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Who Captures Whom? The Case of Regulation

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Last month, Mises.org republished a first-rate article written by Gary North in 1978 titled "Walking into a Trap." (http://mises.org/daily/2293)

To the best of my knowledge, this was the first time anyone had provided a detailed dynamic model explaining how the government traps and captures an industry it regulates.

The article provided an accurate blueprint for the multi-year gradual process by which doctors, hospitals, and the medical industries in general have since been and are being captured and turned into drudges of government bureaucrats.

The Chicago School of economics favored and still favors the theory of "regulatory capture." Under this theory, an industry or some portions of an industry cultivate government to obtain laws and rules that favor the industry.

The government trades favors for what it wants. Politicians gain political contributions, side payments, and votes for being seen to control the industry. The industry captures the regulators. End of story.

North went much further. He called the first step of obtaining favors "baiting the trap." But matters do not stop there, he pointed out. The trap is set when the industry becomes comfortable with its subsidy, tax break, tariff, exclusive position, license, or whatever. It then begins to extract monopoly rents and to lower product quality.

This then leads to further steps such as public outcry and a government demand for the industry to police itself. Then come crisis, further regulatory intervention, and eventually a government stranglehold over the entire industry via a panoply of boards and price controls. This is when the trap is sprung. The market is replaced by government power and bureaucrats. Government, its aim being control, traps and captures the industry.

In the shorter term, the interest groups use the state against the public. In the longer term, the state and its bureaucrats rule the roost. In the end, the government

bureaucracies expand. Paperwork and soft jobs rule the industry, innovation and competition are eclipsed, and the public suffers from poor product quality and high prices.

Extending the Model

I think North's model can be extended, deepened, and enriched in several directions.

First, if the regulation and control by the state get bad enough, we may predict that substitute industries will arise because the basic demand for services still remains and this creates profit opportunities. The market may find new ways to provide the same kinds of services. If the railroad industry is killed off, then trucking, buses, private autos, and air transport have incentives to replace rails. If medical practice declines, then home medical devices may spring up. Or the AMA may get competition from other kinds of doctors, domestic and foreign. The competition to meet needs will continue under new forms.

Second, the government will observe these substitutes arising. It has an incentive to stop them or control them. It can do this by extending regulation to these new markets. The industry under regulation will itself probably call for regulation of the new competitors so as to maintain its monopoly position. They will use fairness, equity, fair competition, and safety (to name a few) as cover stories.

The government will add stories of its own, such as the essential nature of the service, or the claim that it forms a natural monopoly, or that it's critical to national defense. It makes no difference if the rationales are false as long as they sound plausible and keep the public apathetic or even mildly supportive.

The government will be happy to accommodate the demand for new regulation. It may pile on safety regulations or licensing requirements that raise costs in the competing industries or slow their growth. Hence, in the case of railroads, we can predict that truck, bus, and air transport will also come to be regulated.

There is a glimmer of hope in all of this. Gary North in private correspondence points out that "the regulators are usually behind the curve in technology and creativity. They are regulating last decade's model." The market leaps ahead at such times, and the public gets a reprieve.

Third, we may predict that political reform or liberalization movements will occur. There are political profit opportunities for populist reformers who promise to reform an under-performing system. By promising that the state will loosen its grip on the industry, they may gain public support and win election. Subsequently, we may even see privatization occur, as under Thatcher in England.

Within the seemingly monolithic Communist systems of the Soviet Union and China, we have seen rival factions compete for control. The more liberal reformers have won out and relaxed the centralization. The same thing goes on in other basically illiberal countries. Even Castro's Cuba has seen a loosening trend because he could not kill the patient altogether. And there are more moderate and more statist factions in Iran.

Fourth, while such reform movements go deep enough to be noticeable, they hardly ever go all the way back to a high degree of freedom. And after a while, enthusiasm peters out and the counter-liberal forces begin to regroup and reassert their dominance. This occurs partly because reform movements are often not radical enough. If they retain large vestiges of the earlier regulatory systems, then they will be blamed when things go badly. And things often do go badly unless a complete

deregulation occurs. Statists have had a field day in California because of the botched and partial de-regulation in the electricity industry.

Fifth, the government does not find that all industries are equal prey. It has an incentive to control those industries (a) that can't escape as easily from the country and (b) for which there are fewer substitutes. At the time the US government began to control the railroads, autos and airplanes didn't exist. And the large fixed capital investments of the railroads within the continental United States made them good fixed targets. Similarly, medical services have to be delivered to individuals on the spot within the country's borders, and home medical devices like those today were not widespread in 1910 — although there have always been home remedies.

Sixth, when over-regulation occurs and the trap is sprung, we predict that the industry will try to escape overseas if it can or the customers will take their business overseas if they can. They will search for lower-cost places to do business. Many clear examples occur under financial regulation because many elements of financial dealings can be transacted overseas. Ceilings on interest rates paid on deposits led at one time to dollars fleeing overseas, whereupon a eurodollar market grew up. Sarbanes-Oxley regulation leads to overseas listings or even incorporation. Excessive regulations of exchanges leads to lower cost trading venues in London, or else trading shifts to over-the-counter formats.

