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Edited by
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Preface

> [Herbert] Spencer, during a pause in conversation at dinner at the Athenaeum, said, "You would little think it, but I once wrote a tragedy." Huxley answered promptly, "I know the catastrophe." Spencer declared it was impossible, for he had never spoken about it before then. Huxley insisted. Spencer asked what it was. Huxley replied, "A beautiful theory, killed by a nasty, ugly little fact."
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> —*Francis Galton, Memories of My Life*

Economic theory is, and should be, always on the move: there are many well-known phenomena we cannot explain satisfactorily—and there are no doubt many more unknown economic phenomena waiting to be discovered. That most fundamental part of economic theory, microeconomics (the study of the allocation of resources and the determination of prices), has been, in recent decades, moving in two directions.

One direction is toward the deepening of the standard theory: the exploration of such concepts as competition, auctions, and dynamic stability, and the recognition of such neglected phenomena as the roles in economics of information and the formation of intelligent expectations by economic actors. This is a fundamental area of economics, and one to which Chicago economists have contributed, but it falls outside the scope of this volume.

The second direction of development has been the widening of the working range of the microeconomist to encompass phenomena previously treated as exogenous in economics. The extension of economic analysis to include the important area of political phenomena is the subject matter of this book. This branch of work is still young—barely three decades old.

The twenty essays in this volume are often subtle and complex in their arguments and sometimes astonishing in their predictions or findings, so I shall not attempt to comment upon them individually. Instead I shall discuss some of the problems they encounter and ideas they suggest.

I. The Political Institutions

Once we raise the question of the nature and functions of the political institutions within which our economy operates, where do we begin and where do we stop? Except for Posner's rich survey of preliterate societies (chap. 5), all the essays in this book and virtually the entire literature of political economy deal with the modern western democratic state. I believe this restriction is due to the youth of the field, and I anticipate that attention will soon be given to a much wider range of political institutions.

Why have the great majority of societies chosen hereditary monarchy (and such lesser variants as the tribal chief and the leader of the highland clan) as the central political decision unit? The monarch will invariably be guided, and largely controlled, by either a hereditary class (the nobles) or a representative assembly, but the monarch will possess substantial autonomy if his post is not purely ceremonial. Why a monarch? Why hereditary?

The monarch has two advantages over the broadly chosen president or prime minister, under certain conditions. The succession is established without (great) controversy, and the monarch can act—for example, declare war—with a minimum of consent. A society whose circumstances often require the making of major decisions, with rapidity, may find a monarchy much more efficient than a democracy. Great and urgent decisions are almost always decisions on the waging of war. Domestic policies usually affect various groups unevenly, and only a deliberative process is likely to find acceptable solutions. Foreign policy is much less divisive—indeed, there is a tradition that asserts that wars unify a nation.

Monarchies rely upon the dice of genetics to produce able leaders, and the phenomenon of regression to the mean is sufficient to guarantee that on average the monarch will not be among the most able people of his time. Still, he can hire them, and it can be immensely costly to resolve the succession by any form of rivalry. Many civil wars, indeed, have been wars of succession, and they impose costs of a magnitude enormously greater than the costs of mediocrity. Indeed, there may be no necessary costs to mediocrity.

Once foreign policy recedes from the center of the political stage and the pace of domestic change accelerates, neither monarch nor nobility becomes appropriate to the tasks of expressing and reconciling the important interests of the society. Traditional societies have no need for democracy, or, if you wish, have already incorporated its desires into the stable social framework. Changing societies must adapt the political framework to economic change and to evolving culture and technology. Ultimately the resulting policies must achieve consent. A Japan can do well enough with an autocracy so long as its social change is slow, but leaps toward explicit democracy when the social change accelerates.

Whatever the governmental form, equilibrium in the political marketplace for legislative goods and harms is determined by the nature and composition of the politically effective coalitions and the size and nature of the programs they achieve. Sensible suggestions are strewn through these essays on the reasons that some coalitions (farmers, the aged) are strong and other groups (small service businesses, the rural poor) are politically weak. The suggestions do not amount to a tight, tested theory, and that is clearly a fundamental goal of future research.

