Public Choice Concepts and Applications in Law

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Chapter 2

Interest Group Theory and Rent-Seeking

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INTRODUCTION

In order to aid the American steel industry in March 2002, President George W. Bush imposed tariffs on imported steel that ranged from eight to thirty percent,[1] depending on the type of steel.[2] The tariffs aided the steel industry by dramatically increasing the market price of steel in the United States. At the same time, however, this price increase was passed on to producers who relied upon steel inputs, including, for example, automobile manufacturers, producers of machinery, and the construction industry. The resulting price increases were substantial. One study estimates that over 200,000 jobs were lost in the United States in steel-using industries in the first year of the tariff alone, a number that exceeds the total employment in the entire United States steel industry.[3] In contrast, the same study estimates that the tariffs saved fewer than 10,000 jobs within the steel industry at a cost of between $450,000–$584,000 per job. Some manufacturers were able to pass along part of the raised cost of steel inputs to end users in the form of higher prices. This strategy was most effective in those industries for which demand for goods was relatively

1. *See* Proclamation No. 7529, 3 C.F.R. 15 (2003) ("To Facilitate Positive Adjustment to Competition from Imports of Certain Steel Products"). The action was taken by President Bush pursuant to Article 2.1 of the World Trade Organization (WTO) Agreement on Safeguards (1994), *available at* http://www.wto.org/english/docs_e/legal_e/25-safeg.pdf (setting forth the rules for application of safeguard measures pursuant to Article XIX of the General Agreement on Tariffs and Trade (Apr. 15, 1994), *available at* http://www.wto.org/english/docs_e/legal_e/gatt47_02_e.htm#articleXIX [hereinafter GATT 1994]), which permits a country to impose "Emergency Safeguards" if "serious injury" could result to domestic producers as a result of unfair trade practices such as the improper dumping of goods. *See* World Trade Organization, Trading into the Future 29–32 (2d ed. 2001), *available at* http://www.wto.org/english/res_e/doload_e/tif.pdf. The procedures for implementing safeguards are codified in U.S. law at 19 U.S.C. § 2253 (2006).

2. For an informative discussion of the steel tariffs, see Robert Read, *The Political Economy of Trade Protection: The Determinants and Welfare Impact of the 2002 US Emergency Steel Safeguard Measures*, 28 World Econ. 1119 (2005). The steel tariffs were lifted twenty-one months later in December 2003 following an adverse ruling by the WTO that the tariff violated the GATT 1994. *Id.* at 1132–33.

3. Joseph Francois & Laura M. Baughman, The Unintended Consequences of U.S. Steel Import Tariffs: A Quantification of the Impact During 2002, at 12 (Feb. 4, 2003), *available at* http://www.citac.info/about/issues/remedy/2002_Job_Study.pdf.

inelastic,[4] including, for example, in the markets for certain automobiles, motor vehicle parts, machine goods, and construction inputs. Nonetheless, some analysts have determined that the net effect of the tariffs, including the increased cost of consumer goods and jobs lost within manufacturing industries relying upon steel inputs, was substantially greater than the benefits in terms of jobs retained or gained within the steel industry itself.

In *Federalist No. 10*, James Madison famously expressed fear that transient majorities, or "factions," would form with the power to deploy the machinery of government to their advantage. Madison posited that one of the principal missions of constitutionalism is to divide and control the government to make more difficult the possibility that factional violence would form and operate the machinery of government to the detriment of the electorate. While Madison's thesis represents a major contribution to contemporary American political theory, the example of the steel tariff raises the possibility that as a description of how the United States system of governance actually operates, the theory might be incomplete.[5]

Building upon the tools from chapter 1, and introducing several new ones, this chapter will begin the process of constructing simple models designed to explain important features of the political process. Although we will emphasize familiar processes within the United States, several of the insights that we develop can be generalized to alternative political systems. The analysis will explore the conditions under which majoritarian or minoritarian factions, meaning interest group coalitions that produce majority alliances or influential minority interest groups, are likely to thrive within the U.S., or other, political processes; how those processes are structured to limit or to harness such interests; and what the implications of such processes are for the procurement of various forms of public and quasi-private legislative goods. We begin by introducing the essential tools from interest group theory. After doing so, we will discuss actual cases that raise important questions concerning the relationship between processes through which legislation is procured and the proper role of courts in evaluating resulting legislation.

We begin by inquiring how the steel industry was able to succeed in acquiring a protective tariff even though, whether weighed in terms of the number of people, the number of firms, or the value of economic activity, it appears that the aggregate economic losses well exceeded the resulting gains to the steel industry.[6] For those who might assume that governmen-

4. For a discussion of price elasticities, see chapter 1, appendix.

5. It is also often believed that the President will be less responsive to special interests than a typical member of Congress will be because the President has the incentive to consider the interests of the entire country and thus internalizes all of the costs of inefficient policies. *See* Peter H. Aranson, Ernest Gellhorn, & Glen O. Robinson, *A Theory of Legislative Delegation*, 68 Cornell L. Rev. 1, 41 (1982). Yet the steel tariff was imposed by the President interpreting GATT and was only repealed after an adverse ruling by the World Trade Organization. What might explain the President's behavior in this case? For a discussion, see Read, *supra* note 2, at 1126–27, 1133–34.

6. For an analysis that establishes that these various measures reveal that losses exceeded gains, see Read, *supra* note 2, at 1129–31.

tal processes generally conduce to the "public interest," the steel tariff at a minimum appears to be an important cautionary tale. The story becomes even more significant, however, if it somehow reveals a fundamental limitation of the public interest view of legislative procurement of public goods and services.

I. PUBLIC AND PRIVATE INTEREST MODELS OF GOVERNMENT

We begin with the "public interest model" of government regulation, which dominated throughout much of the twentieth century. This view came into prominence with the rise of the industrialized era. Both within the media and popular culture, there was a strong perceived need for the government to provide benign intervention to combat the increasingly horrific working conditions associated with early industrialization. For one prominent example, consider Upton Sinclair's famous 1906 novel, *The Jungle*, which, in widely exposing the unsafe and unsanitary conditions associated with the meat packing industry at the turn of the twentieth century, provided a strong impetus for the creation of the Food and Drug Administration.[7]

The development of economic science provided a strong theoretical foundation for relying upon the government to correct widely perceived imperfections within market processes that generated "market failures." Regulatory advocates recognized that self interest did not invariably align with the public good and believed that proper government intervention was necessary to ensure that markets produced socially optimal, or at least preferred, results.

The analysis once again returns us to the works of the economists, Arthur Cecil Pigou and Ronald Coase.[8] Pigou claimed that where property rights were imperfectly defined, property owners acting in their self interest were motivated to engage in profitable economic activities even when those activities generated substantial "negative externalities" such as pollution. Because owners of polluting firms did not internalize the full social cost of production, Pigou claimed, the quest for profit thrust a wedge between the level of output chosen by a self-interested private actor and the socially optimal level of the activity. The resulting market failure implied that left to its own devices, the market (or more accurately individuals within the market) tended to produce too many goods for which all costs were not internalized, with the effect of passing on real costs to others who did not benefit from their economic activities. Pigou

7. UPTON SINCLAIR, THE JUNGLE (1906). For alternative accounts, see Marc T. Law & Gary D. Libecap, *The Determinants of Progressive Era Reform: The Pure Food and Drugs Act of 1906, in* CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY 319 (Edward L. Glaeser & Claudia Goldin eds., 2006) (noting influence of producer groups); Gary D. Libecap, *The Rise of the Chicago Packers and the Origins of Meat Inspection and Antitrust*, 30 ECON. INQUIRY 242 (1992).

8. *See supra* chapter 1, at section II.I (discussing Pigou and Coase).

proposed resolving this difficulty by, among other means, imposing a tax that resulted in the full internalization of the costs of economic activity.

The public interest model of government that corresponds with Pigouvian regulation rests on an important premise. It assumes that the government can identify various deficiencies in private market orderings, with the negative externality of pollution as one important example, and then create an appropriate legal response that will encourage private actors to account for the divergence between private costs and total costs. By better aligning private and social costs of economic activities, Pigouvian regulation would promote socially beneficial outcomes.

Pigou's argument has been subject to two lines of critique, the first offered by Nobel Prize-winning economist Ronald Coase. Coase challenged the assumption that government is capable of collecting and using all of the information needed to identify and correct such market failures. Public choice provides the basis for the second critique. The government, even if theoretically capable of operating as a Pigouvian central planner, is unlikely to actually do so in practice. Thus, while the public interest model of government rests upon identified market failures as compared with a theoretically perfectly functioning market that aligns private and social costs, public choice identifies the failings of an idealized view of regulation in which the government can effortlessly (and costlessly) correct market failures. Public choice is not concerned with theoretically ideal institutions, whether markets, legislatures, or other institutions.[9] Rather, it is concerned with identifying the relative strengths and weaknesses of real world institutions as a means of making more meaningful assessments concerning when particular responsibilities for decision making are better channeled toward one institution or another.

