# WHAT MAKES REFORM HAPPEN?

**Roger G. Noll and Bruce M. Owen**

REGULATION IS A PECULIARLY American institution. All nations use political and legal processes to constrain the economic activities of their citizens, but most other countries implement such policies by giving government officials great direct authority. Important industries are nationalized, or regulatory decisions are entrusted to a controlling bureaucracy that has far more power than the typical U.S. regulatory agency.

The American regulatory process is a reflection of the democratic and egalitarian principles held by the Founding Fathers, especially their fear of centralized government power. Its organizing principle is that decisions should be based on objective analysis and made only after the views of all who are likely to be affected are heard and considered. Elaborate rules regarding rights of participation, the evidence pertaining to a decision, and the statutory basis for a policy action have developed to serve this principle. Thus, like many American legal processes, regulation is designed to serve principles of equity and the public interest in a rational way in an environment populated primarily by advocates of particular economic interests. For the most part, these participants are motivated by their economic stakes in the decision, and as a result will typically clothe their self-interested positions in terms of the public's interest in equity and efficiency.

The interest-group theory of regulation attempts to explain who will participate in the regulatory process and how the bias in the range of the participants will affect policy decisions. Interest groups are costly to organize and to maintain, and participation in the regulatory process is also expensive. Thus, members must have a sufficiently high stake in the activities of a group to induce them to bear these costs. Moreover, relatively small groups of people who basically agree and whose individual interests are intense will generally find it easier to organize than will larger groups of people who have important areas of disagreement and whose individual stakes in an issue are relatively small. In general, the factors

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affecting the ability of a group to organize effectively tend to favor producer interests (trade associations, large corporations, labor unions) and "single-issue" groups, whose members have extremely strong feelings on a particular issue, over the more diffuse interests of the general population. Some special interests can even be created by regulation itself. A new rule may serve to protect one group of firms from competition, in which event these firms, motivated by their interest in the new regulatory status quo, can be expected to participate actively in future regulatory proceedings.

The substance of regulatory decisions depends in part on who participates in the formal proceedings of an agency. Administrative law requires that decisions take into account the information gathered in those proceedings. Moreover, represented groups can always appeal a regulatory decision they dislike—which raises the possibility that decisions unfavorable to a represented group may be reversed, whereas decisions that are excessively favorable to represented interests at the expense of unorganized groups will not be challenged.

Viewed through the lens of interest-group analysis, much of regulation appears to be a peculiarly cruel hoax. The pure interest-group model implies that the regulatory process, far from protecting citizens against monopoly abuses, threats to health and safety, and degradation of the environment, will become instead an instrument for protecting well-organized groups against this very public interest. Moreover, because each new regulation tends to create new special interests whose survival depends on its continuation, deregulation and other regulatory reforms appear least likely to succeed in the very areas where policy has departed most from serving the public.

Not surprisingly, the view that regulatory politics is based on special economic interests has led to very cynical conclusions not only about regulatory policy making but also about the overall role of government. Political scientist Murray Edelman has coined the term "symbolic politics" to apply to a wide range of policies that are justified publicly as serving some broadly based public interest, but that in reality consist of special favors for some small groups (*The Symbolic Use of Politics*, 1946). Historian Gabriel Kolko puts the matter even more strongly, interpreting regulatory policies in Marxist terms as straightforward means to protect capitalists from consumers and workers (*Railroads and Regulation: 1877–1916*, 1965).

While regulation often has been obviously protective of special interests, such cynical conclusions do not fit all of the facts, especially since the early 1970s. One example is environmental regulation. Although by the late 1970s, federal, state, and local regulation of emissions into the atmosphere had erected significant barriers to new competition, the initial passage of environmental legislation can hardly be attributed to cynical machinations by industry. The very interests that now oppose reform in environmental regulation because existing control methods are biased in favor of established firms were most vociferous in opposing the legislation back in the 1960s. Indeed, the switch in positions may be entirely rational. The initial cost that the controls imposed on established firms may well have exceeded the later benefits they received when the regulations retarded entry by new competitors. But now that the controls are in place, some firms prefer a system biased in their favor to a more balanced and more effective one.

