, p. 909).[9] Thus an incentive existed to prefer repeat prosecution. Tollison went on to cite other evidence that antitrust enforcement has little nexus with the traditional economic conception of social welfare. In fact, there is evidence "that antitrust is at least partly a veil over a wealth-transfer process fueled by certain relevant interest groups" (Tollison 1985, p. 910, 911).

Antitrust policy is usually rational, inasmuch as it can purposefully provide a buffer against losses when demand for a firm's products falls. Indeed, it is rational because it can also be used as a means for interest groups to benefit. Given that the apparatus of the political process makes benefits available, it is rational that cost minimizing economic actors will seek to use those means to enhance profit maximization. Quite often, doing so is best facilitated by directing regulation with the organizational efficacy and efficiency of special interest groups.

Capture theory

Given the economic incentives available to producers, it is likely that they will form interest group coalitions to "use the apparatus of public regulation for their own gain" (Shughart 1990, p. 38). By concentrating benefits into spe-

[9] Citing R. A. Katzman (1980), *Regulatory Bureaucracy: The Federal Trade Commission and Antitrust Policy*, MIT Press: Cambridge, Massachusetts.

cial interest groups that seek beneficial regulation, while dispersing the costs of the regulation over a wide range of consumers or taxpayers, they are able to direct the regulatory process. Such analysis falls under the public choice classification known as "capture theory." Shughart summarizes some of the benefits available.

> As a result of its lobbying advantage, industry can therefore often successfully use the political process to secure for itself such regulatory favors as direct cash subsidies, control over the entry of new rivals, restrictions on the outputs and prices of complimentary and substitute goods, and the legitimization of price-fixing schemes (Shughart 1990, p. 38).

With the romanticized view of the state destroyed by Buchanan and Tullock, economists in the Chicago School, notably George Stigler and Sam Peltzman, began to develop congruent theories of regulation that matched the new view of political actors. As Stigler argued, policies can be recognized as originating to benefit private interest groups, perverting any public interest origins since the policy-makers have been captured by politically proficient groups. At its origins, it is plausible that economic regulation was sought by firms in order to use the political process to increase profits, while passing the costs to taxpayers and consumers. But in contemporary society, policy-makers are aware of the advantages of managing, selling, and distributing political favors. Thus, they too can use regulation for political gains. Mitchell and Simmons point out that reform movements may simply be means for legislatures to reload discharged favors, and thus benefit politicians who are able to provide more goodies and so attract industrial customers.

> The enactment of [tax] rate reductions, elimination of loopholes, and simplification of rate schedules in fact support our analysis. Congressional politicians have in effect wiped the slate clean so that they may once more "auction" off tax exemptions and other privileges. (Mitchell and Simmons 1994, p.58)

A simple capture is costless to political actors in the sense that it merely requires a policy maker to grant political favors, as if with a stroke of his magic wand. Peltzman improved capture theory by modeling the tradeoffs legislators face between gains in political support (from granting favors) and losses in political support (from explicitly or implicitly taxing other groups). A crucial implication is that the losing groups are not taxed as much as the winning groups would like (i.e., as would maximize their political profits)."[10]

Table 2.2 Means of regulatory capture

Two means of capturing regulators:
(1) Suggest and create a *new* committee which favors a firm or industry, or
(2) Influence or buy (even bribe) a current committee in order to achieve the same thing.

Chicago work in regulatory theory

Stigler argued that "regulation is acquired by the industry and is designed and operated primarily for its benefit" (Stigler 1971, p. 1). In fact, regulation may be viewed as either a resource or a threat to any industry. It may provide defense against both market forces and harmful rent seeking activi-

[10] Some of these ideas adapted from Edward Lopez, supra.

ties by other actors, or offense against a firm's present or potential competitors. Stigler noted four particular policies which are sought by industries or firms.

- Cash subsidies for itself or complimentary industries.
- The erection of barriers to entry against rivals.
- The suppression of substitutes for its own products.
- Price fixing — e.g., preventing payments for special services or price controls to foster higher than competitive returns.

However, Stigler also noted three elements of the political process which limit the effectiveness of industries or firms in seeking these things.

- Dispersion of political power in the market, notably small firms in regulated industries have more political power than they otherwise would.
- Bureaucratic red tape makes such actions costly and time consuming.
- Powerful outside interests have a say in the policy process.

Stigler comments, "The industry which seeks political power must go to the appropriate seller, the political party…[which] has costs of operation…The industry which seeks regulation must be prepared to pay with the two things a party needs: votes and resources" (Stigler 1971, p. 12).