Not long after the rise of industrialization, political scientists began to critically assess the public interest understanding of benign government processes. One famous illustration, E.E. Schattschneider's study of the 1930 Smoot–Hawley Tariff,[10] demonstrates some of the conceptual difficulties that reemerged in the steel tariffs.[11] The Smoot–Hawley Tariff differs from the recent Steel Tariffs in that it resulted from a federal statute rather than from an executive proclamation. Through a series of logrolls, Congress managed to endorse a combination of prohibitive tariffs that benefited various industries, but that did so at tremendous cost to the national economy. Schattschneider's analysis, which rests on a pluralist understanding of politics,[12] views Congress as a neutral conduit that

9. *See* Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1 (1969) (describing the nirvana fallacy that "pervades much public policy economics"); *see also infra* chapter 3, at section I.F.2.

10. Tariff Act of 1930, Pub. L. No. 71–361, 46 Stat. 590 (codified as amended at 19 U.S.C. §§ 1202–1681b (2006)).

11. E.E. SCHATTSCHNEIDER, POLITICS, PRESSURES AND THE TARIFF (photo. reprint 1963) (1935).

12. Pluralist theory, a precursor to the modern theory of public choice, viewed the legislature as a conduit through which special interest groups accomplished their own legislative outcomes. *See* EARL LATHAM, THE GROUP BASIS OF POLITICS 35 (1952) (positing that "[the] legislature referees the group struggle, ratifies the victories of the successful coalitions and records the terms of

rubber-stamped an industry-negotiated pact, one primarily reached outside formal political processes. Modern public choice analysis builds upon pluralism but recognizes the importance of modeling the interest of legislators themselves in interacting with various other forces, including constituencies, lobbyists, and actors within other branches of government. The public interest view of government stands in stark contrast with this pluralist understanding, and also with its more modern counterpart, the modern theory of public choice.

As the steel tariff example and the discussion of the Smoot–Hawley Act demonstrate, the public interest model imperfectly describes the workings of actual political processes. At a minimum, these examples might illustrate the possibility that political actors, and Congress as an institution, sometimes depart from the "public interest" in favor of producing outcomes that benefit special interest groups. Public choice theorists claim that interest group influence on legislative outcomes is commonplace, with the effect of producing narrow tax exemptions, protective tariffs, industry subsidies, and competitive restrictions (also known as barriers to entry). While Madison expressed the concern that governmental processes would allow majoritarian factions to benefit at the expense of the public, revisiting the microfoundations of collective decision making allows us to appreciate how well-organized minority interest groups frequently prevail even in Madison's complex constitutional scheme that was specifically designed to improve legislative accountability and limit the vice of factional violence.

A. RENTS, QUASI-RENTS, AND RENT SEEKING

We can now more fully appreciate the concept of economic rents, introduced in the appendix to chapter 1. Recall that an economic rent arises when an economic activity, for example labor, earns a return that exceeds the opportunity cost of the income-producing asset. Monopolists earn economic rents by imposing restrictions on outputs with the effect of commanding a price paid for the resulting goods or services that is higher than that dictated in a competitive market. Restrictions on the ability of potential competitors to supply the same or similar goods results in "economic rents" for those who capture the market. Those exempt from competition are thus able to supply their goods at a price that exceeds the opportunity cost, or next best use, of the various factors of production. A firm with market power, exemplified by a monopolist, can extract economic rents by restricting supply and thereby raising prices.[13] The monopolist

surrenders, compromises, and conquests in the form of statutes."); THEODORE J. LOWI, THE POLITICS OF DISORDER xviii–xix (1971) (positing that "[the] basis of pluralism and quiescence is the organized group and group interactions, with political man holding the whole together through delegation and negotiation."); Maxwell L. Stearns, *The Public Choice Case Against the Item Veto*, 49 WASH. & LEE L. REV. 385, 400 n.94 (1992) (collecting authorities on pluralism). A major difference between pluralism and the modern theory of public choice and is that the latter accounts for the independent role of political actors, based upon their personal motivations, in affecting institutional outcomes. Stearns, *supra*.

13. For a more detailed discussion, see chapter 1, appendix.

receives rents equal to the difference between the level of profit available under conditions of monopoly and that available under competitive conditions. The following graphic illustrates the monopolistic pricing strategy and the resulting economic rents:[14]

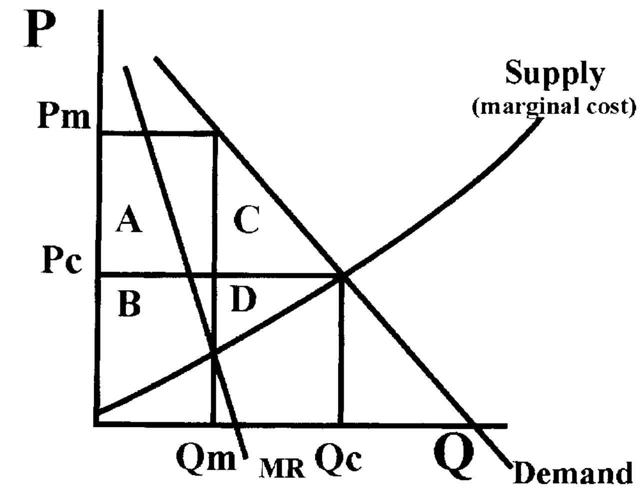

Figure 2:1

Figure 2:1 illustrates the social welfare loss of monopoly. The triangular areas *C* and *D* represent the resulting social "deadweight loss." These triangles represent foregone mutually beneficial, and thus wealth producing, exchanges that would have been conducted absent the monopolistic pricing strategy. Area *C* represents the foregone consumer surplus and area *D* represents the foregone producer surplus. These "deadweight loss triangles" are often referred to as "Harberger triangles," named after the economist Arnold Harberger, who was the first to formalize the analysis and to measure the resulting social loss resulting from monopolistic practices, including those resulting from government policies such as price regulations and government taxes.[15] A principal normative justification for antitrust law, for instance, is to "recoup" these deadweight losses for the economy by preventing a monopolist from restricting supply and thereby raising prices.

As previously shown, areas *A* – *D*, equivalent to the monopolistic rent minus the foregone producer surplus in Figure 2:1, represents the "economic rent," which is largely a wealth transfer from consumers to producers as the result of monopolistic pricing strategy. That strategy allows a reduction in output and an increase in price. Another way of

14. *See supra* p. 35, Fig. 1:6.

15. *See* James R. Hines, Jr., *Three Sides of Harberger Triangles*, J. ECON. PERSP., Spring 1999, at 167.

generating economic rents is through the enactment of regulations that have the same effect of restricting competition and allowing producers to raise prices above competitive levels. Consider the steel tariff. Steel tariffs raise the price of imported steel relative to domestic steel. But they also allow producers of domestic steel to increase their prices to the level of imported steel even though domestic producers do not pay the tax. With respect to imported steel, the tariff proceeds are paid directly to the federal government. With respect to domestic producers, however, the price increases are a direct wealth transfer from consumers to producers of steel.

The distribution of economic rents among the various stakeholders in the benefiting firms, primarily shareholders and employees, depends on how these groups negotiate. In general, however, we can predict some "sharing" of rents between employees and owners of the firm,[16] depending in large part on the relative bargaining power of the different groups. For instance, unionized employees might be in a stronger position to bargain for a greater share of rents than nonunionized employees. The fact that rents typically are shared between owners and employees suggests that employees will generally be willing to provide political support for protectionist or other beneficial regulation.[17]

While monopolistic pricing generates rents like those resulting from protectionist regulatory policies, public choice helps to explain why as a general matter the latter source of rents is likely to be more durable. When markets create opportunities for monopolistic pricing, the rent opportunity attracts new entrants that tend to compete away those rents. For example, markets produce opportunities for monopolistic pricing when start-up investments are sufficiently high that the average cost of the goods in question declines as a result of economies of scale. Declining average cost makes it difficult for potential competitors to enter the market, as a single firm tends to drive out competition at least in the short to moderate term.[18]

Familiar paradigms include electrical utilities, mail systems, and airplane and automobile manufacturers, each of which is characterized by extraordinarily high start-up costs. In most circumstances, however, even these industries eventually invite new entrants and thus competition.