A good deal more has been learned about the policies obtainable by the effective coalitions than about the failures of ineffective groups. The essays in part 3 are a rich sampling of studies of specific regulatory programs, and I shall return to them below. At a more general level, Becker's essay (chap. 2) innovatively develops a calculus of deadweight losses of social policies. Every operative public policy has deadweight losses—costs that have no corresponding benefit to any party directly involved in the policy. Taxpayers end up with larger reductions in income than the treasury receives because of collection costs, constraints imposed by law upon the taxpayers, and the cost of actions taken by taxpayers (e.g., reduced time in the labor force) to reduce taxes. Similarly, the beneficiaries of a public policy receive less than the amount disbursed by the treasury, again because of administrative costs and the regulatory restraints imposed upon the recipients (e.g. inefficient farming practices because of restrictions on the use of land). Becker shows that these deadweight losses impose limits not only upon what beneficiaries can receive but also upon what they seek, and act similarly upon the taxpayers, consumers, or other losers. It becomes the interest of the coalitions to select policies, including sizes of policies, that reduce these losses, and a series of illuminating theorems are deduced from the theory.

The political equilibrium has not been stationary. There was a sustained reduction in the role of the state from 1700 to 1850. More recently, throughout the world and especially in the western world, the growth of the politicized sector of economic life has been immense and similarly sustained. A major study of this development is made by Peltzman (chap. 1). He shows how weak the empirical bases for the traditional explanations for this great change have been. Almost by definition, the growth of the state has been due to the appearance of coalitions or special interest groups (in turn due largely to the changing nature of the society); Peltzman gives a subtle explanation for this development that perhaps paradoxically centers on the diminishing inequality of the distribution of income as well as on the growth of cohesive interest groups. Self-interest rationally pursued is at the center of Peltzman's theory. It is interesting to recall that de Tocqueville found a cumulative tendency toward equality in democratic societies:

> The hatred that men bear to privilege increases in proportion as privileges become fewer and less considerable, so that democratic passions would seem to burn most fiercely just when they have least fuel. . . . When all conditions are unequal, no inequality is so great as to offend the eye, whereas the slightest dissimilarity is odious in the midst of general uniformity; the more complete this uniformity is, the more insupportable the sight of such a difference becomes. Hence it is natural that the love of equality should constantly increase together with equality itself, and that it should grow by what it feeds on. . . .
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> Every central power, which follows its natural tendencies, courts and encourages the principle of equality; for equality singularly facilitates, extends, and secures the influence of a central power.[1]

De Tocqueville can be interpreted as arguing that the state's aggrandizement is due to either an ideology of equality or a pervasive role of envy in political life. I shall be so bold as to vote with Peltzman, if one must choose between an opaque passion and a rich portfolio of hypotheses.

II. The Theory of Regulation

A distinction is often drawn between the fiscal operations of government, which are constituted by its taxation, borrowing, and spending, and the regulatory operations of government, whose effects on the governmental budget may be negligible at the same time that their effects on the economy are large. This is a distinction of technique rather than of purpose or effect. Fiscal policies have large effects upon the economy, and indeed taxes are often ostensibly used for "regulatory" purposes (e.g., the taxation of liquor and gambling devices). A citizen can be aided or injured equally by a tax or subsidy or by a publicly created cartel of private enterprises such as that of taxicabs or milk marketing authorities. If and when we devise reliable measures of the effects of both public fiscal and regulatory policies, they should be explicable by the same theory of governmental activity.

The paramount role traditionally assigned by economists to government regulation was to correct the failures of the private market (the unconsidered effects of behavior on outsiders), but in fact the premier role of modern regulation is to redistribute income. The farm pro-

[1] *Democracy in America* (New York: Alfred A. Knopf, 1945), 2:295. Interestingly, de Tocqueville assigns a role to education directly opposite to Peltzman: "the concentraton of power and the subjection of individuals will increase among democratic nations, not only in the same proportion to their equality, but in the same proportion as their ignorance." *Ibid.*, 299–300.

grams are designed to increase farm incomes, the rent control programs are designed to increase tenants' incomes; tariffs are intended, in Ambrose Bierce's famous definition, to protect producers from the avarice of consumers. This change in the fundamental role of regulation is so widely accepted, and so copiously documented, that it would be pedantic to cite the vast and growing host of supporting studies.

According to one view, the new orientation of regulation courts tautology: one can always find beneficiaries of a policy (Mother's Day for florists) and proceed to ascribe the existence of the policy to that interest group. A more proper view is that conditions favoring the existence of successful interest groups must be determined and the explanations of the existence and tactics of the parties to thousands of regulatory policies must be brought under one general theory. Peltzman's paper and my own (chaps. 7 and 6, respectively) have made beginnings to this challenging work.

