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# Of Stranded Costs and Stranded Hopes

## *The Difficulties of Deregulation*

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FRED S. MCCHESENEY

Given the manifest inefficiency of government regulation, why is there so little deregulation? Of course, some deregulation, including the privatization of state-owned industries, has occurred in recent decades. The United States experienced a spate of high-profile deregulations from 1978 to 1980 in the natural gas, trucking, and airline industries (Crandall and Ellig 1997). In Europe, deregulation has occurred concurrently with, and often as part of, the privatization of numerous sectors of the economy.

But the observation that deregulation has occurred in some markets in some places naturally raises the question, Why has it not occurred in all markets, everywhere? In America, deregulatory passions have cooled, leaving the vast bulk of regulated industries untouched. If one added the failures to privatize industries such as the postal service and east-coast railroad service, plus the current to-and-fro over deregulating electricity supply in different states, the list of missed opportunities for deregulation would be even longer. Even that staunch free-marketer, Ronald Reagan, achieved little in the way of deregulation. And in some areas where government control of the economy fell during the 1980s (notably in telecommunications) the reductions have proven to be only temporary respites or are constantly threatened. Much telephone deregulation in particular has turned into reregulation.<sup>1</sup> The Contract with America announced by the Republicans in 1994 to reduce government regulation is now just a rueful memory.

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Fred S. McChesney is a professor in the Law School at Cornell University.

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Why is deregulation so hard to achieve? I shall suggest several reasons. Perhaps the most interesting ones pertain to the potential gains from deregulation, which, I maintain, are often smaller than they are believed to be. In short, deregulation may not be worth the candle.

Two preliminary points merit emphasis. First, the analysis here is positive. It attempts to explain as a purely descriptive matter why there is often little pressure for deregulation. No broad normative conclusion is advanced (or warranted) that deregulation is not a good thing or that it should never be attempted.

Second, no one positive explanation for the frequent lack of enthusiasm for deregulation suffices. One grand theory of deregulation would be more satisfying intellectually, but a single model cannot explain the difficulty of reversing regulation. This condition should hardly be surprising. After all, there is no unitary model of regulation, either, despite certain economists' habit of speaking of "*the* economic theory of regulation." Rather, economists have gone from a relatively simple model, which explained some regulation well and other regulation not at all, to a plethora of models developed in more ad hoc fashion to explain practically all forms of regulation (Aranson 1990). Greater coverage has been achieved at the cost of universality. So it is in explaining deregulation, or the lack thereof.

## Regulation, Transaction Costs, and Deregulation

### *The Nature of the Problem*

The issue of deregulation arises only when regulation has already occurred. Social scientists have extensively analyzed how and why regulation occurs (Aranson 1990; McChesney 1998).

In the simplest model, depicted in figure 1, producers seek regulation in order to raise prices from the competitive level  $P_c$  to some regulated level  $P_r$ . The higher price reduces the amount of the product purchased from  $Q_c$  to  $Q_r$ . Consumers lose in two ways. Area I (the "Tullock rectangle") represents the monetary transfer from buyers to sellers caused by the higher price.<sup>2</sup> Area II (the "Harberger triangle") is the dead-weight consumer-welfare loss that results because marginal consumers forgo purchasing the product even though the price they are willing to pay exceeds the marginal cost ( $MC$ ) of producing the product (Harberger 1954).

Thus, regulation causes losses to consumers (areas I + II) that exceed the gains to producers (area I only). In effect, regulation represents a political-market failure. Buyer-losers would always be willing to compensate seller-winners *not* to be regulated. In a

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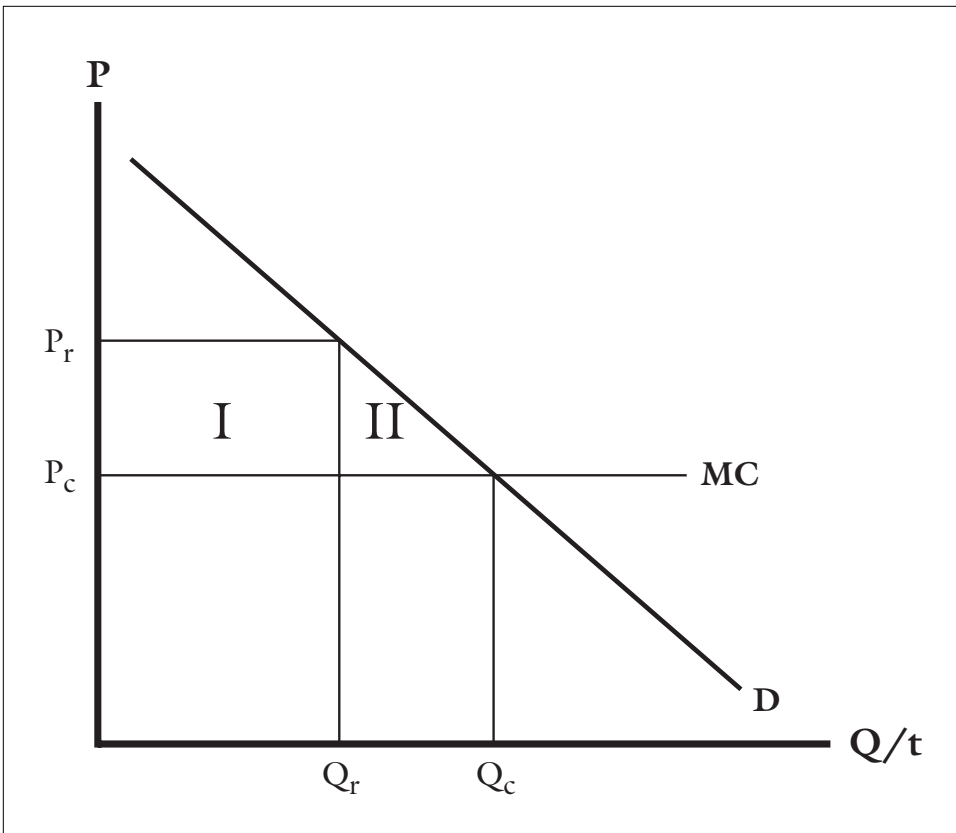
1. "Undoubtedly, the greatest surprise in telephone industry deregulation has been the absence of deregulation, for the industry continues to be almost as highly regulated today as twenty years ago" (Crandall 1988, 78).

2. Although area I was originally treated as a transfer, Gordon Tullock argued in a seminal article on rent-seeking (1967) that much, if not all, of area I represented dead-weight losses because producers would expend resources in the competition for regulatory advantage.

purely Coasean world of zero transaction (including information) costs, regulation would never occur. As in all Coasean analyses, to explain the outcomes actually observed—in this case, the fact that regulation does indeed occur—the analyst must focus on the nature of transaction costs (Wenders 1987; McChesney 1991). Why does the political marketplace malfunction so that consumers do not purchase the right to be unregulated?