16. *See* Sandra E. Black & Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 AM. ECON. REV. 814 (2001) (finding that regulation of competition in banking industry resulted in rent-sharing with banking employees); *see also* Marcello Estevão & Stacey Tevlin, *Do Firms Share their Success with Workers? The Response of Wages to Product Market Conditions*, 70 ECONOMICA 597 (2003); Pedro S. Martins, *Rent Sharing Before and After the Wage Bill* (IZA discussion paper No. 1376, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=614441.

17. For instance, the United Steelworkers of America were vigorous political supporters of the decision to impose steel tariffs. *See* Read, *supra* note 2, at 1125–26. The United Auto Workers also provided strong support for federal bailout proposals of the automobile industry in 2008. Matthew Doland & John D. Stoll, *UAW Faces Prospect of More Concessions*, WALL ST. J., Nov. 17, 2008, at A4 (noting that "the UAW is standing shoulder-to-shoulder with the [auto] companies in an intense public campaign to plead for a federal bailout").

18. *See supra* chapter 1, at note 73 (citing WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 217 (10th ed. 2006)).

Federal Express competes with the United States Postal Service, oil distributors compete with natural gas, and while the market remains concentrated, several manufacturers compete in the production of automobiles and airplanes. But one need not resort to this sort of large scale industry to illustrate the proposition of market power. While large scale natural monopoly is uncommon, conditions that characterize natural monopoly such as declining average cost for the relevant range of outputs, arise within many start-up industries. In nearly every industry, for at least some period of time, high start up costs give rise to economies of scale and declining average costs. Over time, however, the perceived opportunities for the resulting quasi-rents—rents that result from temporary market conditions that allow prices above the opportunity cost for the relevant factors of production[19]—encourage others to incur the necessary initial start-up costs to offer competing market products.[20]

Government-conferred rents in contrast are usually created by erecting barriers to entry, such as restrictive licensing or permit regimes. Thus, the process of eroding rents through entry of market competitors is stifled. Governmentally created rents are also more permanent for a second reason. While monopolistic activity is subject to prosecution under antitrust laws, regulatory schemes with anticompetitive effects are exempt from such laws.[21]

II. THE ECONOMIC THEORY OF REGULATION[22]

Given the durability of legislatively conferred rents, it is important to consider the circumstances under which legislators, behaving rationally, are likely to confer such rents and the nature of the rents that industry groups, behaving rationally, are likely to seek. In two famous articles, written in the 1970s, George Stigler and Sam Peltzman addressed these questions. In *The Theory of Economic Regulation*,[23] George Stigler chal-

19. Fred McChesney defines "rent" as, "[R]eturns to the owner of an asset in excess of the level of returns necessary for him to continue using the asset in its current employment. Thus, a rent is any return above what the owner would earn in the asset's next-best alternative use." FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION 10 (1997). As McChesney notes, economists have never agreed on a precise conventional definition of "rent," especially in contrast to the term "quasi-rent," which refers to *temporary* returns on assets above opportunity cost. *Id.*; *see* Armen A. Alchian, *Rent*, *in* 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 141–42 (John Eatwell et al. eds., 1998). Unless otherwise specified, in this book, we will follow the general convention of public choice economics and use the term "rent" to refer to returns above the asset's opportunity cost, regardless of whether temporary or permanent.

20. Another vehicle for the production of quasi-rents is product differentiation, which provides a vehicle even within markets generally characterized by competition for varying degrees of market power as a result of increased inelasticity of demand for the differentiated good.

21. *See* Parker v. Brown, 317 U.S. 341 (1943); *see also* Report of the State Action Task Force, Federal Trade Commission Office of Policy Planning (2003), *available at* http://www.ftc.gov/os/2003/09/stateactionreport.pdf.

22. Portions of the discussions that follow are adapted from MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY 120–21 (1997).

23. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

lenged the intuition that most regulation is imposed upon industries to benefit the public and instead posited that much regulation is affirmatively acquired by industries to secure monopolistic rents. Stigler questioned why, for example, the oil industry, in which the supply is relatively elastic (meaning that output is sensitive to changes in price), lobbied for import quotas rather than for import tariffs or direct cash grants. If the regulation had been aimed at protecting domestic production capabilities for national defense purposes, as industry interests generally claimed, tariffs could have achieved that with all costs paid into the national treasury rather than to industry participants. Direct cash grants or subsidies also would have produced the stated objective of ensuring a domestic oil supply at a substantially lower cost to consumers than import quotas.

Quotas, unlike tariffs, by definition limit market supply and thereby prevent entry from dissipating rents. Stigler posited that the industry preference for quotas reflected the desire of producers, operating in a market typified by elastic supply, to prevent potential market entrants from sharing the benefits of regulation. He further demonstrated that state licensure requirements often serve the same purpose of inhibiting market entry and securing monopolistic rents for the industry acquiring the regulation.

Stigler considered when legislators, behaving rationally, are likely to provide regulatory benefits sought by industries. His analysis suggests that well organized and small groups (especially those without significant opposition), those best able to confer regulatory benefits upon their members, are most likely to engage in effective rent seeking, meaning affirmative lobbying efforts to secure beneficial legal protections against competition, while large and diffuse groups are not.[24] Behaving rationally, legislators are likely to be responsive to these sorts of constituent pressures, which help to further prospects for reelection.

In explaining the significance of Stigler's insight, Sam Peltzman stated:[25]

> In one sense, Stigler's work provides a theoretical foundation for [a] "producer protection" view [of regulation].... Stigler seems to have realized that the earlier "consumer protection" model comes perilously close to treating regulation as a free good. In that model the existence of market failure is sufficient to generate a demand for regulation, though there is no mention of the mechanism that makes that demand effective.... Since the good, regulation, is not in fact free and demand for it is not automatically synthesized, Stigler sees the task of a positive economics of regulation as specifying the arguments underlying the supply and demand for regulation.[26]

24. These themes are systematically explored in MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

25. Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

26. *Id.* at 212.

Peltzman refined Stigler's model to link regulatory output not only to the size and organization of the lobbying group, but also to the votes gained and lost in response to the implemented regulation. Peltzman explained:

> In sum, Stigler is asserting a law of diminishing returns to group size in politics: beyond some point it becomes counterproductive to dilute the per capita transfer. Since the total transfer is endogenous, there is a corollary that diminishing returns apply to the transfer as well, due both to the opposition provoked by the transfer and to the demand this opposition exerts on resources to quiet it.[27]

By focusing on votes rather than group size, Peltzman was able to incorporate a factor into his model that was only a detail in Stigler's original formulation: "[T]he costs of using the political process limit not only the size of the dominant group but also their gains."[28] In the resulting model, regulation results not merely from a bidding process in which optimally formed industry groups win, but also it arises as a result of a more subtle and complex process through which the suppliers of regulation, namely the legislators, weigh the gains derived from the prospective transfer against the costs borne in terms of lost votes.

In a comment on these articles, Gary Becker posited that competitive political forces might serve to reduce the relative size of those deadweight societal losses that result from industry regulation. Thus, whether quotas, tariffs, or subsidies predominate in a particular industry is likely a function of which is the most cost effective, and thus efficient, form of wealth transfer, meaning a transfer that creates the smallest deadweight loss. For Becker, this insight explains the choice of regulatory form in terms other than the common belief that "voters are systematically fooled about the effects of policies like quotas and tariffs that have persisted for a long time."[29]

One issue that will be addressed throughout this course is whether the economic theory of regulation supports heightened judicial scrutiny as a means to minimize legislatively procured rents. Many scholars whose works we discuss later in this book have proposed imposing judicial barriers to enforcing the products of legislative rent seeking. At least since the New Deal, however, the Supreme Court has not gone along. One potential silver lining, suggested by Becker, is that if we are willing to accept the fact that at least some regulation is a form of wealth transfer, rather than a vehicle for promoting the public good, we need not worry terribly much about the form that the regulation takes. The public choice equivalent of Adam Smith's invisible hand will move wealth transfers to their most cost effective form.

27. *Id.* at 213.

28. *Id.*

29. Gary Becker, *Comment*, 19 J.L. & ECON. 245, 246 (1976). To be clear, Becker is not addressing the normative merit of the redistributive policy, but only the extent to which the choice among available policies generating a wealth transfer affects the size of the resulting deadweight loss.

A. ATTORNEY LICENSING

Based upon this analysis, consider the age-old regime of professional attorney licensure. By requiring membership in a state bar, the licensure regime effectively limits the supply of lawyers in each jurisdiction. From a public interest perspective, licensing of professional services can be justified on the basis that consumers might find it difficult to determine the quality of these services. But by restricting supply, the bar also allows lawyers to raise their prices above what the prevalent market price for legal services would be in the absence of the licensure regime, with the effect of facilitating rents for those admitted to practice law.