Stigler later considered the political benefits available from industrial interest groups, as Tollison summarizes:

> Stigler suggested that an asymmetry of firm sizes, products, and interests in a "industry" tends to promote more effective collective action by the industry (e.g., a larger

> association budget). He argued that participation is mandated by the desire to protect specialized industry interests (Tollison 1988, p. 342).[11]

Peltzman built on Stigler's premise, noting that his theory may be used to determine broadly "the optimum size of political coalitions" and highlighting the fact that a small group with a large per capita stake will dominate large groups with diffused interests (Peltzman 1976, p. 212). He concludes:

> The central question for the theory then becomes to explain this regularity of small group dominance in the regulatory process (and indeed in the political process generally). The way the question is posed already foreshadows one of the results of the theory. For in Stigler's model, unlike most market models, there are many bidders, but only one is successful. There is essentially a political auction in which the high bidder receives the right to tax the wealth of everyone else, and the theory seeks to discover why the successful bidder is a numerically compact group. The answer lies essentially in the relationship of group size to the costs of using the political process (Peltzman 1976, p. 213).

Peltzman went on to create a formal mathematical model of regulation (building on Stigler's basic model), in which he shows that the "supply-demand apparatus can be converted into a constraint on regulatory behavior" (Peltzman 1976, p. 240). Some of his more significant implications include: (1) regulation being weighted toward consumers during expansions and producers during depressions, (2) that pro-

[11] Citing George J. Stigler (1974), "Free Riders and Collective Action: An Appendix to Theories of Economic Regulation," *Bell Journal of Economics and Management Science*, Vol. 5, p. 359.

ducer protection will lead to consumer protection over time, (3) that profitable regulated firms will tend to have the lowest prices, (4) that regulation reduces systematic and diversifiable risk, and (5) that regulators have an incentive to limit entry by restricting new firms who would cater to low-cost customers but to be more tolerant of new firms who will tend to suppress differences in the elasticity of demand (Peltzman 1976, pp. 226-232, 235-239).

Antitrust origins

Stigler argues that a political market exists for regulatory action (Stigler 1975, pp. x, xi). According to public choice theory, firms have an incentive to capture their regulators. Indeed, historically, regulation has its roots in private industry rather than the efforts of shrewd legislators (High 1991, p. 1). Hence, it is plausible that rent seeking produces regulation in order to promote private interests at taxpayer expense (High 1991, p. 2). There is evidence that certain businesses benefited from regulation last century, strategically using public policy to capture regulators and thus retain considerable control over the regulatory process (High 1991, pp. 6-8). As Tollison notes, the costs of regulation become a mechanism for driving out marginal competitors (High 1991, pp. 10, 17 — quoting Tollison).

Subsequently, economists began to analyze the origins of antitrust theory apart from the romanticized, public interest theory of government. In the United States, federal antitrust began with the Sherman Act in 1890. In an important historical survey, Thomas DiLorenzo provides evidence that the Sherman Act may not have been in the public interest. The antitrust laws served private interests and were antithetical to competition and economic efficiency. In fact,

these laws were a major source of monopoly power (DiLorenzo 1985, pp. 73-74).

The trusts under political scrutiny when the Sherman Act was imposed were from industries that "were expanding much faster than the economy as a whole, a phenomenon that has been overlooked by those who adhere to the standard account of the origins of antitrust" (DiLorenzo 1985, p. 80). It seems that some pertinent data have been missed or ignored. Some congressmen who knew the Act was not in the public interest supported it anyway out of fear of "political backlash." The public interest angle was merely a ruse of public policy.

Actually, businesses seem to have benefited from antitrust laws over time, which have served to protect them from competition more than prohibiting monopoly (DiLorenzo 1985, p. 81). Indeed, "it was government regulation itself that was the source of monopoly power" but "the average voter has little or no financial incentive to discover the true costs of protectionism" given the logic of concentrated benefits and dispersed costs (DiLorenzo 1985, p. 82). Even the *New York Times*, which had been a supporter of antitrust legislation initially, changed its mind after considering the Sherman bill's proponents. "It is not unlikely that the Sherman Act was passed to help draw public attention away from the actual process of monopolization in the economy [via government privilege], among the major beneficiaries of which have always been the legislators themselves" (DiLorenzo 1985, p. 83). In summarizing his study, DiLorenzo notes:

> It is held as an article of faith by most economists that the Sherman Antitrust Act is a guarantor of competitive markets. Even though it is now widely held that the enforcement of the Sherman Act over the past 95 years has probably reduced industrial competitiveness, there is

faith that the original intent of the Sherman Act was to promote competition in an increasingly monopolized economy. The evidence, however, indicates otherwise. The trusts of the late nineteenth century caused output to expand even faster than the rest of the economy—in some cases more than ten times faster for decades at a time. As a result, prices in the allegedly monopolized industries were *falling*. This was even acknowledged by the critics of the trusts in Congress, who complained that falling prices drove less efficient "honest men" out of business. There was relatively little enforcement of the Sherman Act for at least ten years after it was passed, but it did serve to immediately divert attention from a more certain source of monopoly, tariffs, which were sharply increased just three months after passage of the Sherman Act by a bill sponsored by Senator Sherman himself. Interestingly, the great majority of economists of the day viewed competition as a dynamic process and thought that mergers (formal or informal) facilitated social coordination. There was no substantial support among economists for the Sherman Act, even from the most severe critics of *laissez-faire* such as Richard T. Ely…Even though modern economics embodies an "efficiency" rationale for the Sherman Act, that rationale was never used to make a case for the original enactment of the law. Rather, it was constructed, *ex post*, as a rationalization for a law that already existed. Moreover, it appears that the efficiency rationale for antitrust has often been used by legislators as a justification for protectionist policies. Legislators have always had incentives to enact protectionist legislation, and the economics of antitrust has sometimes provided intellectual support for these objectives (DiLorenzo 1985, p. 87).

While the historical evidence of falling prices and rising output does not necessarily conclude (on account of the possibility of strong positive demand and supply shifts) that there was no monopoly power among the trusts prior to the Sherman Act, it is surely strong corroborating evidence. Classifying the Act as a public choice phenomena enacted to benefit private interests at public expense must certainly be a credible judgment.

DiLorenzo and High further extended this thesis by suggesting that acceptance of the perfect competition model actually drove acceptance of Sherman by twentieth century economists. Most economists around the time of the Act were opposed to it. They believed that the existence of profits would automatically limit monopoly durability and so legislation was unnecessary. However, those economists held a view of rivalrous competition, similar to the Austrian conception of rivalry, rather than the form found in static competitive models. Using such perfect competition models, standard monopoly power can be found in most industries. Austrian economists have long been keen to repeal the Sherman Act, especially in light of their view of analyzing competition as dynamic rivalry rather than pinpointing properties of equilibrium in a static model (DiLorenzo and High 1988, pp. 424, 425). As noted in chapter one, ideas have a powerful influence over economists and policymakers, as well as social phenomenon, over time. Thus, the widespread acceptance of modern antitrust laws have much to do with the acceptance of static ideas about competition. This change in economic theory has caused a dramatic change in policy analysis in the last century. Economists at the time of Sherman were "doubtful of the necessity of antitrust laws" and "objected to trust-busting," recognizing the efficiency value of the process of competition (DiLorenzo and High 1988, pp. 428, 429). But this thinking was abandoned later in the twentieth century.

> Once perfect competition was accepted as the idea benchmark, economists concluded that most markets were inherently monopolistic. It was not that markets themselves had become less competitive, it was that the *idea* of competition had changed. This logically led to endorsement of antitrust law as a cure (DiLorenzo and High 1988, p. 431).

DiLorenzo and High conclude that the perfectly competitive model has misled the economics profession, at least in terms of antitrust policy. They suggest that competition as rivalry, held by both nineteenth century economists and modern Austrian economists, provides a better understanding of competition (DiLorenzo and High 1988, pp. 433, 432).

Shughart has also investigated the antitrust statutes and disputes the notion that they were "a public-spirited effort on the part of their framers to limit the extent of monopoly power in the economy" (Shughart 1990, p. 11). (The first antitrust legislation occurred in Maryland (1867) and then expanded to other states and eventually the federal level.) Both he and Stigler argue that popular conceptions of the Sherman Act are seriously incomplete. However, Shughart criticizes Stigler's assumptions.

> Stigler's analysis of the origins of the Sherman Act is flawed by the fact that he assumes throughout that the statute was intended to promote competition. This presumption leads him to use the term "potential monopoly" as a synonym of "large" and perhaps more efficient enterprises rather than in the proper sense of firms having the power to restrict output and raise price (Shughart 1990, p. 15).