The conventional answer focuses on the relative organizing costs of the potential winners and losers from regulation. Consumers are more numerous than producers, so they have a greater incentive to free-ride on the efforts of others to fight off onerous regulation. Hence, producers work harder to get regulation than consumers do to oppose it. Likewise, individual consumers lose little if each pays \$1 more for a widget. An individual consumer therefore has little incentive to fret about regulation. In contrast, the producer who sells a million widgets a year at the higher price cares intensely about the extra \$1 million he will earn under regulation. Finally, with only a \$1 loss at stake, consumers may be rationally ignorant of regulation's potential impact on them in the first place (McCormick, Shughart, and Tollison 1984).

**Figure 1: Regulated Market**



In any particular case, it may be unclear which (if any) of these factors—greater free-riding, disaggregated losses, and rational ignorance among consumers—truly explains the particular regulation under scrutiny. For present purposes, the important point is that the very existence of regulation indicates that *some* impediment to informed, low-cost contracting exists. The onset of regulation attests to some contracting failure in political markets.

### *A Possible Solution: Demand-Driven Deregulation*

It follows that deregulation will not come about unless the market-failure reasons for regulation abate. But it is far from likely that conditions will change in any important way. Given economies of scale in production—one specialized supplier can produce many more of an item than a single consumer will want—producers of any given product will practically always be fewer than consumers of that product. Producers therefore will almost always face less free-riding than consumers and therefore will be more intensely interested in maintaining regulation than consumers will be in removing it. Rational ignorance among consumers will not change as long as consumers' stakes are so small. "To the extent that regulation persists, equilibrium indeed must be inferred" (Crew and Rowley 1988).<sup>3</sup>

Here, then, is the first reason why so little deregulation occurs. The very fact of regulation indicates the presence of conditions sufficient for its existence—conditions such as producers' superiority in numbers and knowledge, plus their more intense preferences. Those conditions are unlikely to change in most markets, although, of course, they might change. In a careful cross-sectional regression model, deregulation of state telephone services has been shown to be a function of differences in interest-group variables across states (Kaserman, Mayo, and Pacey 1993). Likewise, one frequently hears (among economists at least) that airline deregulation occurred because it was increasingly easy for consumers to see (i.e., increasingly difficult for them to remain ignorant) that regulation increased air fares. So many instances of nonregulation provided information about lower fares that consumers' growing knowledge finally tipped the balance against continued regulation. Moreover, those who stood to gain from deregulation, regular airline customers, are a much smaller, more intensely interested group than consumers generally.

Still, it is hard to believe that American consumers are any less informed now about the effects of, say, Food and Drug Administration (FDA) drug regulation than they were of the effects of airline regulation in the 1970s. The problems of drug regulation—the extraordinarily time-consuming and expensive process of getting the FDA to approve a new drug, the fact that other countries approve drugs faster with no

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3. For a more formal and extended treatment of this point, see Peltzman 1976. The point is similar to that of Becker (1983), who argues that what is must be efficient, or else a different state of the world would be observed. But Crew and Rowley's point (like Peltzman's) is positive, whereas Becker's is normative.

apparent impact on drug safety—are reported frequently in the popular media. Those seeking access to specific drugs (e.g., Laetrile some years ago) are often a relatively small, intensely interested group. Thus, although the “changing-conditions” model furnishes a plausible theory of deregulation after the fact, it does not provide a convincing, predictive model *ex ante*.<sup>4</sup>

One final aspect of the demand-driven deregulatory sequence must also be recognized. The very existence of regulation not only indicates that proponents of regulation outweigh opponents politically, but it sets in motion a process that over time increases the number of those favoring continued regulation. Even those who initially might lose from regulation are often brought into the rent-creating deal later, and then switch from being opponents to being proponents of regulation. Union workers, for example, will demand at the collective-bargaining table a cut of firms’ regulatory rents, and they can get their cut because by shutting down the firm they would prevent the firm’s owners from getting the rents promised by regulation (Rose 1987). Regulation might hurt labor generally, by reducing production and therefore the demand for labor services, but organized workers share with firms’ owners the rents created by regulation and therefore join the owners in opposing deregulation. Similarly, telephone regulation has involved considerable cross-subsidy of residential customers by business firms, with the result that home telephone customers oppose deregulation in the telephone industry (Kaserman, Mayo, and Pacey 1993). Those who specialize in rent-seeking (e.g., lawyers, lobbyists), facing devaluation of their services if rent-creating regulation is less durable, will fight deregulation. Regulation, once attained, thus creates its own defenders, who are more numerous than those who initially benefited.

### The Transitional Gains Trap

The possibility that changes in consumer organization, preference intensity, or information might spur a drive for deregulation relates to potential demands for deregulation. Absent some change along those margins, there is little reason to think that politically relevant demands for deregulation will materialize very frequently once regulation has been imposed. Even if consumers’ demand for deregulation did increase, however, that greater demand is only a necessary, not a sufficient, condition for deregulation. A disequilibrating increase of consumers’ demand for deregulation predictably will be offset (at least partly, perhaps fully) by an increase of producers’ demand to retain the regulation. Indeed, the very preexistence of regulation gives rise to a supply-side opposition to deregulation.

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4. Moreover, the “changing-conditions” model is essentially tautological. After the fact, when deregulation has already occurred, it can be ascribed to a reduction in transaction-information costs. When no deregulation occurs, it will be said that the conditions have not changed. By definition, given the dead-weight losses of regulation, these statements must both be true.

### *The Trap*

Gordon Tullock (1975) was the first to appreciate the trap that regulation creates for future attempts to deregulate. He noted that regulated firms often are not unusually profitable, even in industries (such as taxicabs) where entry is explicitly limited and prices set at supracompetitive levels. This seeming anomaly occurs because markets capitalize the discounted present value of regulatory rents into current firm values. Thus, only the firm's owners at the time of regulation experience a wealth increase. Subsequent generations, who buy into the regulated industry (e.g., by purchasing taxi medallions or the shares of already regulated firms), can expect only normal profits, because the entire value of the Tullock rectangle expected to accrue over time has been reduced to its discounted present value today. Gains to the first group of owners are merely "transitional"; later owners' gains are zero.<sup>5</sup>

Tullock's insight contains two lessons for deregulators. First, newcomers to the regulated industry can earn supracompetitive returns only by imposing *new* regulations, not by operating under the old regulations, whose value has already been captured by the old owners. But those who would increase regulation (for example, by a second round of price increases or entry restrictions) face the same regulatory equilibrium that partisans of deregulation face. As previously noted, regulations that have been in place for a while presumably represent an equilibrium outcome that balances the interests of gainers (firms) and losers (consumers). That very equilibrium explains why regulated industries tend not to get increased regulation any more than they get decreased regulation. Regulatory regimes, once established, tend to be stable.

Second, and perhaps more important for the deregulation issue, the transitional character of the regulatory gains creates the "trap" to which Tullock called attention. Although subsequent purchasers (of medallions, shares, and so forth) may not earn greater-than-competitive returns from their investment, they certainly will suffer a wealth loss if regulation is abolished, causing entry barriers to be removed and prices to fall to their competitive levels.