Experience has revealed that the task of explaining when and why a regulatory policy was passed is usually much more difficult than the ascertainment of (some) important effects of that policy. This acknowledged difficulty has led some students of regulation to invoke a prevailing ideology to explain the appearance of legislation. An ideology (such as de Tocqueville's) is a commanding set of beliefs, beliefs that are probably not grounded upon self-interest or are related to the interests of the holders in so subtle and obscure a manner as to make it more useful to treat the beliefs as data. Ideology therefore plays the role in analyzing political phenomena that tastes play in analyzing ordinary economic behavior of individuals. The analogy is not satisfying, however, because political activity is conducted by organized coalitions, and a closer economic analogy is to the theory of the firm and associations of firms (cartels)—where tastes commonly play a most modest role overshadowed by the pursuit of profits.

Ideologies are measured in the literature of regulation by such opaque numbers as the ADA ratings of legislators or the state votes for a conservative or liberal candidate. These indices of opinion have received remarkably little study. We do not know how the strategic issues are chosen that govern the ratings, nor whether issues are chosen to obtain favorable ratings for preferred legislators, nor whether the ratings influence elections. These indices are dictated by necessity, and necessity is the mother not only of invention but also of arbitrary decisions. The difficulty that supporters of ideology seek to escape is one which I believe we shall have to address frontally: the construction of a theory of political coalitions.

My own belief is that politically effective groups have used the state to foster their ends in all periods of history. In some periods there was little scope for political actions to benefit important groups. What could Iowa farmers do a hundred years ago to increase their profits when prices were determined in European markets? Whom could they tax when they constituted almost the entire state population? The influence of opportunity upon the scope of and nature of political activity is a fertile ground for historians to till.

III. Specific Regulatory Policies

The studies of individual regulatory policies, of which Harold Demsetz's seminal study of utility regulation and the essays in part 3 of this volume are important examples, serve both scientific and policy ends. They provide us with a rich variety of results, proving that truth can be stranger than theory. They begin to provide us with quantitative estimates of the support for policies and the effects of these policies, tasks no general theory can yet undertake. Finally, they may already begin to have effects upon the regulatory policies. Let us illustrate these services.

Economists have often been accused of cynicism (by people, one wonders, paid to criticize us?). To the important degree that cynicism and realism overlap, the charge is probably true. Consider a public policy that on the surface seemed necessary to deal with a problem which private markets could not handle: the improvement of the air and water of the society. No one polluter, be he a steel mill operator or the owner of a passenger automobile, could justify the costs he would bear in reducing his contribution to pollution by the benefits he alone would receive: most of the benefits of an act of emission control would clearly accrue to the community at large.

The clean air legislation would seem to fit the argument for social controls to deal with the externalities imposed upon the community by unregulated behavior. One would expect public policy to impose stronger restrants on polluters as the society becomes wealthier, for a richer society demands more environmental amenities as well as more private goods and services. No doubt these forces have been important in the development of the clean air policies, but so, too, as Pashigian shows (chap. 17), have the special interests of regions and localities. The areas where the levels of pollution are relatively high (as the New England and North Central regions) have been instrumental in limiting the competition for their industries by the areas (in the South and West) where levels of air purity are high, by imposing a non-degradation rule upon the entire nation. The Clean Air Act has been turned into a device, like the minimum wage, to protect one region at the cost of another—and at the cost of the nation. There is nothing exceptional about this case: it could be duplicated by the rivalries of industries for profit from American grants to relieve foreign distress or from other philanthropic policies.

Some public policies seem to impose substantial costs but have no major beneficiaries. How can the existence of such policies be explained? Perhaps by recognizing that societies, like people, can make mistakes. Any event, no matter how baffling, can be "explained" by the simple statement, "It's a mistake." But what value has such an explanation without a theory about the kinds of mistakes a society can make and how soon they are corrected? Prohibition was an error that fourteen years was required to correct—is that par for national mistakes?

Even more troublesome is the policy which not only lacks important beneficiaries but *persists*. Both of Peltzman's fine studies (chaps. 10 and 11) illustrate this puzzling situation; let us concentrate on the regulation of drugs. The 1962 Drug Amendments added a requirement of efficacy to the previous requirement of safety before a new drug would be licensed by the Food and Drug Administration. The review process for new drugs became extremely long and costly, and the flow of approved "new chemical entities" dropped precipitously. Peltzman employed a variety of approaches to determine whether consumers of drugs benefitted on balance from the protracted review process, and each led to the conclusion that consumers were injured. He found no offsetting benefit for the pharmaceutical firms that supply the drugs (although more recent research suggests that large firms were favored and small firms injured).

Why, then, have only minor improvements in the drug review process been grudgingly allowed in the quarter century since the passage of the Kefauver Act? The bureaucracy of the F.D.A. surely could not withstand the medical professions if they were opposed to the present procedures. The constant efforts to slow down the immense growth of health expenditures in the United States should lead to an examination of the substantial tax the F.D.A. imposes on new drugs. Neither has happened, and the persistence of the program is evidence either of the slowness with which complex public policies are appraised by the community, or of the incompleteness of our understanding of the policy. If the ability of voters to obtain and absorb information is sharply limited, we should explore its effects over a wide range of political activity.