In setting admissions standards to the bar, lawyers might be tempted to take into account (perhaps subconsciously) their financial self-interest in restricting the supply of lawyers, thus increasing their own salaries in addition to pursuing the more benign goal of protecting consumers against incompetent lawyers. This temptation is especially strong given that the bar is a self-regulatory regime, meaning that members of the bar, working through their state supreme courts, set the standards for the entry of new lawyers into the profession.[30]

This unusual, non-legislative process adds to the difficulties of consumers organizing to oppose consumer welfare-reducing rules adopted by the bar.[31] One estimate concludes that licensing of attorneys in the United States raises entry level salaries for lawyers by more than $10,000, resulting in "a total transfer from consumers to lawyers of 19% of lawyers' wages and a total welfare loss of over $3 billion."[32] Moreover, it appears that the difficulty of the bar exam is set not to guarantee a certain minimum level of competency to practice law, as would be consistent with the public interest theory of the bar. Instead, the bar failure rate is correlated with the number of test-takers, suggesting that the exam is more difficult to pass as the number of applicants to the bar rises, regardless of the applicants' merits.[33] A purely cynical view of this regime might suggest that while law students lament the need to study for and pass the bar exam, it is lawyers themselves, rather than prospective clients, who most benefit from the licensure regime.

The supply restriction may have distributional consequences with the bar as well. For instance, to the extent that the requirements of the bar exam are set higher than necessary to protect the public, this may have a

30. James C. Cooper, Paul A. Pautler & Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091, 1101–02 (2005); *see also* Einer R. Elhauge, *The Scope of Antitrust Process*, 104 HARV. L. REV. 667 (1991).

31. *See* Cooper, Pautler & Zywicki, *supra* note 30, at 1101–02.

32. Mario Pagliero, What Is the Objective of Professional Licensing? Evidence from the US Market for Lawyers 1 (Mar. 11, 2005), http://www.fep.up.pt/conferences/earie2005/cd_rom/SessionII/II.G/Pagliero.pdf.

33. Mario Pagliero, *The Impact of Potential Labor Supply on Licensing Exam Difficulty in the US Market for Lawyers* (Carlo Alberto Working Paper No. 53, July 2007), *available at* http://www.carloalberto.org/files/no.53.pdf.

disproportionately negative effect on the admission of minority lawyers to the practice of law.[34] One need not embrace an extreme view of the role of the bar in advancing the interests of its own members to appreciate that while this regime does benefit consumers of legal services by ensuring a higher degree of professionalism, greater accountability, and more uniform standards, it also provides substantial benefits to lawyers in the form of reduced competition and correspondingly higher fees.

In addition, this combined set of benefits is not costless. The net result might be to price legal services above what some persons in need of such services might be able to afford.[35] One indication of the resulting social welfare loss is the growing market for services that lawyers traditionally provided through alternative and lower cost means. Some such services do not even require the assistance of any professional, for example computer software that makes it easier for consumers to write a will or to file for bankruptcy.

As a result of the licensure regime, lawyers need not fear entry of unlicensed lawyers undercutting their prices. Not surprisingly, however, lawyers might well be motivated to lobby against the provision of services by unlicensed individuals that at one time required, but are now exempt from, provision by licensed practitioners of law.[36] In addition, through various regulations prohibiting the "Unauthorized Practice of Law," governments promise to prosecute and punish those who provide legal services without being properly licensed.

The practice of law can be analogized to a regulated monopoly in which lawyers earn economic rents for their services. As shown in the discussion that follows, economic theory predicts that at least some of these rents should be "dissipated." What are some of the ways in which the economic rents of the practice of law are dissipated? Why does law school in the United States take three years to complete and cost so much?

B. STEEL TARIFFS AND RENT SEEKING REVISITED: THE ELUSIVE WELFARE LOSS TRIANGLE

In light of the preceding analysis, let us also reconsider the case of the steel tariffs. Assume that a protectionist tariff on steel imports will benefit the steel industry by a total of $10 million. Further assume that there is

34. George B. Shepherd, *No African–American Lawyers Allowed: The Inefficient Racism of the ABA's Accreditation of Law Schools*, 53 J. LEGAL EDUC. 103 (2003).

35. Even within the regulated legal profession there is a variety of quality of lawyers and a variety of fee arrangements and rates. Lawyers who charge high rates for high-expertise services today likely would be unaffected by open entry, as the primary source of their pricing power is their unique expertise. Lower-rate lawyers providing less-sophisticated services, however, likely would see greater competition and lower wages.

36. *See* Cooper, Pautler & Zywicki, *supra* note 30, at 1101–02. For instance, the bars in some states have attempted to expand the definition of the "practice of law" to apply to many services that can be competently performed by non-lawyers, such as title companies, at much lower cost. Requiring lawyers to perform these ministerial services is estimated to add several hundred dollars to the price of a home closing with no discernible benefit to consumers. *See* Letter from R. Hewitt Pate, Acting Ass't Att'y Gen., Timothy J. Muris, Chairman of the FTC, et al., to the Standing Comm. on the Unauthorized Practice of Law of the State Bar of Georgia (Mar. 20, 2003), *available at* http://www.ftc.gov/be/v030007.htm.

only one manufacturer of steel or a sufficiently low number that the producers are able to coordinate outputs to affect price. In theory, the steel industry would be willing to pay up to $10 million in campaign contributions and other forms of lobbying expenditures in an effort to have the steel tariff enacted. If no other costs were involved, including most notably the opportunity cost of alternative uses of firm assets, the steel industry would be willing to pay as much as $9,999,999 to secure the resulting $1 quasi-rent, or "profit" above normal returns.

With some simplifying assumptions, we can now illustrate not only the potential burdens that the tariffs impose on intermediate producers and ultimate consumers of steel products, but also explain why the pressure in favor of the tariff is likely stronger and more persistent than pressure in opposition.[37] Consider the tariff from the perspective of the myriad consumers of steel. These include intermediate consumers who use steel as inputs in production of direct consumer products or as indirect inputs into other production processes and who under certain conditions can pass at least some of the costs on to those who purchase their products. While it is not necessary to set out numbers, we can explain the essential intuition that the tariff results in imposing considerable costs, perhaps greater costs than gains, without generating sufficient opposition to prevent its enactment.

Numerous industries use steel as one of the factors of production. These include, for example, construction, and manufacturers of automobiles and industrial machines.[38] Each of these sets of producers, and each producer individually, has varying degrees of market power, based for example upon product differentiation, brand recognition, and goodwill. In general, market power does not arise as a consequence of some form of industry monopoly, but rather as a result of some combination of these other factors. Purchasers are not indifferent, for example, between which cars or appliances they buy, or even which they buy within a specific price range. Some consumers strongly prefer Toyota, while others strongly prefer Honda. And within any given brand, some strongly prefer sedans, sports cars, minivans, SUVs, or hybrids in any of these categories. While consumers hold strong preferences, and will pay more for their favored products, few if any consumers are entirely unconcerned about price. Thus, despite brand loyalty, a consumer who generally prefers to drive a Toyota Camry might strongly consider a Honda Accord, if the price or the

37. In a later discussion of the Wilson–Hayes model, we will place this analysis in the larger context of legislation that variously benefits or burdens broad to narrow constituencies. *See infra* note 84 and accompanying text.

38. In fact, it is estimated that there are approximately 193,000 steel-using firms in the United States, of which about ninety-eight percent are small businesses with fewer than 500 employees. Read, *supra* note 2, at 1131.

features resulting from a particular promotion are substantially more attractive.

While some factors of production are fungible, consumer products usually are not. Depending upon a producer's degree of market power, it will be more or less able to pass on increased costs to end consumers through higher prices. If we assume that steel is not a good that admits of ready substitutes as a factor of production (at least in the short run), then the demand for steel is relatively inelastic. This means that intermediate purchasers will absorb, at least as an initial matter, most of the burdens of the tariffs through costs that the producers of steel pass on to them: in this example approximately ten million dollars. In turn, they will tack part of that additional cost onto their own products in the form of higher prices. How much they will successfully pass on, versus how much they will absorb in the form of lost profits, is a function of their relative market power over the goods they produce and sell. While incidence analysis, which studies the ability of various industries to pass on costs, would be required to determine where the ultimate burdens of the tariffs fall, our immediate purpose is instead to evaluate the likely impact of interest groups on the creation of the steel tariff. To simplify the analysis, assume that the intermediate producers are able to pass on most or all of the additional costs to the hundreds of thousands of purchasers of products in which steel is a major factor each year.