One possible way out of the trap, the phasing-in of deregulation, while on the face of it promising, is fraught with problems. Suppose that New York announces a phased deregulation of taxi cabs. The immediate effect is an outcry amongst cab owners. They begin to lobby the mayor and the council, and law suits are initiated. The value of the medallion falls by the present value of the reduced profits expected from increased entry plus the extra cost medallion

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5. The gains are transitional because they are capitalized and thus realized only by the first generation of firm owners. Gains may also be transitory because not all avenues of competition are regulated. For example, higher prices and restricted entry would induce taxicab firms to increase the number of drivers and hours beyond their optimal points in search of the higher-priced business, raising costs and thereby reducing the gains from regulation.

owners incur to protect themselves from the deregulation and to reverse it. The effect has been to increase welfare losses. (Crew 1987, 159)

In other words, deregulation may be socially beneficial overall, but it is not universally beneficial. The gross gains from deregulation must be netted out against the costs that current firm owners will bear to avoid losing regulation, even though they are earning no supracompetitive returns. As Tullock summarizes,

It is hard for an economist to recommend any positive action to deal with this sort of situation. It is, as the title of this article suggests, a trap. I can recommend very strongly that we try to avoid getting into such traps in the future, but what about the ones into which we have already fallen? In those cases where there are efficiency gains from reorganizing [i.e., deregulating] the industry, we could presumably compensate the present beneficiaries; but the political possibilities seem to me to be very small. . . . As to its political practicality, I take it I do not have to explain why I think it is low.

The moral of this, on the whole, depressing tale is that we should try to avoid getting into this kind of trap in the future. Our predecessors have made bad mistakes and we are stuck with them, but we can at least make efforts to prevent our descendants from having even more such dead-weight losses inflicted upon them. (1975, 677–78)

These costs are the flip side of the rent-seeking costs identified in Tullock's seminal rent-seeking article. Just as the first generation of firm owners expended resources to obtain rents from regulation, so will subsequent generations of owners spend resources to avoid deregulation.

### *Compensation for Deregulatory Takings: The "Stranded Cost" Controversy*

Tullock's reference to political obstacles raised against compensating the losers from deregulation may seem strange to some. Why does it matter economically whether losers are compensated or not, if deregulation increases efficiency by lowering prices and thus removing the dead-weight loss of regulation? Compensating losers raises only distributional issues, which might seem economically irrelevant if allocative gains can be achieved.

But the matter is not so simple. Throughout the deregulatory episodes of the 1970s, a fundamental property-rights issue arose repeatedly. As Tullock himself wrote, the difficulty in deregulating is not just a positive matter of entrenched interests, such as taxi-medallion owners, exerting political pressure in favor of the regulatory status quo. "In a very real sense they have established property rights in a system that is the creation of the New York City government" (Tullock 1993, 67).<sup>6</sup>



When government alters the legal rules concerning competition in an industry, should compensation be paid to those whose assets (e.g., medallions) lose value? Particularly in the context of current attempts to deregulate electricity supply, this issue has become most contentious, giving birth to a new name: stranded costs. The term is defined somewhat differently by different analysts, but basically “stranded costs could be defined as any investment that will be less valuable under competition than under regulation” (Maloney, McCormick, and Sauer 1997, 59–60). As one study notes, it is “odd that little or no attention was paid to stranded costs in the discussion on airline deregulation, trucking deregulation, and the breakup of AT&T” (Maloney, McCormick, and Sauer 1997, 59). But, perhaps because of their sheer magnitude—reportedly \$28 billion in just one state, California—debates over stranded costs now animate legal, economic, and political debates over deregulating electricity supply (LaBorde 1998).

Indeed, it is the overlap of law, economics, and politics that makes the stranded-cost controversy so thorny. Legally, the argument arises in two forms. First, it is said that the Fifth Amendment’s constitutional prohibition against governmental takings applies to deregulation that leaves investors with stranded costs. Traditionally, the Fifth Amendment has been applied to takings, especially governmental condemnation of land, that facilitate production of so-called public goods (e.g., roads, bridges, and dams).<sup>7</sup> But it is argued as well that deregulation is a taking of property rights that demands compensation of the losers (Sidak and Spulber 1996). Total deregulation of New York City taxis, for example, would reduce the value of medallions to zero, just as would outright confiscation of the medallions themselves. As the argument goes, the confiscation requires compensation under the takings clause, and so must compensation accompany any deregulation that leaves stranded costs.

In addition to the constitutionally based argument, stranded-cost proponents contend that deregulation bears a likeness to breach of contract, in this instance the supposed “regulatory contract” between government regulators and private regulated firms.<sup>8</sup> The legal argument here is both normative and positive. Normatively, it is argued, an implicit contract exists between investors in regulated industries and their regulators, such that lost investment value should be reimbursed: “Investors in the network industries made investment in large-scale facilities in the expectation that they would receive from regulators the reasonable opportunity to recover those investments plus a competitive rate of return” (Sidak and Spulber 1997, xiv). Positively, it is

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6. Tullock went on to note an irony: “Experience indicates, however, that it is much easier to attack the property rights of those who have succeeded in private competitive markets than it is to restore such rights to those who have had them seized” (68).

7. Concern has focused more recently on governmental takings that serve private interests (for example, construction of a factory or sports stadium) and on whether payments made to the victims of governmental takings are truly compensatory. The already classic discussion is Epstein 1985. See also Haddock and McChesney 1991.

claimed, courts have recognized the existence of the “regulatory contract,” a claim with which others disagree.<sup>9</sup>

The legal case for the existence of property rights in regulated firms, such that deregulation legally requires compensation for stranded costs, is at present contested. Not all scholars agree that, as a matter of constitution or contract, compensation for stranded costs is required, and certainly no court has held that compensation must generally be paid. But the legal ambiguities have not stopped proponents of reimbursing stranded costs from inserting claims for compensation into deregulatory proceedings, as Tullock predicted the deregulatory “trap” would impel them to do.

The economics of the stranded-cost issue seem more straightforward. The economic argument is woven from several strands. First, as to the supposed “regulatory contract,” the basic economics of regulation indicate that no compensation for stranded costs is warranted. The very reason that deregulation is desirable is because regulation has restricted output and raised prices. As illustrated in figure 1, regulated industries have been charging supracompetitive prices all along, which implies that investors in industries about to be deregulated have already been compensated. “That firms are currently receiving price exceeding the anticipated competitive equilibrium price means that output price is greater than the minimum average cost of production. The conclusion is that firms are receiving stranded cost recovery *now*” (Maloney, McCormick, and Sauer 1997, 69; emphasis added).<sup>10</sup> To pay investors again when deregulation arrives is to compensate them twice.