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## Reform at the CAB and FCC

Recent developments in transportation and communications regulation also are at variance with the cynical conclusions drawn from interest-group theory. Perhaps the most dramatic turnaround in regulatory policy took place in the mid-1970s at the Civil Aeronautics Board. In the early 1970s, the CAB appeared to have only one purpose—the cartelization of the airline industry. It refused even to process

applications from new companies wanting to enter the interstate airline business. It denied standing in regulatory proceedings to consumer interests. It attempted to organize collusive agreements among airlines to reduce service in competitive markets so that airlines could earn higher profits. And it engaged in an almost comical process of trying to cure by regulation the recurrent outbreaks of "non-price competition" in service amenities, even to the point of writing detailed prescriptions for the size of a coach-class seat and the amount of meat that could lawfully be served on a sandwich.

Then, almost overnight, the board reversed itself and adopted a procompetitive policy. It vastly increased the route authorities granted to established airlines. It allowed new low-price carriers to enter the industry. It even advocated its own dissolution. Much of this reversal has been attributed to personnel changes made in 1977: the appointment of Alfred Kahn as CAB chairman and Elizabeth Bailey as a member, and the hiring of Darius Gaskins, Michael E. Levine, and other top staffers to oversee the deregulatory process. Without doubt these people played a key role in airline deregulation, but the agency had begun its dramatic shift even before they arrived (Martha Derthick and Paul Quirk, in Roger G. Noll, *Regulatory Policy and the Social Sciences*, forthcoming). Since the mid-1960s there had been critics within the agency itself who found its protectionist policies unwarranted. When academic scholars, Congress, and the courts joined in the criticism, the board turned to these internal dissidents for analysis and recommendations. The resulting "Pulsifer Report" (1975) was a blueprint for turning the CAB around.

A similar dramatic policy reversal took place at the Federal Communications Commission at approximately the same time. Established by the Communications Act of 1934, the FCC spent its first thirty years viewing interstate telecommunications as a natural monopoly and pursuing a policy of protecting the dominant firm, AT&T, from competitive entry. In the late 1960s, however, the FCC came to the view that a definite boundary between monopoly and competition had to be drawn and that the boundary should be based on what was most desirable for users of the system. Thus, the Specialized Common Carrier Decision (1971) and the first Computer Inquiry (1971) permitted competitors if they offered distinct new services, while affirming that the heart of the interstate telecommunications system—message toll telephone service—would remain an AT&T monopoly.

Like the character who released a genie from a bottle, the commission soon lost control of the competition that its decisions created. The prospect of competitive entry, even at the fringes of the industry, attracted a variety of newcomers and provoked a variety of competitive (and anticompetitive) responses by AT&T. Within a few years the boundary between monopoly and competition became technically and economically indistinct and legally arbitrary. By the mid-1970s, one competitor, MCI, had begun to offer a service that was equivalent to message toll telephone service. When the FCC tried to block the service, the courts said it could not unless it demonstrated, based on objective evidence, that protection of the AT&T monopoly was in the public interest. Rather than attempt the demonstration, the agency resorted to regulation by reluctance: competition would be permitted wherever it appeared reasonable and possible, and regulation would be used only where competitors were weak or nonexistent. In the second Computer Inquiry (1980), the agency all but gave up the idea of identifying a technical boundary between monopoly and competition, and laid out ground rules for allowing competition to flourish wherever it might arise.

More recently, the FCC has again led the way in deregulating certain aspects of cable television and broadcasting. Its current proposals to create more low-power VHF television stations, to allow direct satellite-to-home broadcasting, and to repeal its restrictions on network participation in television program syndications markets are but the latest in this series of reforms. Similar stories can be told about the Interstate Commerce Commission's position on trucking regulation and the Environmental Protection Agency's introduction of market-like processes for pollution control.

Cases of this kind can teach us much about the process of regulatory reform. In these instances the agencies took the lead in deregulating or reforming regulatory policies, anticipating by several years changes espoused by Congress and the executive branch. Such stories show that while regulation can be responsive

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primarily to well-represented special interests, it need not be. This suggests an important question: why were a number of agencies able to resist the concatenated forces of special interests in the mid-1970s and embark on a dramatic reevaluation of their own policies?

### Generalizing the Interest-Group Model

We must begin by recognizing that the interest-group view of government does not state that well-organized interests always get what they want. Instead it predicts which interests can be expected to organize effectively to press their views in decision-making processes. And it tells us that when policy makers, whether in regulatory agencies, the executive branch, or Congress, passively respond to requests put before them, special interests are likely to carry the day. This recalls the central difficulty that the Founding Fathers perceived as they wrestled with the problem of constitutional design: how, they asked, can a government be devised that is responsive to the citizenry but does not passively allow policy to be captured by factions?