Furthermore, Stigler went so far as to say, "I like the Sherman Act." He deemed it a veritable public interest law.[12]

Shughart goes on to discuss the development of key cases which apply the Sherman Act. He shows that it was more of an act of social policy than of economic efficiency; sort of an economic engineering endeavor. Courts have rarely been concerned with whether firms have actually restricted competition, as evidenced especially in *Addyston Pipe & Steel*, *Standard Oil*, and *Brown Shoe*. Indeed, economic variables seem to have had little influence on the Antitrust Division (Shughart 1990, pp. 18-30).[13]

> Overall, then, antitrust enforcement does not appear to be predictable on the basis of social welfare criteria. The empirical evidence indicates that the antitrust agencies do not select cases to prosecute on grounds of their potential net benefit to consumers…Likewise, various studies have found that the mergers challenged by government are generally not anticompetitive…In short, there is little or no credible evidence suggesting that the actual effects of antitrust comport with the effects implied by the model of the "public interest." Scholars and policymakers have typically responded to such findings in the past by calling for closer adherence to economic principles in the future, but it is time to abandon this tired rhetoric. The absence of systematic support for the idea that the consumers are the beneficiaries of antitrust provides firm ground for rejecting the hypothesis that they were the intended beneficiaries. Indeed, because it requires that all failures of policy be explained by error or

[12] See DiLorenzo 1985, p. 74, citing T. Hazlett (1984), "Interview With George Stigler", *Reason*, Vol. 46, January.

[13] The case citations are *U.S. v. Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898); *Standard Oil Co. v. U.S.*, 221 U.S. 1 (1911), and *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962). Shughart provides a lucid critique of antitrust via these cases.

> ignorance, the consumer interest theory of antirust is no theory at all. A rethinking of antitrust is clearly in order, but not with the conventional tools of welfare economics (Shughart 1990, p. 30).

The quest for monopoly power and damage abatement

Some groups have been especially proficient in maintaining legislative favors. Mitchell and Simmons point out that labor unions are an example of government mandated monopoly.

> For decades, they have been awarded a special status in the law permitting them to benefit in ways not permitted other organizations, especially private firms…although monopoly tendencies exist in the free market, the chief form of monopoly is found in government-mandated labor unions. If there is a role for antitrust laws, perhaps they ought to be applied to labor organizations (Mitchell and Simmons 1994, p. 200).

However, there are also back-door profits possible in the political process of which political actors can avail themselves. Fred McChesney notes that when political actors are placed in power, they also gain the curious *right* to impose (or threaten) costs on economic actors, and thus extract booty from them.

> 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 actions…Political office confers a prop-

> erty right, not just to legislate rents, but to impose costs (McChesney 1987, pp. 101, 102).

Of course, McChesney is simply using a euphemism for theft with his rhetoric about rights to impose costs. He contends that "existing estimates of the welfare costs of government regulation overlook the costs of inducing government *not* to regulate" (McChesney 1987, p. 103). He also notes euphemisms for threats of robbery, such as milking. "Milked victims describe the process simply as blackmail and extortion" (McChesney 1987, p. 108). The desire by victims to avoid being milked (or violated) by political actors often leads to economic distortions and game playing. McChesney explains:

> 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. (And… legislators can always enact statutes now and sell repeal later.) (McChesney 1987, p. 109).

The social costs of games like capturing regulators, avoiding being milked, and rent seeking are not always recognized as substantial, especially by those who cling to the naïve view of government. Yet these activities impose considerable social losses as political favors are sought by firms or industries.

> 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 (McChesney 1987, p. 109).

However, seeking rents is costly, and rents can be reduced or destroyed by government intervention. For instance, politicians can mandate minimum quality or information standards and then send agents to police the market for quality and truth (McChesney 1987, p. 113).

> 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 [in the American used car industry]—compensate legislators not to intervene (McChesney 1987, p. 115).

In this case, an industry sought damage abatement, distorting private investment decisions. Political actors benefited merely by threatening costs, rather than by offering a favor or goody (McChesney 1987, pp. 116-117). McChesney notes that this often overlooked aspect of political action is an integral part of the theory of public choice. Indeed, "the problems of political opportunism and the imperfections of private-capital protection create disincentives or 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." These costs must be added to the costs of deadweight loss, rent seeking, compliance with regulation, and "diversion of resources to less valuable but unregulated

uses." Thus, he concludes, "There is no such thing as a free market" (McChesney 1987, p. 118).

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