Payment for stranded costs would be overcompensation for another reason, too. Surely, no one would claim that the capital markets in which public utility bonds and shares trade are inefficient. In efficient capital markets, investors assume the risk of deregulation and receive compensation for bearing it. That capital markets operate to price risk is demonstrated by the markets’ reaction to other risk-related events such as the Three Mile Island accident (Maloney and Sauer 1998, 5).<sup>11</sup> Again, because risk is compensated *ex ante*, it would be excessively compensatory to pay investors for stranded costs *ex post*.<sup>12</sup>

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8. See Sidak and Spulber 1997:

The sweeping deregulation of public utilities being proposed and implemented at the state and federal levels promises to bring the benefits of competition to markets for electric power and telecommunications. Those benefits include improvements in operating efficiencies, competitive prices, efficient investment decisions, technological innovation, and product variety. The benefits of competition, however, do not include forced transfers of income from utility shareholders to their customers and competitors as a result of asymmetries in regulation. . . . As regulators dismantle barriers to entry and other regulatory restrictions, they must honor their past commitments and avoid actions that threaten to confiscate or destroy the property of utility investors on an unprecedented scale. (1)

9. Perhaps the most important case in this respect is *United States v. Winstar*, 116 Supr. Ct. 2432 (1996). Scholars differ, however, on the reading of *Winstar*. Compare Sidak and Spulber (1997, 171–77) with Baumol and Merrill (1997, 1037).

10. Regarding the alleged “regulatory contract,” the authors continue, “there also exists a compact between citizens and their government. . . . Producers and consumers were supposed to get competitive prices as part of the bargain” (84).

“Paying such investors for losses due to policy changes is equivalent to offering refunds to holders of losing lottery tickets” (Sansing and VanDoren 1994, 565, 567).

The preceding observations only scratch the surface of what has become a heated debate about whether compensation should accompany deregulation. Some economists, even noted deregulators such as Alfred Kahn (1998), agree normatively that stranded costs matter.<sup>13</sup> Others disagree strenuously.<sup>14</sup> For purposes of the present article, however, it is the very existence of the debate, rather than the merits of the respective arguments, that is important.

With respect to the difficulty of deregulation, three points are paramount. First, the stranded-cost debate pertains largely to distributional rather than allocative issues.<sup>15</sup> “While stranded costs may have important financial consequences for a select group of utilities, both theory and history suggest that the impact on the production of electricity will be negligible” (Maloney, McCormick, and Sauer 1997, 83).

Second, those affected by deregulation naturally care much more about the distribution of gains and losses than about any allocative implications.

Of course, in a no-compensation regime, policy changes do create wealth losses *ex post*. Those who suffer wealth losses as the result of the policy change often feel that they have been unjustly treated and are likely to organize and attempt to block the enactment of policies that increase total social welfare but cause transitional losses. (Sansing and VanDoren 1994, 567)

Thus, because it adds new issues and new players to the deregulation debate, the stranded-cost controversy has baleful implications for the transaction costs of achieving deregulation.

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11. Another example of *ex ante* compensation for risk, in the New York City taxicab industry, is provided by VanDoren: “Investors behave as if the probability of deregulation of the taxi industry is 5 percent annually or 100 percent over a 20-year period, even though additional medallions have not been created since 1937” (1998, 10–11).

12. “This approach treats a wealth loss from a policy change no differently than a wealth loss from a change in market conditions, such as a decrease in the demand for product due to technological innovation. Exposure to such risks is a part of normal business risk, for which the market compensates *ex ante*” (Sansing and VanDoren 1994, 567).

13. Hal Hochman (1974) wrote, “To charge investors with responsibility for full discounting of the risk of changes in ‘inefficient’ rules is, for my taste, too facile. It turns public confidence in property rights into a gamble, thus making mockery of the rule of law.”

14. See, for example, Maloney and Sauer 1998; Maloney, McCormick, and Sauer 1997.

15. This is not to say that allocative arguments are not made. It is claimed (e.g., by Goldberg 1976) that, because of specificity of assets and the possibility of contractual opportunism by regulators, regulation should be viewed as a contractual safeguard against deregulatory surprises that prevent recovery of investments made under regulation. “Powerful efficiency arguments demonstrate why one would expect the regulatory contract to have evolved. The regulatory contract contains three essential terms—price regulation, entry regulation, and the obligation to serve—that simultaneously constrained the private exercise of market power and ensured that the utility would have a reasonable opportunity to recover the economic costs of the long-lived, nonsalvageable investments that it made to serve its customers” (Sidak and Spulber 1997, 177).

Dealing with stranded costs raises the administrative cost of deregulation. Compensating investors for investments whose value will tumble with deregulation is required. To think of deregulation as entailing some sort of free lunch—an instantaneous and costless movement from  $Q_1$  back to  $Q_2$  in figure 1—is to commit the nirvana fallacy with respect to regulation. The normative disagreements, be they legal or economic, are less important than the fact that the arguments, positively speaking, have been taken seriously, legally and economically, and hence have retarded and confined deregulation. There are important transaction costs of shifting from a regulated to a deregulated regime.

This observation raises a more ominous point concerning the nirvana fallacy. Transaction costs might be viewed as just an inevitable cost of attaining efficiency, even with public-spirited, efficiency-maximizing legislators and bureaucrats enacting and implementing deregulation. But in the real world of self-interested individuals and political pressure, deregulation does not occur disinterestedly. Rather, the process of deregulation is inherently a political one, because dismantling the regulatory apparatus opens the door to bestowal of political favors, just as regulation itself bestowed rents. That deregulation is under way indicates that the prior regulatory equilibrium has dissolved. There is no reason to expect that the movement to a new equilibrium will be a movement to some social optimum—*au contraire*.

Telecom deregulation that followed judicial dissolution of the government-sponsored AT&T monopoly illustrates the point. Government has explicitly followed a deregulatory policy that favors some firms by keeping other firms out of certain parts of the industry. For example, “quarantine” restrictions have prohibited local telephone firms (the “regional Bell operating companies,” or RBOCs) from providing long-distance services in competition with AT&T, MCI, Sprint, and other specialized long-distance firms (Sidak and Spulber 1997, 55). At the same time, the RBOCs have successfully pushed to keep long-distance carriers out of local service. “This result, barring entry into other markets, is truly an exceptional outcome to an antitrust case” (McChesney 1995, 493). Many other legal-political obstacles to true deregulation have developed in the telecom industry (Crandall and Ellig 1997, 30–31).

Deregulatory politics would predictably play a role in compensating stranded costs. The same regulators who are to decide on appropriate compensation for stranded costs (i.e., investments made under regulation that, under deregulation, will fail to recover their costs) are the ones who are impeding competition under regulation. In fact, it is the inability of regulators to get the price right that spurs the demand for deregulation in the first place. In view of their having gotten the price wrong as regulators, why suppose they will get it right in compensating the losers from deregulation? More likely, the losers under regulation will also be the losers under stranded-cost compensation.<sup>16</sup>

In that respect, it is worth noting that there is no agreement as to exactly what the measure of compensation for stranded costs (if compensation be made) ought to

be. Oftentimes, measurement of investor loss seems to proceed in terms of lost revenues due to deregulation (e.g., MacAvoy 1998). But true investor losses should be measured by stock-price changes, which will reflect only losses due to unsystematic risk. To the extent that utility owners have, or could have, diversified against losses from deregulation by investing in other securities, no compensation would be appropriate (Sansing and VanDoren 1994, 568–69). One must wonder whether regulators, themselves used to analyzing revenues and costs but not stock-price effects, can be trusted to proceed correctly.