If there are 100,000 such purchases in a given year, likely a very low estimate, then the average added cost per consumer is approximately $100. If the costs are passed on over several years, the figure will be substantially lower. And of course to the extent that the producers themselves bear part of the cost through lost profits, the cost to consumers is further reduced. Of course prices fluctuate based upon numerous factors, and few consumers will focus on the precise cost of each individual factor when making a major purchasing decision. But for simplicity, let us assume that they do or that the information concerning the precise impact of the tariff on the products they purchase is freely available, or perhaps even stated on the invoice.

Consider whether from the perspective of 100,000 purchasers of steel products *each year*, it is rational to invest in opposing the steel tariff. One might imagine that as with the producers, it is rational for each consumer to invest up to the full value of the passed on cost, here $100, in opposing the tariff. And yet, consumers face additional obstacles to effective lobbying. A core insight from interest group theory is that when the size of the affected group is large and diffuse it is unlikely that such opposition will effectively mobilize.

C. FREE RIDING AND THE LOGIC OF COLLECTIVE ACTION

In *The Logic of Collective Action*, public choice theorist Mancur Olson argued that when groups are small and well organized, as appears to be the case with steel manufacturers, they are well positioned to lobby in favor of beneficial legislative procurements.[39] In contrast, when groups are large and diffuse, as is the case with the consumers of products for which steel is a major factor of production, they are poorly positioned to lobby for or against such procurements.

While numerous problems can inhibit effective lobbying, the most important for our immediate purposes returns us to the phenomenon of "free riding."[40] Each individual consumer will rationally decline to invest in opposition to the extent that successful lobbying efforts benefit consumers of such products generally. Each person or firm hopes that other similarly situated consumers will lobby in his or her place. Of course, the incentive to free ride is universal, and so it is rational for the group as a whole to decline to make the necessary investment in opposition to the procurement of the tariff. And this is so even though the aggregate benefit of the lobbying might well exceed even the financial benefits the tariff affords the steel industry.

1. Information Costs, Rational Ignorance, and the Timing of Payoffs

The preceding analysis assumes that consumers freely obtain information about particular factors of production for the goods they purchase. That assumption is certainly ambitious. Information is extremely costly to obtain. Complex consumer goods have a sufficiently large number of inputs that it would be impractical for most consumers to educate themselves concerning the precise costs of any individual factor, such as the price of steel, and how that cost affects the overall price of the good. Economists have dubbed this problem "rational ignorance."[41] Given the cost of acquiring information, the likelihood that the information could be used productively, and the obvious difficulties of free riding, relatively few consumers will be rationally motivated to invest in researching regulatory processes that benefit specific industry constituencies at their expense. To what extent might rational ignorance, combined with free riding, help to explain the political dynamics of the steel tariffs?

Finally, the prior discussion assumed that both the benefits to the steel producers and the cost to consumers of the steel tariffs was borne at a single time, or within a single year. That is almost certainly not the case. The steel producers did not immediately realize the full $10 million estimated value of the tariffs, and consumers did not bear the entire burden at one time, or even within a single year. Instead, the benefits to the producers and the costs to consumers were spread over many years,

39. *See* OLSON, *supra* note 24, at 53–65.

40. *See supra* chapter 1, section II.E.

41. Rational ignorance means that individuals will decline to invest in obtaining information where the marginal costs of gathering that information exceed the expected marginal benefits. For a general discussion, see Morris P. Fiorina, *Voting Behavior*, *in* PERSPECTIVES ON PUBLIC CHOICE 391, 396 (Dennis C. Mueller ed., 1997) (citing ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 238–59 (1957)); *see also* JAMES M. BUCHANAN, PUBLIC FINANCE IN DEMOCRATIC PROCESSES: FISCAL INSTITUTIONS AND INDIVIDUAL CHOICE 7–9 (1967).

and most likely even decades, in the form of more highly priced goods and services affected by the price of steel.[42]

The same is true for virtually all legislatively conferred rents, including those associated with professional attorney licensure. In each case, the value of the barrier to competition (from foreign producers in the case of steel, and from unlicensed practitioners in the case of attorneys) is spread over a sufficiently long period of years that the burden such a regime poses for any individual consumer is substantially further reduced. For end consumers, the effect, predictably, is to exacerbate both the free rider and rational ignorance problems.

More recently, theorists have debated whether rational ignorance produces random or systemic effects in inhibiting such potentially welfare-enhancing policies as free trade. In *The Myth of Democratic Failure*,[43] Donald Wittman argues that although voters are likely to be rationally ignorant, this alone should not produce flawed political outcomes if voter errors are not systematically biased and thus are randomly distributed over policy options. Economist Bryan Caplan instead claims that because voter preferences are subsidized through political processes as a result of the forced-rider problem, their ability to indulge welfare-reducing policy preferences might systematically and adversely skew public policy over a range of issues.[44]

2. Group Size Revisited

The effects described above might well be different for small and organized groups. An affected interest group will have a considerable motivation to factor in the potential financial benefit of a conferred quasi-rent. While this requires such groups to calculate the *discounted present value* of the expected stream of economic benefits to be generated over the life of the regulation in question, this is essential to assessing the potential value of the proposed regulation and to evaluating how much it is worth investing in lobbying. The interest group will have to discount the stream of benefits in light of the (1) time-value of money ($1 million ten years from now is worth far less today than $1 million next year), and (2) the probability that the law might be repealed in any given year as actually

42. This analysis, however, would not hold for a firm seeking to acquire a company that benefits from a tariff. *See* PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 700–02 (16th ed. 1998) (explaining effect of a tariff). For the firm seeking to be acquired, the present value is a function of the additional predicted income stream, discounted to present value, associated with the tariff. *Id.* at 252–54 (explaining general formula for present value). As a result, the steel tariffs would represent a one-time capital gain to the acquired firm, but no gain to the acquiring firm. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 41–43 (6th ed. 2000) (defining an asset that pays a fixed sum for a specified time as an annuity and describing its valuation.)

43. DONALD A. WITTMAN, THE MYTH OF DEMOCRATIC FAILURE: WHY POLITICAL INSTITUTIONS ARE EFFICIENT (1995).

44. BRYAN CAPLAN, THE MYTH OF THE RATIONAL VOTER: WHY DEMOCRACIES CHOOSE BAD POLICIES (2007). While Caplan labels this phenomenon "rational irrationality," his usage of those terms might depart from standard economic convention as used throughout this book. For our purposes, the more important point, however, is whether Wittman or Caplan is more likely to be correct in viewing rational ignorance as having systemic or nonsystemic effects on public policy.

occurred within less than two years in the case of the steel tariffs following a World Trade Oganization (WTO) ruling.[45] Whatever the discount times probability yields, it remains rational for the benefiting group to invest up to that amount to secure the present value of the stream of rents. This calculation informs cost-effective, or rational, rent-seeking activity.

D. THE GEOMETRY OF RENT SEEKING[46]

To understand the economic significance of such legislation, it will be helpful to reconsider the market power paradigm:[47]

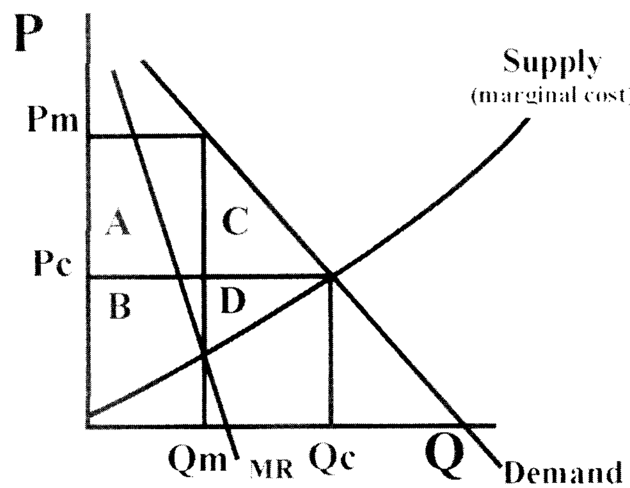

Figure 2:2

The shaded area in Figure 2:2, depicting forgone consumer and producer surpluses, represents a societal deadweight loss. If the firm produced to the point where the supply (or marginal cost) curve intersects the demand curve, societal welfare would improve as more of the relevant goods are produced and sold at a lower price. The monopoly rents, A—D, that arise in noncompetitive markets provide industries with incentives to attempt to secure market power through the political process. As Professor Charles K. Rowley has observed: "[D]uring the 1960s ... economists [tended to] dismiss the welfare cost of tariffs and monopolies as unimportant in view of the minute values associated with the Marshallian deadweight loss triangles of lost consumers' surplus associated with their existence."[48]

45. *See supra* note 2, and cites therein.