The Chicago students of regulation have usually assumed, explicitly as often as tacitly, that the players who count in regulation are the producers and consumers. Political intermediaries—parties, legislators, administrators—are not believed to be devoid of influence, but in the main they act as agents for the primary players in the construction and administration of public policy. That view is much less popular among political scientists and economists at large than the opposite one that the political machinery has a strong influence on policies. It is easy to guess that the truth lies between these views: when and how much does the political machinery influence the outcomes of policy?

Pashigian's study of the ownership of urban transport facilities (chap. 12) is an interesting case study of this problem. In large American cities, most transport facilities were privately owned as late as 1960, but public ownership grew rapidly in the next decade. To me, his most interesting finding is that public subsidies grew rapidly for the publicly owned systems and served to reduce revenue per vehicle mile in public systems relative to private systems. It was easier to get subsidies for public than for private transit systems; is this generally true?

IV. Effectiveness

The first reaction of almost everyone to a proposed policy is to judge it on the assumption that it will more or less achieve its announced goals. One wonders whether this attitude thrives chiefly in our society and our time. We know all too well that no regulation achieves exactly what it intends. Most policies fall considerably short of goals and some actually move us away from the goals (important examples being found in the clean air programs). Some policies exceed their expectations: could the purpose in assisting convicts to make legal appeals have been to provide legal training during their incarceration?

The discrepancy between purpose and achievement is often due partly to the design of a policy, but it is also due to the problem of enforcement. No statute governing the behavior of many people has ever been spelled out in full detail and enforced with full rigor. Try to imagine the resources that would be required to achieve so unambiguous a goal as preventing everyone from driving more than fifty-five or sixty-five miles per hour for even brief distances. How much more inconceivable the fulfillment of the task of collecting every dollar of taxes due, or of insuring the purity of every bite of food.

Compliance with rules must be achieved by compulsion: sanctions are the heart of the regulatory process. It is for that reason that the calculus of crimes and punishments of Becker (chap. 18) is fully as pertinent to economic regulations as to criminal statutes.

Indeed, the problem of enforcement is equally pervasive in the dealings between private parties. Every contract involves promises whose performance must sometimes be compelled; even a simple exchange of money for a commodity involves implicit warranties such as that the seller has legal possession of the commodity he is selling. I suspect that the recent and extensive increase in attention that economists are paying to principal-and-agent problems and to the role of reputation in private enforcement may have been due partly to the appearance of a growing literature on enforcement in public policy.

The use of a payment system to insure fidelity to contractual obligations, the subject of chapter 19, was noticed as long ago as 1776, when Adam Smith observed that "the wages of labour vary according to the small or great trust which must be reposed in the workmen." This is an instance of what may become a common occurrence: an economic phenomenon long recognized and given casual attention becomes a theoretical corpus with a large and important domain of applicability when subjected to standard economic analysis. The compensation of corporate executives, for example, is clarified by this analysis of the price of fidelity.

V. Conclusion

These and other extensions of economic analysis to political processes, and in particular regulatory processes, support two conclusions. The first is that with traditional theoretical and empirical tools the economists have made substantial progress toward understanding public regulation. The second is that it is reasonably certain that new theories and new methods will be required to unravel some of the major problems we have encountered. Progress and challenge are attractive to the scholar, and they become irresistible when they are joined to a subject of great potential importance in the world of affairs.

The practical applications of these studies will differ for different scholars. The studies will arm some scholars for frontal attacks on policies which are objectionable: the traditional economists' attitude toward restrictions on international trade is an example. Our adherence to free trade despite the perpetual strength of protectionism entitles us to be called practitioners of the optimistic science. For other scholars, it is sufficient to present at higher levels of comprehensiveness and precision the effects actually achieved by a given policy. Then it is for the society at large to make what use it wishes of this new and better knowledge. I believe that putting more accurate price tags on policies will often lead to changes in these policies. The most ambitious goal of these studies reaches farther: it should eventually become possible to offer general advice on the best ways to achieve the goals of policy. We cannot now give general answers to questions such as what is the most efficient way (the way with least deadweight loss) to help declining industry A, or protect workers from danger B, or purify the streams of county C? If—indeed, when—we can give this kind of instruction, in which the social goals are accepted and efficiently implemented by the economist, we shall be able to abandon our traditional lament that our advice is given too little attention by our society.

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