For years—though less now than in the 1960s—regulatory agencies have been roundly criticized for embodying the kind of government process most susceptible to factional abuse. Having narrowly specialized, targeted responsibilities, they are easily overlooked by the electorate—and often by political leaders in the executive and legislative branches as well. Because they normally possess quasi-legislative decision-making authority constrained only by broad, often extremely vague policy mandates, they face the danger of becoming miniparliaments in which only a handful of interests even seek representation. And the administrative requirements for bureaucratic policy making impose expensive procedural burdens on agencies, increasing the likelihood that only directly affected interests will find it worthwhile to bear the costs of representation.

Prior to the regulatory reforms of the 1970s, the conventional wisdom was that while the politicians might sincerely believe that regulatory statutes served some diffuse public interest or noble purpose, the agencies had actually evolved into moribund protectors of the very interests they were supposed to control. The 1970s brought a dramatic refutation of this conventional wisdom at a variety of agencies. The question is why, and what does this portend for the future of regulatory reform and deregulation?

In the long run, several factors militate against the full "capture" of an agency, that is, its complete subordination to special interests. One is the protection against it afforded by the constitutional design of the federal government.

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A fully captured regulatory agency is vulnerable to attack by political entrepreneurs who owe no political debt to the special interests involved and will exploit the exposure opportunities that the agency's misdeeds create. The economic interests that are hurt by the agency's behavior will rally round the politician who attacks it, and vice versa. Here the public activities of a political entrepreneur can bring about a sort of informal interest group without the individuals involved making the effort to organize. The separation of the legislative and executive branches of the government and the complicated system of representation in elected federal offices make it unlikely that a special interest can so strongly influence all officials that the threat of political entrepreneurs can be foreclosed.

An example of this kind of activity is Senator Edward Kennedy's investigation, launched in 1974, of the policies and practices of the Civil Aeronautics Board. Another example is the use of deregulation as a presidential campaign issue by President Carter in 1976 and President Reagan in 1980.

A second factor militating against full capture is the continuing scrutiny of regulatory policy by scholars in economics, law, and politi-

cal science. In each of these disciplines the study of regulatory policy constitutes a separate, well-developed field of research. The poor performance of several economic regulatory agencies in the twenty years following World War II gave rise to a spate of scholarly books and articles that provided an intellectual foundation for the work of reformers in the agencies and elsewhere in the government. Political entrepreneurs have found it useful to hook up with scholars anxious to provide critical policy analysis. Senator Kennedy did so by engaging a former law professor, now Judge Stephen Breyer, to organize the airline hearings. President Carter did so by appointing academics to the CAB and ICC. And President Reagan did so by appointing Christopher DeMuth and Murray Weidenbaum to Executive Office of the President positions having important oversight responsibilities for regulatory policy.

A third factor lies in the nature of government service. Regulators have no direct financial incentive to operate as efficient cartel managers. While some argue that regulatory agencies are revolving doors through which the ambitious pass quickly on their way to jobs in regulated industries, such incentives are at best indirect. They tend to apply only to a fraction of an agency's employees and then only at the highest levels. In addition, responding obediently to requests from a client group does not establish one's credentials as an active decision maker in the private sector, a position requiring analytical skills as well as a knack for making things happen. Moreover, an important regulatory reform is bound to create a need for executives who understand the change and how to cope with it: ardent deregulators can be attractive executive material. Thus, Darius Gaskins and Michael Levine are now executives of the firms they once regulated—or, more accurately, deregulated. In any case, it seems implausible that all the key posts in an agency would be filled for any significant period of time by those seeking rewards from the firms that they regulate by obediently granting their wishes. Indeed, most regulatory agencies—including those that were moribund—have always had some staff members and commissioners who viewed themselves as independent actors attempting to perform a public service, much to the distress of the companies that were ostensibly in control of the agency.

Even before the tumultuous 1970s, agencies were collectively and steadily improving their capabilities for analysis and beginning to use internal studies and general inquiries to examine important policy issues. A strong analytical capability is vital for an agency seeking to serve a general public interest—the protection of consumers from monopoly, for example—in an environment in which only the regulated industry and its most powerful customers are likely to be represented. Such a capability is necessary if an agency is to sift out the purely self-interested material from all the information presented by groups participating in its deliberations as well as to produce its own independent information by monitoring the industry's performance. The FCC's creation of its Office of Plans and Policy and, later, its special staffs for the cable television and network inquiries, stand as an excellent example of how to provide such independent capability. The extensive research these staffs conducted led to several important initiatives, such as the current proposals to repeal the financial interest and syndication rules, to permit direct broadcast satellites, and to license low-power television stations.