46. Portions of the discussion to follow are based upon STEARNS, *supra* note 22, at 120–25.

47. *See supra* chapter 1, appendix.

48. Charles K. Rowley, *Introduction*, *in* PUBLIC CHOICE THEORY I: HOMO ECONOMICUS IN THE MARKET PLACE, at xxiv (Charles K. Rowley ed., 1993).

In a famous paper, *The Welfare Costs of Tariffs, Monopolies, and Theft*,[49] Gordon Tullock challenged the intuition that deadweight loss triangles imposed a relatively small cost on society by demonstrating additional costs to monopoly power, and in particular monopoly power created and protected through the process of regulation.[50] In what Rowley describes as "arguably [The Virginia School's] single most important contribution to public choice,"[51] Tullock posited that the deadweight loss represented by foregone consumer and producer surpluses do not represent the full costs of rent seeking. Instead, he argued that the full value of monopoly rents might be dissipated in the very process of rent seeking.[52] Given the value of monopoly power, we would expect interest groups, behaving rationally, to expend significant resources in attempting to secure legislatively conferred rents. The resulting costs constitute a further deadweight societal loss that might well offset the value to the acquiring firm of the resulting monopoly rents.

Figure 2:2 helps to illustrate Tullock's essential insight.[53] As previously noted, the areas $C+D$ (foregone consumer and producer surplus respectively) are the deadweight cost of monopoly, or "Harberger Triangles." The area A was recognized as a simple wealth transfer from consumers to producers that takes the form of a monopoly "rent." Tullock observes, however, that producers would be willing to expend the full value of the monopoly rent, here depicted as the rectangular area A minus the foregone producer surplus D, to secure the monopoly rent. This process of expending some of the economic rents in pursuit of acquisition of the expected value of those rents is a process known as "rent dissipation."[54] The full social cost of rent-seeking can be estimated as the sum of the Harberger deadweight loss triangles (areas $C+D$) *plus* the so-called Tullock rectangle (area A). In equilibrium the analysis suggests that all rents will be fully dissipated. Generating accurate estimates of the social welfare losses that result from rent-seeking activity has proven elusive, but as Tullock maintains, including the cost of rent seeking itself increases the likelihood that these losses will be substantial.[55]

49. Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967).

50. *Id.* at 226, 232; *see also* Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975).

51. Rowley, *supra* note 48, at xxiv.

52. Tullock, *supra* note 49, at 226, 232.

53. In Tullock's original formulation, he presented a flat supply curve that did not account for area C plus D, which represents forgone Ricardian Competitive Rents. The presentation in the text presents the analysis based upon an upward sloping supply curve to render the analysis consistent with the presentation in the chapter 1, appendix.

54. Note that the phenomenon is not limited to political rent-seeking. For instance, the acquisition of a patent right provides the patent holder with a monopoly rent during the enforcement period. The opportunity to collect these monopoly rents will tend to encourage overinvestment in research designed to produce a patented product relative to one that is not patentable. As an example, it is often observed that there might be a "patent race" to invent a new drug before a competitor does so, leading to heightened investment in attempting to be the first to patent the drug and thereby win the "prize" of a legal monopoly for the period of the patent.

55. *See* Robert D. Tollison, *Rent Seeking*, *in* PERSPECTIVES ON PUBLIC CHOICE, *supra* note 41, at 506, 512–14 (summarizing studies).

Rent-seeking expenditures reduce social wealth in a number of ways, including diverting resources from productive activity toward lobbying for purely redistributive transfers.[56] These costs include the efforts and expenditures of those seeking monopoly rents, such as hired lobbyists and managerial time, all of which could instead be deployed to productive economic activities. Public choice theorists posit that as rent-seeking becomes more lucrative, politicians and regulators will increase their efforts to secure positions that provide them with the power to confer rents. Just as firms will rationally invest in rent seeking, so too legislators will invest time and other resources in securing positions that empower them to respond to rent-seeking efforts. Ambitious legislators will tend to concentrate on those regulatory areas more likely to be the subject of rent-seeking activity, such as appropriations committees, as compared with committees that although equally important from a public interest perspective, lack such opportunities. The incentive to rent seek distorts activities of other economic actors by diverting attention from socially productive activities. Consider whether top legal talent is more fruitfully deployed, for example, in drafting commercial contracts or other activities that increase social wealth or in facilitating or directly lobbying on behalf of industry.

1. The Rise and Decline of Nations[57]

In his influential book, *The Rise and Decline of Nations*,[58] Mancur Olson took the preceding analysis a significant step further. Olson linked the tendency of interest group influence—or rent seeking—over time to the decline in the rate of economic growth in Western democracies after World War II.[59] Olson demonstrated that those countries whose economic and political infrastructures were harmed most severely during World War II—Germany, Italy, and Japan—sustained the strongest economic development over the next twenty-five years, while those whose economic and political infrastructures remained intact—Australia, New Zealand, the United Kingdom, and the United States—performed most poorly during the same period.

While it might appear counterintuitive that the military victors in World War II would prove the subsequent losers and vice versa, the result makes more sense when we reconsider it from the combined perspectives of rent seeking and opportunity costs. At any given time there are two different ways for a producer to earn money in an economy. They can either produce new goods in the competitive market, or they can engage in rent-seeking activity. When a nation's political infrastructure is gutted, firms behaving rationally will make a different calculation concerning the

56. *See* James M. Buchanan, *Rent Seeking and Profit Seeking*, *in* TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 3 (James M. Buchanan, Robert D. Tollison, & Gordon Tullock eds., 1980).

57. Portions of the discussion that follows are based upon STEARNS, *supra* note 22, at 121–23.

58. MANCUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES (1982).

59. *Id.* at 74–117.

extent to which they deploy resources across these two activities. Not only are rent-seeking opportunities likely to be scarcer in a regime with a compromised political infrastructure, but also the ability of the government to issue the necessary commitments (or bonds) that confer regulatory protections that will remain in place is diminished. Conversely, politically conferred rents are likely to be more durable in more stable regimes. And because the present discounted value of those rents will be higher as a result of more durable bonds, rational firms will be increasingly willing to make the necessary investments to secure those rents in stable regimes with well-established political infrastructures.

Olson's analysis suggests that substantially reducing rent-seeking behavior requires radical, rather than narrow or incremental, institutional reform. Olson demonstrated that rent seeking not only imposes significant economic costs that can pull the production possibility frontier inward,[60] but also, it can inhibit ordinary economic growth that otherwise would push the frontier outward over time.[61] In light of the significant societal loss that rent seeking represents, public choice theorist Dennis Mueller has posited that: "The task of reform is to design institutions that allow and encourage those forms of competition that create rents by creating additional consumer and citizen surpluses, and discourage competition designed to gain and retain existing rents."[62] Still others have posited that even if we can devise such institutional reforms, their adoption will simply relocate—but not eliminate—rent seeking. Thus, William H. Riker and Steven J. Brams explain:

> Of course, when vote trading is banished from the legislature, political compromise goes on someplace else politically antecedent to the legislature. Thus in state legislatures and city councils with disciplined parties, it is in the majority caucus or in the mind of the boss that the compromise takes place. In England, the Cabinet serves as one place of compromise and very probably something like vote trading goes on there. Since the Cabinet situation is unstructured in comparison with the Parliamentary situation, however, it is probably hard to identify the trades and compromises that do occur.[63]

Recall that the production possibility frontier, reproduced from chapter 1 below,[64] represents the potential economic output for an individual, firm, or nation, as between two commodities.

60. *See* chapter 1, appendix.

61. *See* DENNIS C. MUELLER, PUBLIC CHOICE III 555 (2003).

62. DENNIS C. MUELLER, PUBLIC CHOICE II 245 (1989).

63. William H. Riker & Steven J. Brams, *The Paradox of Vote Trading*, 67 AM. POL. SCI. REV. 1235, 1238 (1973).

64. *See supra* chapter 1, at III.F.