In any event, one must recognize that deregulation is (*a*) costly in a world in which regulators (legislators and bureaucrats) perform public-spiritedly to maximize efficiency or social welfare, and (*b*) even more costly if legislators and bureaucrats deregulate in non-public-spirited ways. Discussions of deregulation commit the nirvana fallacy when they suppose it to be costless. To the extent that deregulation is costly, people demand less of it. Then, predictably, government officials supply less deregulation. At the margin, expected residual value may be insufficient to motivate the initiation of deregulation.

### **Irretrievable Costs: The Ghost of Rent-Seeking Past**

Tullock's explanation of the transitional gains trap compels us to appreciate that the losers from deregulation will—often credibly—demand compensation for their losses, reducing the net gains from deregulation. The ongoing stranded-cost controversy shows that investor claims for remuneration may have legal justification, whatever the purely economic merits of the claims, so that even disinterested public officials might respond to those demands. The losers from deregulation may well get preferential treatment from deregulators. All these phenomena reduce the gains from deregulation that would otherwise accrue.

#### *The Potential Gains from Deregulation*

But how great are those gains to begin with? Robert McCormick, William Shughart, and Robert Tollison (1984) have argued that, under certain plausible conditions at least, the gains are minimal. They note that standard analysis of deregulation treats it as a return to the status quo ante. In other words, only two states of the world are

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16. Alfred Kahn (1998) warns more generally of the problems for deregulation created whenever regulators are left in place to “assist” in deregulation. He warns in particular of the bureaucrats’ incentives to “micromanage” competition (for example, by deciding who will be allowed to compete and on what terms) rather than just ending regulation and letting the market find its own way. But Kahn is somewhat inconsistent on this point, advocating a continuing regulatory function for antitrust-type problems such as alleged “essential facilities” potentially possessed by some deregulated firms. “Just as efficient competition must be conducted on the basis of the relative efficiencies of the several contenders, so must it be unbiased by the exercise of monopoly power to exclude rivals from the opportunity to compete on that same basis. Arguably, this function might be left to the antitrust laws. But protection of captive ratepayers remains the continuing responsibility of regulatory commissions” (35–36).

posited, one regulated and the other competitive. But McCormick, Shughart, and Tollison argue that the deregulated world cannot be a return to the competitive status quo ante because the original shift from competition to regulation will have been associated with rent-seeking investments by regulated firms. Those costs are sunk—unrecoverable even in the event of deregulation.<sup>17</sup> For example, lobbyists' and lawyers' time has been expended to gain passage of regulatory legislation, time that could have been used to create rather than diminish wealth overall.

Two implications follow. First, the wealth lost in rent seeking is not recovered, or even recoverable, merely by abandoning the regulation. The economy's production possibilities have been irretrievably diminished by the rent seeking. For instance, the construction of more lobbying-related facilities (e.g., golf courses and restaurants) than is optimal without rent seeking has drawn on resources that cannot be returned costlessly to competitive production.<sup>18</sup>

Second, to the extent that the resources diverted to rent seeking were specialized in the production of the good ultimately regulated, the relative cost of producing regulated versus unregulated goods has risen irretrievably. Suppose, for example, that procuring the regulation of widgets requires the time of not just lobbyists and lawyers but also the presidents of widget-producing companies—hardly an extreme supposition. As executives spend more time in Washington or Albany and less time in the widget factories, less specialized capital becomes available to produce widgets in the later, deregulated world. The relative price of widgets therefore will be higher in the deregulated world: the price can never return to  $P_c = M_c$  in figure 2. Under deregulation the price will be some  $P_d = MC'$  (where  $MC' > MC$ ), a price between  $P_r$  and  $P_c$ .

McCormick, Shughart, and Tollison's focus on the sunk costs of rent seeking presaged the current fascination with the stranded costs of deregulation. In effect, they pointed out that among the stranded costs are those (including the costs of investing in human capital) borne to secure regulatory favors, because the value of that capital is greater under regulation than under deregulation. Not only are those costs irretrievable; they distort subsequent production possibilities even in a deregulated world. Whereas the current stranded-cost debate revolves largely around distributional issues, the McCormick-Shughart-Tollison model reveals the long-run allocative consequences of those stranded costs. Those consequences occur whether investors with stranded costs are compensated or not.

McCormick, Shughart, and Tollison's analysis, which suggests that deregulation may have few if any benefits, is obviously provocative.<sup>19</sup> Upon reflection, its insights—admittedly counterintuitive at first—become more persuasive.

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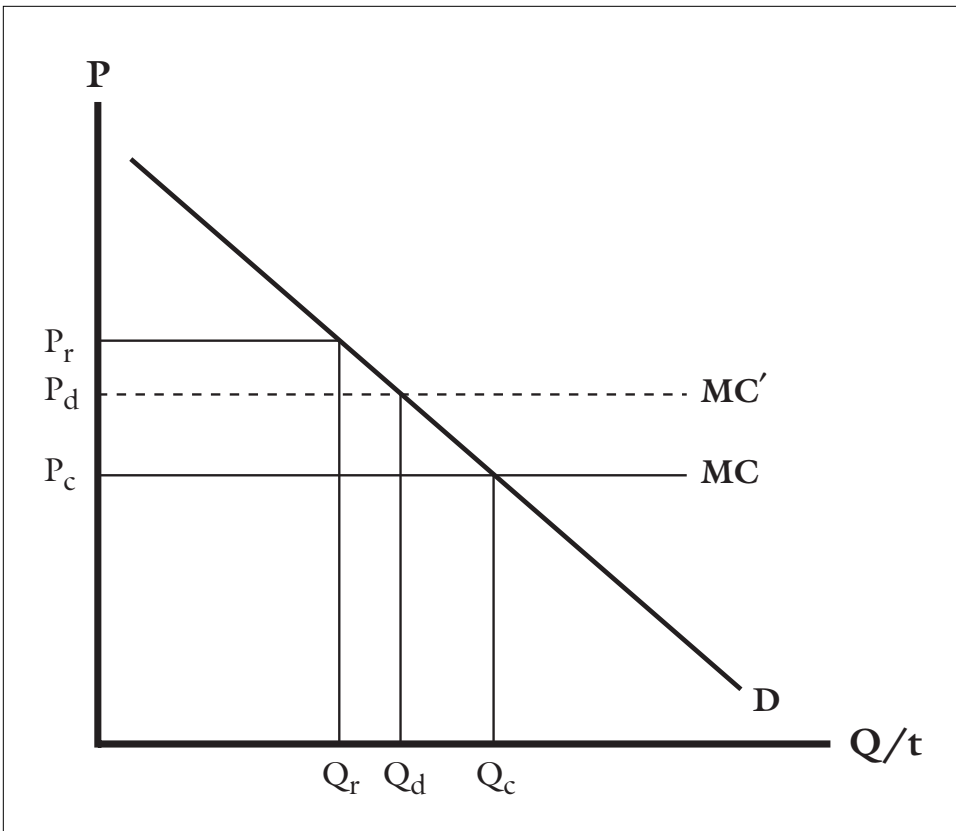
17. As discussed later, in note 20, this point has been disputed.