**The Future of Regulatory Reform**

From these observations we can derive a strategy for reforming regulation and protecting against the factionalism that political analysts have warned against since the founding of the republic. One central element in that strategy is to beef up the corps of analysts who keep their sights trained on the impact of regulatory policy, who figure out the answers to the key questions: whom does the rule affect and in what way? Like the private sector, government is strongly influenced by entrepreneurs—people in agencies and in elected offices whose objective, whether arising from political or personal motives, is to be among the first to become identified with a new political issue affecting the general interest. Such actors can be persuaded by the facts, and hence the importance of inhouse analytical staff and outside scholars.

Another important element in the strategy is to keep the regulatory process accessible at low cost to a variety of interests. The function of an assortment of citizen groups—consumerists, environmentalists, and the like—is not really to represent accurately the diffuse and

heterogeneous general public. That would indeed be an unrealistic expectation. Their more useful functions are to raise questions about the subtle ways in which regulatory rules may serve narrow self-interest and to keep regulatory policy making in the sunshine of public scrutiny. An agency can make effective use of input offered by public interest groups just as it can the input of the well-represented private interests. Here, again, the regulators need internal expertise to help them determine whether the questions raised are valid, whether the position taken is intellectually sound, and whether a true general interest has been identified.

The implications of these arguments for the future of regulatory reform are favorable. Many regulatory agencies can now perform independent internal analysis and presumably will continue to do so unless the budgets for these efforts disappear. Moreover, the regulatory analysis review function is now firmly established in the Executive Office of the President, having survived several reorganizations by three presidents. Even Congress, having expanded its subcommittee staffs and created strong capabilities for policy analysis in the Congressional Budget Office, the General Accounting Office, and the Office of Technology Assessment, can now make its own independent judgments on these issues.

The success of regulatory reform since the mid-1970s gives further cause for hope. Indeed, Michael Levine, now of New York Air and one of the early CAB deregulators, argues that the record of the 1970s should cause a revival of the progressivist "public interest" theory of regulation (*Journal of Law and Contemporary Problems*, Winter 1981). According to this theory, regulation will tend to focus on areas where there is a public interest to protect—monopolized markets and the like—and will actually make matters better in the long run. The protectionist economic regulation of the post-World War II era can be viewed as an aberration, caused by an unjustified loss of confidence in market competition during the Great Depression.

If this view is accurate, the work of Levine and his fellow deregulators leaves an important legacy that transcends its effects on prices and costs in deregulated industries. Because of the reforms of the past decade, a solid history is being constructed to support the view that competitive market forces benefit the general public and that regulation should be dismantled or redirected when it tries to stifle them. This is not to say that government has no role in channeling and constraining the freewheeling activities of the private economic system. The lesson instead is that private market incentives are a powerful force for serving the interests of the general public and can be effectively channeled to that end by enlightened, procompetitive policies. In some cases, such as most of communications and transportation, this line of reasoning leads to deregulation. In others, it leads to a change in the way regulation is undertaken. Thus in environmental regulation, the analysis implies a greater reliance on marketable emissions permits, emissions fees, and cost-benefit analysis in setting and attaining environmental objectives.

In our view, recent history carries an important message about the American experiment with regulation: in every regulatory determination there ought to be a presumption—open to rebuttal—in favor of using competitive market approaches for achieving effective social control of business. Arguments against deregulation based on a desire either to avoid competition or to preserve interests inadvertently created by regulation itself deserve short shrift.

This point warrants elaboration. Economic and technological conditions are always changing, and market competition is usually the system that adapts most efficiently to change. But who lobbies for the invisible hand? Competition has only a fragile constituency. The benefits of competition to the public are theoretical and diffuse, but no less real than the benefits of regulation to particular interests. Advocates of deviations from the competitive model ought to bear the burden of proof.

The future of reform depends on institutionalizing the means to ensure that the economic basis of interest groups is examined and understood in the policy-making process. This requires not that we be cynical but that we come to appreciate the perspicacity of the Founding Fathers in designing a governmental system that can make use of the energy of such groups without necessarily being captured by them. The system can run well only if we encourage the participation of all interests and of the analysts who weigh their arguments. ■