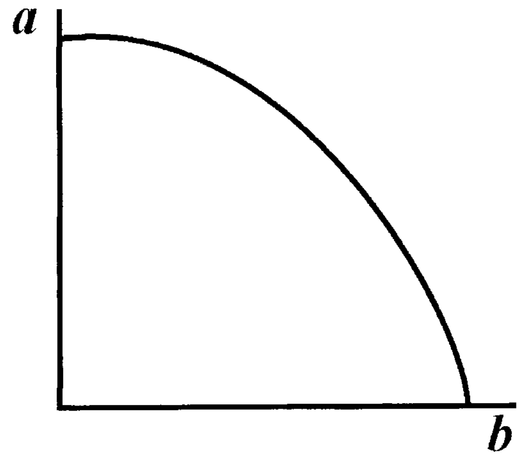

Figure 2:3

An individual is capable of producing two forms of output, *a* and *b*, such that for each commodity the person experiences decreasing marginal productivity. Producing the first unit of *b* would require this person to forego relatively little in her production of *a*, and producing each additional unit of *b* would require this person to forego producing a somewhat larger quantity of *a*. Conversely, producing additional increments of *a* requires relinquishing larger and larger increments of *b*.

The production possibility frontier can be used not only to depict the production potential for an individual or firm, but also on a larger scale, to depict the maximal output of an industry, state, or nation. Industries maximize their economic output when they produce at the most highly valued point along their production possibility frontier. Olson's analysis of the post World War II economies of the former Allied and Axis powers not only reflects diminished opportunities for rent seeking, but also might reflect more profitable private market opportunities in nations whose economic and political infrastructures had been destroyed. There was great pent-up postwar demand for new goods in those economies destroyed by the war and great economic opportunities for private sector development. In contrast, for those nations that suffered less infrastructure damage, in the aftermath of a booming wartime economy, one that had succeeded in pulling the affected nations out of the Great Depression,[65] industries were likely already producing at or near their production possibility frontiers. If so, the potential profits that such industries were capable of generating from rent seeking were as high or higher than the potential profits such industries were capable of generating from the next best available investment activity. Mueller captures this insight as follows:

65. J.R. Vernon, *World War II Fiscal Policies and the End of the Great Depression*, 54 J. ECON. HIST. 850, 850 (1994) ("What ended the Great Depression? In the traditional view, the answer is World War II, a conclusion that appears in the works of numerous economist and historians.").

> To temper the resistance of [interest] groups to the losses they would experience by eliminating those programs that facilitate rent seeking, even greater gains must be offered. Perhaps this observation explains why it is sometimes politically easier to eliminate or reduce a large group of restrictions on trade than just a few. The deregulation movement in the United States [in the 1980s during the Reagan Administration appeared to have been successful] because it attacked regulations in many industries. To come fully to grips with the rent-seeking problem, one must think in terms of radical reforms; fundamental redefinitions of property rights.[66]

If Olson is correct, then his analysis would require us to weigh the benefit of societal and institutional stability against the cost of rent seeking. The calculus is especially daunting given that to the extent institutional reform is successful, meaning that it is a stable solution to prior rent-seeking activity, we might once again expect to see rent seeking rearing its ugly head.

E. HOLDOUTS, TAKINGS, AND THE COMPARISON BETWEEN PUBLIC CHOICE AND LAW AND ECONOMICS REVISITED

The concepts of rent seeking and rent dissipation have significant implications for the economic analysis of law. Consider, for example, Richard Posner's analysis of the Fifth Amendment's requirement of "Just Compensation" for property taken for public use under the Eminent Domain Clause.[67]

Posner postulates that the purpose of the Eminent Domain Clause is to prevent welfare-reducing takings of private property. The basic economic logic of the Eminent Domain power is to permit the government to overcome "holdout" problems in order to assemble contiguous parcels of land in order to build public works, such as roads, schools, and public buildings. Holdouts are the flip side of free riders. Both involve problems of collective action; while free riding focuses on the supply side, in the willingness of group members to affirmatively support group interests, holdouts focus on the demand side, on the disinclination of individuals to sell to an interested buyer seeking to transform assembled parcels into a substantially more highly valued use.

A classic theoretical holdout illustration involves the efforts of a developer, for example Disney Corporation, to acquire a sufficiently large tract of land to build a theme park, in this instance Disney World in Orlando, Florida. If Disney simply announced its intent, and then offered the fair market value to relevant property owners, would those owners

66. MUELLER, *supra* note 62, at 245 (citing James M. Buchanan, *Reform in the Rent-Seeking Society*, *in* TOWARD A THEORY OF THE RENT-SEEKING SOCIETY, *supra* note 56, at 359).

67. U.S. CONST. amend. V ("nor shall private property be taken for public use, without just compensation"). The Takings Clause applies to state and local governments through the Fourteenth Amendment Due Process Clause.

sell? Certainly not. Some might, but more savvy owners would "hold out" in the hope that Disney would acquire a sufficiently large number of properties that it would desperately need the remaining property to facilitate the development. At this point, Disney and the final holdout, or group of holdouts, stand in the relation of a *bilateral monopoly*.[68] In this example, the most highly valued use of the property involves the sale to a single buyer, Disney, and Disney needs to acquire the property from a very specific seller or group of sellers. Assume that without the property, Disney cannot build the park, but with the full group of contiguous parcels it can, thus producing a value of $100 million. The final holdout might try to extract a "rent" up to the full value of the $100 million, say $99,999,999. Disney will try to minimize its payout (above the previous fair market value of say, $200,000). The resulting negotiating range—between $200,000 and $100 million—is huge, and in a bilateral monopoly, unlike in a competitive market regime, there is no obvious or stable equilibrium outcome. Instead, the ultimate sale will result in the purchaser and the holdout allocating the enormous gains from the ultimate sale. In fact, Disney solved the holdout problem in Orlando through reliance upon several "straw" purchasers, meaning separate individuals who acquired the properties without disclosing that they were making those purchasers for a common entity, namely Disney Corporation.[69]

1. A Law and Economics Analysis of Takings

Consider the extent to which the holdout problem explains the inclusion of the requirement of just compensation in the Fifth Amendment Eminent Domain Clause. Under standard law and economics analysis, the constitutional requirement of "Just Compensation" is presumed a necessary means of forcing the government to pay the market price for the property that is taken. If the price that has to be paid for the land exceeds the value that the government places upon it, then the government will forego taking the property because it will not be willing to pay more for the land than it is worth. Conversely, if the government values the land more highly than the fair market value, it can effect the taking, compensate the owner, and still improve societal welfare. In this analysis, the just compensation requirement ensures that the government will take property only when it actually places a higher value on its proposed use of the land than does the landowner.[70]

68. A bilateral monopoly is a relationship involving a monopolistic seller and a monopsonistic buyer. A monopsonist is a buyer with market power over purchases such that it has price-setting power, comparable to that of a monopolistic seller, based upon how much of the good in question it elects to purchase. SAMUELSON & NORDHAUS, *supra* note 42, at 238 (explaining bilateral monopoly in the union/labor market context).

69. For an informative discussion of reliance upon straw purchasers, including those involved in the Disney acquisition of property in Orlando, Florida, see Daniel B. Kelly, *The "Public Use" Requirement in Eminent Domain Law: A Rationale Based on Secret Purchases and Private Influence*, 92 CORNELL L. REV. 1 (2006).

70. This assumes that the government fully internalizes the costs in engaging in these sorts of projects. Given the problem of agency costs, as described in chapter 1, however, it may be that the incentives of those individuals who make the actual decisions are not fully aligned with that of "the government" as a whole.

Richard Posner claims that this traditional law and economics justification is incomplete.[71] Assume that as compared with the government, the landowner places a higher value on her property. Posner maintains that under standard economic assumptions,[72] a welfare-reducing taking still will not occur even in the absence of a requirement of just compensation. Posner observes that a property owner who is about to have his or her land seized will not acquiesce in the taking, but will instead expend resources, including hiring lawyers or lobbyists, to fight it. Indeed, based upon the preceding analysis, we could predict that the property owner would rationally invest up to the total value he or she places on the property to avoid the welfare-reducing taking. Alternatively, the property owner would be willing to simply pay off the government to let the property owner retain the land, rather than to have the government acquire it and deploy it to a lower valued use. In contrast, if, as compared with the homeowner, the government places a higher value on the property, the landowner will not rationally invest sufficient resources in attempting to block the welfare-enhancing taking. Thus, Posner concludes, the outcome should be the same whether or not just compensation is expected.[73]

2. An Alternative Public Choice Analysis of Takings

While Posner's analysis reveals the limits of the standard account of the Just Compensation Clause, public choice also demonstrates the limits of this alternative law and economics analysis.[74] As a matter of standard economic analysis, Posner appears correct in asserting that eliminating the requirement of just compensation would not increase the risk of social welfare reducing takings. But this analysis focuses solely on the deadweight loss resulting from a potentially inefficient government taking. Relying on public choice theory, Todd Zywicki has suggested an alternative analysis grounded in public choice that provides a positive justification for requiring just compensation in the context of eminent domain. As Zywicki observes, Posner's analysis fails to account for the social cost of this regime, which includes the additional expenses Tullock associates with rent seeking (or rent extraction).[75] These include the very expenses that Posner properly identifies as ameliorating the risk of inefficient takings, such as expenditures on lawyer's fees and political efforts. These are real resources expended solely for the purpose of blocking the transfer that results in moving land from a more highly valued to a less highly valued use. So although such lobbying activities reduce the risk of realizing the deadweight loss (the lost "triangle"), it substantially increases the

71. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 3.7, at 56 (7th ed. 2007).