18. Mixon, Laband, and Ekelund (1994) find that the number of golf courses and restaurants in the capital cities of American states is higher, *ceteris paribus*, than the number in noncapital cities.

The economic intuition of our analysis is simple. The original act of rent seeking that created the monopoly employed, for example, the best and brightest legal minds in the industry. Moreover, legal skills were acquired that serve no purpose other than rent seeking. This reduces the human capital stock of lawyers with knowledge of industry practices such as contract negotiation and enforcement. When the industry is deregulated, the cost of obtaining additional output rises because legal inputs are now relatively less efficient at providing services to the industry.

This is just an example of the argument. The same point applies to other resources, especially managerial expertise and entrepreneurship, which are deflected from productive pursuits into the original act of rent seeking. It is, for example, fairly common to hear arguments that regulation drains managerial talents, dulling initiative and the incentive to innovate. On this account, marginal costs rise because the managerial talents acquired under regulation—dealing with regulatory bureaucracies, for example—are not

**Figure 2: Deregulated Market**



instantly adaptable to a deregulated environment. (McCormick, Shughart, and Tollison 1984, 1078)

The model depends on certain assumptions that may not always apply.<sup>20</sup> Nonetheless, it is remarkable how the methodologically—and substantively—different approach taken by McCormick, Shughart and Tollison leads to the same conclusion that Tullock reached by analyzing the transitional gains trap. Large gains can be had *ex ante* by preventing the imposition of regulation on competitive markets; the gains *ex post* from deregulation are relatively small. Stranded costs are really just a subset of a more general phenomenon indicating that deregulation can never replicate the status quo ante.

Finally, McCormick, Shughart, and Tollison note that the relatively large gains from stopping regulation in the first place versus instigating deregulation afterwards are reflected in the activities of free-market pressure groups:

Efforts by political action groups, such as the Right-to-Work Foundation, stand to be a drain on society's resources. They cannot produce anything unless they prevent further monopolization through regulation. We do not, of course, expect these organizations to be ignorant of this principle. From a positive perspective, we expect them to allocate their efforts to prevent new regulations from appearing rather than to get old regulations abolished. Thus, groups such as the CATO Foundation and the Sierra Club will spend the bulk of their efforts on upcoming legislation, not on attempts to repeal old laws, even though those laws may have caused large losses to fiscal conservatives or to environmentalists. (1076)

That is, whatever regulation's losses have been, they are largely irretrievable once regulation has been imposed. Like Germany's offer in 1914 to restore Belgian neutrality after German troops had marched through Belgium to attack France, deregulation's promise to "restore" competition is "a feat that rates with the restoration of virginity" (Tuchman 1962).

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19. The article has been read as implying that deregulation is difficult because out-of-pocket marginal costs of production fall under regulation, certainly a position few economists would adopt. See Lott and Reynolds 1989. But McCormick, Shughart, and Tollison do not espouse that position. Rather, they focus on changes in relative prices due to past resource allocations. The relative costs of production are permanently altered by regulation and the costs incurred to achieve it.

20. Principal among these is the assumption that all rent-seeking costs of regulation have indeed been sunk, a point that has evoked dispute (e.g., Crew and Rowley 1988, 167):

Only if the monopoly is continuously perceived to be completely durable would a normative efficiency case in favor of continuing regulatory monopoly necessarily coincide with political stability in favor of such an outcome. It cannot reasonably be inferred that all regulatory monopolies always reflect such durability characteristics in political equilibrium, even if initial rent-seeking outlays reflect such an expectation. Even the extreme forms of the rational expectations extravaganza allow for exogenous shocks that stimulate unanticipated performance adjustment.

McCormick, Shughart and Tollison (1984, 1076) admitted in their article that their assumption that all rent-seeking costs are sunk *ex ante* may not always hold.



McCormick, Shughart, and Tollison's model supplements one's understanding of the importance of regulatory equilibrium in explaining the lack of interest in deregulation. As noted before, regulation itself must be taken to represent a political equilibrium in which producers have gotten from politicians some but (thanks to consumer resistance) not all of the benefits available from regulation. Only with changes in underlying parameters—consumer information, avoidance of the free-rider problem, and so forth—would a push for deregulation develop. But again, such changes are only necessary, not sufficient, conditions. Even if problems of consumer ignorance and organization are solved, McCormick, Shughart, and Tollison emphasize, no push for deregulation should be expected if consumers cannot recover through deregulation what they have lost via regulation. "It is not that potential gainers from deregulation are large in number, diffuse, heterogeneous, and face high organizational costs; rather, *they do not exist to any degree*" (1075, emphasis in original).

### *The Actual (or at Least Measured) Gains from Deregulation*

The extent to which gains do exist is an empirical issue. How much do consumers really recover from deregulation? In figure 2, is  $P_d$  sufficiently far below  $P_r$  that consumers have an incentive to push for deregulation? Or is  $P_d$  so close to  $P_r$  that, as McCormick, Shughart, and Tollison's model indicates, the gains to consumers in pushing for deregulation are not worth their time and trouble?

It goes without saying that measuring the gains from deregulation entails assumptions and methodologies that may prove more persuasive to some than to others. But empirical observation is the only way to resolve empirical questions. Robert Crandall and Jerry Ellig (1997, 2), surveying a series of studies that analyze perhaps the four most important American deregulatory achievements of the late 1970s and early 1980s, arrived at annual values for consumer benefits due to deregulation (measured in both price reductions and service-quality increases) as follows: long-distance telecommunications, \$5 billion; airlines, \$19.4 billion; trucking, \$19.6 billion; and railroads, \$9.1 billion. The total annual benefits thus amounted to some \$53 billion, or a total annuitized value of \$758 billion at an interest rate of 7 percent (a conservative figure for the late 1970s and early 1980s, the years of deregulation). Assuming a population of 275 million Americans, that means an average per capita value into eternity for all four deregulations of about \$2,750.

That sum is not a trivial, admittedly. But is it enough to induce individuals to devote considerable amounts of their own time and money to achieve deregulation? People do not live into eternity, but the present-value difference between, say, thirty years of benefits and an eternity of benefits is not immense. With a conservative assumption of an eternity of benefits spread over thirty years, the average annual consumer benefit per capita is only some \$90 annually. If just half of consumers are voters or otherwise able to push for deregulation, that figure would be \$180 annually. This,

of course, refers only to that part of the Tullock rectangle recovered, not the (much smaller) Harberger triangle. Still, the amount is not overwhelming.

