

Lecture VIIA: Interest Groups

XXIII. Introduction. During the 1960s and 1970s, a more or less separate literature on the politics of interest groups emerged which attempted to model the manner in which regulatory commissions would set regulations. Although all this literature was linked to Mancur Olson's work on the *Logic of Collective Action* (1965), generally the new work was a bit more rigorous and substantially more focused on political interest groups than Olson's analysis.

A. The literature on the political economy of regulation can be said to have begun with Tullock's (1967) analysis of the dead weight loss of political and other efforts to obtain monopoly power and tariff protection. That paper characterized dynamic losses from interest group and other activities that have come to be called Rent Seeking activities.

- i. Not much additional work was done within this framework until in the middle seventies when Anne Krueger (1974, *AER*) independently reinvented the idea and named the phenomena rent-seeking,
- ii. and Richard Posner (1975, *JPE*) attempted an empirical analysis of the dead weight loss of rent-seeking by would-be monopolists.

B. To a large extent, the subsequent analysis of the political economy of interest groups was developed by Chicago economists with an interest in industrial regulation.

- i. Stigler's (1971, Bell J of E) argued that "the central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation." Perverse economic regulations emerge as a consequence of electoral threats on the part of large enterprises. "If the [elected] representative denies ten large industries their special subsidies of money or governmental power, they will dedicate themselves to the election of a more complaisant successor." ... "The industry which seeks regulation must be prepared to pay with two things a [political] party needs: votes and resources." (This theory is sometime summarized as the "capture" theory of regulation, insofar as regulated industries get the regulations that they want. See also some of Stigler's earlier work on the "capture theory".)
- ii. Peltzman (1976) argues that "what is basically at stake in a regulatory process is a *transfer of wealth*. The transfer, as Stigler points out, will rarely be in cash, but rather in the form of a regulated price, and entry restriction and so on." He goes on to argue that:
 - a. "[T]he costs of using the political process limit not only the size of the dominant group but also its gains."
 - b. "[Elected politicians] maximize net votes or majority in his favor. There is no presumption that the marginal utility of a majority vanishes at one... Greater majorities are assumed to imply greater security of tenure, more logrolling possibilities greater deference from legislative budget committees and so on."

C. (Although these "Chicago" ideas are clearly extensions of the public choice literature of the 50's and 60's essentially no mention is made of those literatures beyond a passing citation of Olson's work on collective action.)

D. The Chicago approach took a great leap forward in 1983 with the publication of Gary Becker's "A Theory of Competition Among Pressure Groups for Political Influence" (*QJE*) where the interest group approach to regulation was extended to encompass all political policies.

- i. Becker argues in that piece that all policies that emerge would *tend to be efficient*.
- ii. This provocative claim was softened in later work, but he continues to argue that "no policy that lowered social output could survive if all groups were equally large and skillful at producing political influence" (1985, J Pub E).
- iii. Even this claim ignores the Rent-seeking losses that such a process would generate.

E. The Rent-seeking literature was somewhat reinvigorated by Becker's work and a collection of works edited by Buchanan, Tullock and Tollison published previously in 1980, *Toward a Theory of the Rent-Seeking Society*.

F. Work in the Chicago interest group and rent-seeking "traditions" continues to the present time, with surprisingly little cross referencing of research using other approaches. [See also Donald Wittman (1989, *JPE*).]

XXIV. Olson's Logic of Collective Action

- A.** Public goods aspect of collective action: diseconomies of scale: free riding
- B.** Need for selective incentives and/or encompassing interests

XXV. The Old and New Chicago Regulation Models

A. The Peltzman model of regulation is perhaps the most widely used model from the Chicago school. It is widely used as a model of regulation in a setting where regulatory commissions are assumed to have some discretion but be politically obliged to take the interests of both consumers and the regulated into account.

- i. One simple and widely used version of the Peltzman model, argues that the regulator maximizes his "political support" (often characterized with the regulator's utility function) which is defined over the welfare of consumers and firms subject to the regulation. Regulators and/or elected representatives need political support willingness to provide desired political support to the regulators (or elected representatives) increases with the welfare of the groups affected by the regulated.
- ii. Regulators/Legislators set regulations (and transfers) to maximize political support (campaign contributions and the like).