Seventh, if business escapes the country as in the case of some financial services, then we predict that the government will once again respond in order to maintain its control. One method of control is to form a political cartel with other governments. This is a movement in the direction of world government. It is usually called "harmonization." The most heavily regulating government will try to get the other governments to "improve" their regulation, that is, to copy that of the heavy regulator. This occurs in the guise of labor, safety, and environmental standards, for example.

The objective is for the government that is losing control of businesses that exit its territory to stem the flight of capital to other countries. The success of this sort of cartel depends on a number of factors such as political pressures, side payments, technical matters, ability of capital to move, and the availability of cartel-busting countries willing to house industries.

The foreign apparel firms can jump around to a great many countries. Banking can move fairly easily, but has some problems in establishing a reputation. Financial centers require banking and clearing techniques. But, in general, even cartels of governments run into cheating and enforcement problems. Woe to the consumer when they do not.

More generally, there will be some more highly controlling governments that try to make other governments harmonize their fiscal and monetary policies with theirs. Alternatively, a government can impose various sorts of controls to prevent industries and capital from leaving their country.

It's worth pointing out that state and local governments can also play the same regulation game. But they can't control those industries that can easily flee the state and do business in another state. This is why states focus on more locally oriented interests like barbers, beauticians, and construction trades, etc. Even so, they face the ultimate threat of depopulation of the state or locality. A small locality, however, such as a university town, can impose rent controls since it can count on the university remaining in the area, and students may not wish to travel or find that travel time and costs are high.

Credit-Rating Industry

The credit-rating industry provides a recent example of North's analysis in a new context.

The Securities and Exchange Commission (SEC) that governs the securities industries in the United States has gradually been increasing its control over securities businesses since 1933, using as a basis such legislation as the Securities Act of 1933, the Securities Exchange Act of 1934, and later the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, and others.

The pace of SEC regulation has picked up in the last 25-30 years. The SEC staff is now up to about 4,000, and most people will be surprised at how many pies it has its fingers stuck into. One sub-industry that the SEC regulates is the credit-rating industry: firms that evaluate corporate and government debt issues and issues ratings on them.

The Enron failure provided the SEC with an opening to extend its pre-existing control over this industry, that is, to spring the trap. The credit-raters were blamed for not picking up quickly enough on the hidden Enron debts and lowering the Enron ratings. This accords with the North model prediction that crisis eventually occurs within the regulated industry.

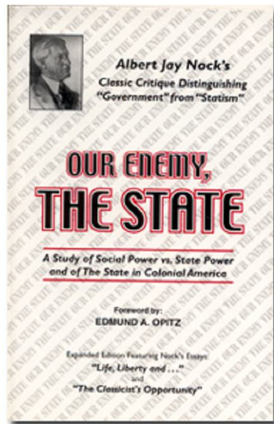
The SEC baited and set the trap much earlier. In 1975, the SEC created a designation for credit-raters: Nationally Recognized Statistical Rating Organization (NRSRO.) The SEC rule created a cartel of 3 firms: Standard & Poor's Credit Market Services, Moody's Investors Service, and Fitch, Inc. — these being the only firms that qualified for use by broker-dealers for satisfying another of the SEC's rules on net capital. As North's model predicts, the credit-raters were only too happy to take the bait and endorse this arrangement.

The harmonization issue is up in the air because the International Organization of Securities Commissions (the cartel agent of government securities regulators) and the European Parliament are also investigating the credit-raters. The collapse of the Italian firm Parmalat in 2003 was Europe's Enron, and led to this criticism as well as some talk of starting up competitive credit-raters in Europe.

In the United States, the Sarbanes-Oxley law required the SEC to investigate credit-raters. The SEC report suggests that additional oversight and control will now occur. The areas mentioned include making the NRSROs disclose more information on how they arrive at their ratings and making them disseminate the ratings more widely. Both of these measures will undermine the rating businesses.

The report talks of requiring the debt-issuers to provide more information about various financial contracts. It calls for attempts to resolve perceived conflicts of interest that are somewhat like those that the SEC got into between accounting firms and corporations. These involve the fact that the companies purchase ratings, that the rating analysts have direct contact with those whom they rate, and that the rating firm has ancillary activities that also do business with the firm whose debt issues are being rated.

It's back in print (http://mises.org/store/Our-Enemy-



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If the SEC takes steps along these lines, it means large changes for the rating firms and far more control over what they do. It probably also means lower quality ratings services at higher costs.

Then the report suggests that the SEC investigate alleged anticompetitive practices and also revisit its NRSRO rules. These statements raise the possibility of new entrants into the credit-rating business. The odds against this are high. It is far more likely that the SEC will opt for more rules that supposedly make the industry behave competitively.

Perhaps the most important and startling items in the SEC report are for the SEC to "explore whether more direct, ongoing oversight of NRSROs is warranted" and if so, to "explore whether it is advisable to ask Congress for specific legislative oversight authority." If these are implemented, then we are seeing movement into what North calls the final stage of "skinning the victim." In this stage, the government institutes quality-control boards and begins to influence pricing. The victim industry's quality deteriorates and it begins to operate at a loss.

Conclusion

Gary North's government trap or capture model provides an abundant set of predictions about how governments accumulate power and control over industries. It applies well to a recent case, the credit-rating industry. I've provided some extensions to the model that suggest which industries are most vulnerable and what sorts of further dynamics might occur as and after the government captures an industry.

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