Of course, a margin of error surrounds these figures. One need not be a dyed-in-the-wool Austrian economist to register an important caveat to the calculations. Because the figures are necessarily based only on information currently available, they cannot capture all the dynamic gains—currently unforeseeable with any specificity—due to alterations in market structure, technological change, new information (including learning by doing), and other changes that predictably accompany deregulation. The airline industry of 1999 is not the airline industry of 1978 minus the Civil Aeronautics Board. As summarized by the authors of the study from which the preceding estimates are taken,

Benefits of regulatory reform continued to accrue long after the market was first opened. Even if some firms adjust quickly to the deregulated environment, that environment changes much more quickly than the regulated environment. The industries in this study did not move from a “monopoly equilibrium” to a new “competitive equilibrium.” Rather, they moved from a fairly stable regulated environment to an evolutionary environment in which competitive rivalry continually forces producers to improve their performance. Since it is unlikely that firms will ever stop learning, and consumers are never satisfied with the status quo, a stable equilibrium is extremely unlikely. (Crandall and Ellig 1997, 4)

One other point from the quoted passage deserves emphasis. As McCormick, Shughart, and Tollison emphasized, models of deregulation that assume the post-deregulatory world will be identical to the pre-regulatory world are suspect. Regulation itself gives rise to changes, so the particular market will never be the same. Europe was at peace at the beginning of 1939 and again at the end of 1945, but the continent had changed enormously in the interim.

### **On Being “Unregulated”: Quasi Regulation and Rent Extraction**

Apart from the impossibility of restoring a pristine competitive status quo ante, in most economic sectors no “competitive” market exists to begin with. Even in markets lacking prototypical economic regulation, governments constantly intervene via indirect regulation to achieve similar ends. Taxation is an obvious example of such “quasi regulation,” increasing prices and, when applied discriminatorily (as it often is), restricting entry. Further, even without direct regulation or a quasi-regulatory surrogate, many markets must contend with simple extraction of rents by politicians. To the extent that quasi regulation and rent extraction substitute for direct regulation, the gains of “deregulation” are obviously smaller.

### *Quasi Regulation*

Although government does not directly regulate the prices of certain goods, from liquor and cigarettes to gasoline and airline service, it indirectly does so very effectively by imposing excise taxes. Moreover, government has often used excise taxation to erect entry barriers to benefit certain firms by excluding others. A classic example is the discriminatory tax imposed on margarine to favor butter producers:

Caught in [a] vise of falling butter prices and rising competition from a new product, the dairy industry's response was predictable: they appealed to government for protection from "unfair" competition from the upstart oleomargarine manufacturers. The dairy industry's early rent-seeking success came with action by the states, especially the dairy states. In the 1880s, most states passed legislation regulating the manufacture and sale of oleomargarine, levied taxes on it, or both, while several states banned its sale altogether. Other states passed laws prohibiting manufacturers from adding yellow dye to the product, thereby making margarine less attractive. New Hampshire required the addition of an unappealing pink color. . . . Finally, in 1886, the industry was successful in getting a law passed by Congress and signed by the president requiring the licensing of manufacturers, wholesalers, and retailers of oleomargarine . . . and imposing an excise tax of two cents per pound. As a result of this legislation, the number of oleomargarine manufacturers dropped by more than a third. (Gifford 1997, 69–70)

A modern-day equivalent has been Congress's attempt to impose differential excise taxes on cigarette firms, in particular to favor one manufacturer (Brooke Group, formerly Liggett and Myers), which has shown itself willing to cooperate in federal and state government campaigns against cigarette companies (Bulow 1998).

Note that part of Big Butter's campaign against the margarine manufacturers included claims of "unfair competition." In addition to its power to tax otherwise "unregulated" industries, government's consumer-protection and antitrust powers likewise allow it to exert its influence over nominally unregulated sectors. There is little evidence that government price-fixing cases keep prices down, more that they actually raise prices (Sproul 1993; Marvel, Netter, and Robinson 1988). The same conclusion applies to mergers: no evidence exists that government enforcement policies have in any way enhanced competition; much evidence points the other way (e.g., Eckbo and Wier 1985).

Antitrust, however, is a valuable tool for politicians seeking to control the allocation of resources, including jobs in their districts (Coate, Higgins, and McChesney 1990). The examples are numbingly numerous. One involved the successful pressure by Nevada senators Richard H. Bryan and Harry Reid to keep Northwest Airlines from competing with local Nevada carrier Reno Air by opening new Northwest routes

from Reno to the West Coast (McChesney and Shughart 1995, 341–43). The most obvious use of antitrust in quasi-regulating a nominally unregulated industry is the current Microsoft affair. The Justice Department's Antitrust Division would effectively reduce Microsoft to a regulated common carrier by requiring it to carry competitors' products in its Windows package and to display competitors' icons on the Windows opening screen. The suit represents a great victory for Microsoft's competitors (and their political backers), who for years have been importuning government antitrusters to "do something" about highly successful Microsoft.

Is quasi regulation a substitute for actual regulation? If so, the points raised by McCormick, Shughart, and Tollison apply with even greater force. The putative gains (lower prices, greater outputs) from deregulation would be lost to subsequent quasi regulation. This possibility is an empirical question, of course, one that has not been investigated systematically.

But anecdotal evidence indicates that at least sometimes quasi regulation replaces actual regulation. A crude indication is the continuing growth of government relative to the gross domestic product. Government taxing and spending have grown steadily as nominal regulation has declined through the deregulation of industries such as natural gas, airlines, and trucking.

Several examples are revealing. People seeking the regulation of guns seem largely to have given up on official regulation, seeking instead to reduce the number of guns by increasing their prices through excise taxes, as well as by pushing in the courtroom for strict liability against gun manufacturers and sellers for gun-related accidents (Kobayashi 1997). Perhaps the greatest example of the link between deregulation and quasi regulation, at least historically in the United States, is that of alcohol prohibition. Prohibition is simply an extreme form of entry-barrier regulation, one that greatly benefited some sellers (bootleggers, gangsters, foreign distillers) at the expense of others. Whatever the political reasons for enacting the regulation, it took only fourteen years for deregulation to occur, in the very first months of Franklin Roosevelt's administration. Roosevelt campaigned on the promise to repeal the restrictions on alcohol, promising to tax it heavily instead:

Roosevelt's primary justification for increasing taxes was to generate additional federal revenues. The Depression had devastated the economy, and tax receipts were consequently down. . . . Realizing the revenue-generating power of liquor taxes, Roosevelt pledged to repeal Prohibition in order "to provide therefrom a proper and needed revenue." The Democratic party's platform had a very un-Keynesian theme: "If only given a chance, Americans might drink themselves into a balanced budget." (Yelvington 1997, 40)

Following the end of Prohibition, excise taxes on alcoholic beverages were imposed at almost double their level before Prohibition.