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iii. Many forms of regulation can be considered in a Peltzman model. Consider for example a decision to set some regulated price, P .

a. Let support be characterized as: $S = \sum_i S_i(P)$

b. Differentiating with respect to P we find that P will be set such that

$$\sum_i S_{iP} = 0,$$

c. which implies that P is set (raised) so that the marginal reduction in support from those favoring lower prices equals the marginal increase in support from those favoring higher prices.

d. In cases where the policy variable is a vector and many different groups are affected by that policy, and all of their interests, as expressed with promises of "support," are balanced off against each other at the margin.

e. Not much attention is given to the incentives of groups to directly lobby for regulatory preference, rather industry effectively reacts to proposals of the regulator (by making larger or smaller campaign contributions).

B. The Becker model is essentially similar and broader, except that the model has no obvious policy maker. Individual's contribute to politically active groups on the basis of their influence production functions.

i. In his 1983 piece, Becker models a political influence game between two groups composed of self-interested net benefit maximizers.

ii. The redistribution takes place via taxes and subsidy interests which can be more or less efficient.

iii. The mechanism which determines the extent to which a the taxed group is taxed and the subsidized group receives a subsidy is called political influence: $I_s = -I_t = i(P_s, P_t, X)$ where P_s is the pressure from group s , P_t is the pressure from group t and X is other variables that matter (say institutions).

iv. Political pressure is the result of group membership size, n , and resources devoted, m , to generating pressure $P = p(m, n)$. (If a is average member expenditure, then $m = na$.)

v. The total tax burden of the taxed group is $n_t R_t$ where n_t is the number of members of group t , and R_t is the tax burden imposed on a typical member of group t . $F(R_t)$ is the amount of revenue actually raised by the tax, net of dwl , so $F(R_t) \leq R_t$. The total subsidy cost of transfers given to the subsidized group is $n_s G(R_s)$ where n_s is the number of members in group s and $G(R_s)$ is the subsidy expenditure per group member. R_s is the amount actually received net of the dwl so $R_s \leq G(R_s)$.

vi. Note that $n_t F(R_t) = n_s G(R_s)$ [all revenues collected are paid out as subsidies.]

vii. The full income of a typical member of each group is $Z_s = Z_s + R_s - a_s$ for the subsidized group and $Z_t = Z_t + R_t - a_t$ for the taxed group.

viii. Individual will contribute the amounts, a_s and a_t respectively, which maximizes their income so that a_t^* is s. t. $R_t a_t = 1$ and as is s. t. $R_s a_s = 1$, e. g. each person contributes to their groups political activity up to where the marginal increase in money's received (or losses avoided) equals one dollar.

ix. Given that $I_s = n_s G(R_s)$ and $I_t = n_t F(R_t)$, $G(R_t) = I_s/n_s$ and moreover using the definition of an inverse function: $G^{-1}(G(R_s)) = R_s = G^{-1}(I_s/n_s)$

x. Differentiating R_s with respect to a_s yields: $R_{s a_s} = [dG^{-1}/d(I_s/n_s)] [(dI/dP_s) dP_s/dm_{n_s}]/n_s$ since $dG^{-1}_R \approx 1/G_R$

xi. a_s^* will be such that $[I_{P_s} P_{s_m}] / G_{R_s} = 1$ [note that this just restates viii above]

xii. and a_t^* will be such that $[I_{P_t} P_{t_m}] / G_{R_t} = 1$ [again see viii above, f. o. c. again]

C. These first order conditions can be used as the source of Cournot reaction functions for the political pressure game.

D. But first, one can get some sense of the comparative statics of the first order conditions. [Diagram of a^* at "MB"="MC"]

i. The higher the marginal cost of the subsidy (the less efficient the subsidy program) the lower the marginal benefit curve is and the smaller a^* is.

ii. The greater the groups relative ability to create influence from pressure, I_{P_s} , the higher the marginal benefits of political contributions and the higher a^* is.

iii. The more political pressure produced by an additional group expenditure, the higher the marginal benefits are and the greater a^* is. [Figure with nash equilibria for typical members of each interest group, comparative statics]

iv. Efficient policies are the best policies from the vantage point of both interest groups and those policies will call forth the most political pressure.

XXVI. Rent Seeking and Efficiency

A. The positive thrust of the rent seeking literature is very much like that of the Chicago school models.

B. The main difference is that the rent-seeking approach is not so optimistic about the normative properties of the outcome of interest group competition. (Early Chicago analysts shared this pessimism.)

i. The rent-seeking literature stresses the importance of " political transactions costs" as a significant source of dead weight loss.

ii. Thus models of rent seeking analyze (and stress) the extent of the resources committed to what often is a *nonbeneficial competitive process*.

iii. (See my 1980 paper in the first rent seeking collection and in the over priced Tollison-Congleton collection.)