If quasi regulation substitutes for actual regulation, some firms (and their customers) would rather be regulated. At the macro level, one would expect an overall substitution effect. Taxation predictably is a positive function of private social wealth produced; private wealth is a negative function of the extent of regulation. Less regulation (ergo higher wealth) should therefore translate into greater taxation.

Again, anecdotal evidence is illustrative. The tobacco companies hoped that placing cigarette warning labels on cigarettes would protect them from the sorts of quasi-regulatory depredations now being visited upon them by state and federal governments. And for a while, their hopes were realized. It is clear that banks would rather have their mergers officially regulated by banking regulators than expose themselves to the quasi-regulatory world of antitrust merger enforcement. Indeed, the Bank Merger Act of 1966 was an explicit attempt to undo the effects of a case brought by the Antitrust Division that declared a bank merger illegal (*United States v. Philadelphia National Bank*, 374 U.S. 321 [1963]). In any event, negative correlation between regulation and taxation is an empirical hypothesis that warrants systematic testing.

### *Rent Extraction*

Is a market that is neither regulated nor quasi-regulated necessarily a “free” market, that is, a “competitive” one in the classical economic sense? By definition, unregulated markets seemingly would have to be classified as free. But actually, that conclusion does not follow. Unregulated markets often remain so only because producers or consumers pay politicians to leave them alone. Just as there are no free lunches, so there are no free markets.

Examples are ubiquitous. Various industries pay politicians—quite legally, it should be added—*not* to be taxed. Microsoft, it is widely reported, has now increased considerably its political contributions in hopes of being left alone by state and federal regulators. The (unregulated) cosmetics industry employs lobbyists in Washington who pressure Congress *not* to regulate the industry. American banks lobby the Federal Election Commission to curtail their ability to make loans to politicians. One banking company alone, Citicorp, employs registered lobbyists and several law firms in Washington to fight off various proposed credit regulations.

Paying not to be regulated is known as *rent extraction*, in contrast to *rent creation*, the hallmark of regulation (McChesney 1997 and forthcoming).<sup>21</sup> Just as rent creation via regulation is not merely a wealth transfer to producers but entails true allocative losses, so does rent extraction involve more than just wealth transfers to politicians. It distorts investment decisions, because some wealth is more easily threatened than other wealth, and it soaks up real resources (e.g., lawyers, lobbyists).

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21. My 1997 book also discusses the examples noted in the previous paragraph.

Modern health, safety, and environmental regulation have given politicians particularly potent threats to induce payments to avoid regulation. The NIMBY (“not in my back yard”) response means that individuals lobby legislators hard, for example, to have toxic dumps placed somewhere else (Yandle 1989).<sup>22</sup> In Louisiana, environmental violators located in districts represented by important legislators face higher threatened fines for their infractions, *ceteris paribus*, but those threats typically are alleviated (Kleit, Pierce, and Hill 1998). The point is not necessarily that the regulation has no benefits, but rather that its mere threat is sufficient to induce payments and produce costly economic distortions.

The real issue here, however, is again whether deregulation increases the amount of economic loss due to rent extraction. Rent extraction and rent creation are not mutually exclusive. Politicians can create rents for an industry but extract some portion of the industry’s existing wealth at the same time. But if deregulation would predictably lead to an increase in rent extraction, the gains from deregulation would be smaller and so less deregulation would be expected, all other things equal.

This issue is yet another empirical one for which no data are available. *A priori*, however, one suspects that deregulation would be followed by greater rent extraction, for the same reasons that deregulation is followed by tax increases. Deregulation, if it occurs, must increase societal wealth. Thus, just as there is more wealth to tax, there is more wealth to threaten and therefore more to be had by rent extraction. The gains from deregulation thus are diminished, reducing the demand for deregulation in the first place.

## Conclusion

Although some deregulation has occurred, doubtless achieving economic benefits, the same kinds of benefits are available in other markets that remain regulated. Why the continued regulation? George Stigler reportedly said that there are never seven important reasons for anything. To stay within that limit, the comparative lack of progress in deregulation is ascribed here to just five factors.

First, even if deregulation promises welfare gains on paper, the very fact that regulation already exists creates a presumption that a political equilibrium exists favoring the status quo. There is little reason *ex ante* to expect changes from that equilibrium in the direction of deregulation to arise or to succeed.

Second, the prevailing model of deregulation is essentially a nirvana model, in that the gains from deregulation can essentially be had without cost. Tullock’s transitional-gains trap alerts us that “innocent” purchasers of firms whose previous owners have already benefited from regulation will seek compensation for deregulation. The

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22. It goes without saying that “the same kinds of economic interests that influence the setting of economic regulations . . . are also at risk in determining the structure of risk and environmental regulations” (Viscusi, Vernon, and Harrington 1995).

ongoing heated debate over compensating for costs stranded by deregulation presents perhaps the best example of the trap. There are plausible legal and perhaps even economic reasons why even publicly interested regulators would pay compensation.

Third, those same regulators, once cast as deregulators, might not deregulate in a way that serves the public interest. Once regulation has created the trap, extrication from it requires legal and bureaucratic resolution of competing property-rights claims. But the same (or very similar) legislators and bureaucrats who created the trap are the ones entrusted to effect the extrication from it. Whatever the efficiency argument for stranded-cost remuneration, in the real world of compensation the efficiency argument probably will not dictate the actual outcome.

McCormick, Shughart, and Tollison highlight a fourth disincentive to deregulate: the losses from regulation are sunk and irretrievable. Tullock's seminal insight was that the major losses from regulation take the form of resources expended in rent seeking. But those costs are sunk. To the extent that specialized resources were involved in the rent seeking—resources that could have been devoted to amassing specific capital in producing the regulated good—the deregulated relative price must be higher than the pre-regulation (“competitive”) price. Hence, the gains from deregulation are smaller than those indicated by the conventional model of deregulation, which presumes a reestablishment of the pre-regulatory status quo. Indeed, gains may not exist at all, or they may be too small to motivate the political effort necessary to procure deregulation.

Fifth, in the spirit of McCormick, Shughart, and Tollison's model, one appreciates that deregulated industries are not necessarily “competitive” thereafter. Quasi regulation (e.g., taxation) and rent extraction distort markets much as direct regulation does. Excise taxes, for example, raise prices and are applied discriminatorily to limit entry. To the extent that quasi regulation and rent extraction substitute for direct regulation—and there is reason to think they do—the attraction of not being regulated diminishes and less deregulation is demanded.

As many have noted, regulation is much easier to get than to get rid of. The predictable path, once regulation has been adopted, is a series of ratchets upward. The notion that it is easier to regulate than to deregulate is hardly anomalous in the perspective of the overall growth of government power. Other scholars have noted that historically much of the growth of government has occurred in a series of distinct ratchets. War is a particularly powerful upward ratchet. A nation's citizens surrender power to the government easily in the event of war, but find that power hard to recover when the war ends and they want it back (Higgs 1987). Regulation appears to work in the same way.

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