72. The analysis assumes no transactions costs.

73. In effect, Posner's argument is an application of the Coase Theorem. Do you see why?

74. *See* Todd J. Zywicki, Rent Seeking: What It Is, Why It Matters (working paper) (on file with author.)

75. Richard Posner has acknowledged this caveat to his argument. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 3.7, at 59 n.6 (6th ed. 2003) (citing Zywicki, *supra* note 74).

amount of social wealth that is dissipated to prevent this loss from occurring (the lost "rectangle").

The just compensation requirement requires a wealth transfer from the government to an individual to compensate him for the taking. In Zywicki's analysis, rather than encouraging socially wasteful expenditures on lawyers and political activity, the just compensation requirement puts the value of the land in the hands of the property owner and not those of the property owner's lawyers. There may still be some litigation over the proper value to assign to the property, but this will substantially narrow the range of conflict and disagreement, and hence the range of expenditures for rent-seeking or rent avoidance by the parties. In contrast, eliminating the requirement of just compensation would facilitate a rent-seeking game with the potential for substantial social cost, thereby replacing what is otherwise a relatively low-cost wealth transfer.

F. RENT-SEEKING IN EQUILIBRIUM: THE CASE OF CAMPAIGN FINANCE REFORM

A corollary of Mancur Olson's analysis of rent seeking and economic growth following World War II suggests that behaving rationally, economic actors will allocate resources until the marginal value of private market production and of rent-seeking expenditures are equal. Thus, if the economic returns to rent-seeking increase over time, public choice predicts that interest groups will invest increasingly greater resources pursuing rent-seeking activities.

Consider the important and controversial question of why campaign expenditures on political activity have historically risen over time. In a provocative article, John R. Lott, Jr.[76] posits "a simple explanation" that campaign expenditures are increasing because the government is getting bigger. The explanation is straightforward: "the more transfers the government has to offer, the more resources people will spend to obtain them."[77] And "[a]s government has more favors to grant, the effort spent to obtain those favors should increase."[78] As the size of government grows, the government, by definition, will have greater ability to transfer wealth. Even public goods such as national defense and highway construction will have important private goods elements susceptible to rent-seeking activity. In other words, if the government has the power to enact laws or regulations that can substantially benefit certain firms or industries (such as a narrowly tailored tax break or a congressional "earmark"), then there will be potential beneficiaries who will rationally invest in rent-seeking in an effort to capture those benefits. Similarly, if the government has the power to enact laws or regulations that can impose substantial costs on particular firms (such as a tax increase or

76. John R. Lott, Jr., *A Simple Explanation for Why Campaign Expenditures Are Increasing: The Government Is Getting Bigger*, 43 J.L. & ECON. 359 (2000).

77. *Id.* at 363.

78. *Id.*

strict regulation), those firms will rationally invest in rent-seeking to prevent the imposition of the cost. Controlling for other possible factors that might have increased the costs of campaigns during that time (such as increases in the costs of television advertising), Lott concludes that the near 180% increase in federal campaign spending and 136% per capita real expense increases for House and Senate races from 1976 through 1994 resulted primarily from the increased opportunities that the growing federal and state governments presented for rent seeking.

Lott concludes that the conventional approach of addressing increasing campaign expenditures by imposing spending or contribution caps is misguided. Although spending caps might reduce the direct monetary expenses of campaigns, they are not likely to alter the total social cost of political campaigns, and, ironically, might even increase social costs by forcing them into less cost-effective forms, including in-kind contributions, rather than direct payments to a candidate. The changed form of contribution, however, does not mean that the overall portion of societal wealth devoted to supporting campaigns has diminished.

Lott further observes that the forms that these contributions can take is nearly infinite and that the corresponding range of governmental transfers is quite broad. Lott states: "If the hypothesis presented here is correct, increased abilities to transfer wealth in any form (for example, regulations or expropriation of property) should lead to increased campaign expenditures."[79] Lott claims that his empirical results, which use government expenditures as a proxy for an increased ability to transfer wealth, support his hypothesis. Lott asserts therefore that the present policy debate misses the critical insight that the difficulties associated with excessive campaign spending cannot be solved by limiting donations. This would simply change the form of payments. Attempts to reduce campaign contributions, for example the McCain–Feingold Campaign Finance Act, which attempts to regulate the form, timing, and substance of political activity,[80] focus primarily on the symptoms rather than the causes of growing campaign finance.

Based upon this analysis, is it surprising that soon after the McCain–Feingold Campaign Finance Act was enacted, it was determined that there were problematic "loopholes," such as the activities of private so-called 527 groups[81] that engaged in political activity outside the reach of the McCain–Feingold Act? If the "loophole" for 527 groups were closed, would that be likely to eliminate the amount of social resources expended on political campaigns? Why or why not?

G. THE PROBLEM OF RENT EXTRACTION

Professor Fred McChesney has demonstrated that through the phenomenon of "rent extraction," legislators can generate the equivalent of the social-welfare loss associated with rent seeking even absent a specific

79. *Id.* at 364.

80. Bipartisan Campaign Reform Act of 2002, Pub. L. No. 107–155, 116 Stat. 81 (codified as amended in scattered sections of 2 U.S.C.).

81. 26 U.S.C. § 527 (2006).

effort by an interest group to direct resources toward securing legislatively produced rents. Assume that a law is enacted that promises a stream of benefits over the next ten years at an expected value of $1 million per year, such as a protectionist licensing scheme. Further assume that six years after the law was initially passed, a member of Congress on the relevant committee that oversees this program announces that she is considering initiating proceedings to have the law repealed.

At this point, if the law remains effective, then the interest group will still receive four more years of economic rents at $1 million per year. How do you predict that an interest group would respond to the proposed legislative action? Interest group theory suggests that behaving rationally, the interest group would be willing to invest up to the present discounted value of the $4 million income stream with the program in place to avoid its repeal. Fred McChesney refers to this scheme as rent extraction or rent "extortion," which he likens to a sort of political blackmail. The politician essentially coerces various forms of contributions or support in exchange for not affirmatively harming the interest group either by taking away an existing benefit or imposing a new cost.[82]

Alternatively, even if there is no quasi-private benefit to protect, the same legislator could approach industry leaders with the threat to impose a costly new regulation. For example, a member of Congress on the committee that oversees the Medicare Program could approach leading pharmaceuticals makers proposing reimbursement caps that are substantially lower than those currently under Medicare. The pharmaceutical industry might respond by offering various forms of political support in exchange for leaving the present higher reimbursement caps in place. In this analysis, it is even possible that the legislator could succeed in rent extraction even if she had no intention of imposing the lower reimbursement caps, provided that her threat appears credible to the pharmaceutical industry leaders.[83]

III. TOWARD A GENERAL MODEL OF REGULATION

Building on the tools set out in this chapter, we will now introduce a matrix that helps to identify the conditions under which the legislature is likely to provide various forms of legislation, including quasi-private goods or public goods, and also under which it is likely to delegate to administrative agencies. While the analysis is necessarily simplified—most legislation will not fit neatly into a single category—it is nonetheless a starting point in assessing the dynamics of legislative processes, procurement, and compromise.

82. MCCHESNEY, *supra* note 19, at 124.

83. For McChesney's empirical support, see *id.* at 45–68 (chapter 3). A politician's credibility will turn on his or her willingness to occasionally act upon such threats. It does not matter if the interest group already "paid" for the law at the outset, as those investments are now sunk costs.

A. THE WILSON-HAYES MATRIX[84]

Two public choice theorists, James Q. Wilson and Michael T. Hayes, have used these insights to create a model of four legislative categories designed to predict which supply and demand configurations will tend to produce too much public action as well as which ones produce too little.[85] For simplicity, Wilson and Hayes divide the benefits associated with legislation into general benefits to the public at large, for example, defense, and narrow or special interest benefits, for example, an industrial subsidy or tariff. Similarly, Wilson and Hayes divide the costs associated with legislation into those that are distributed widely, for example, the former federal fifty-five mile-per-hour speed limit, and those that are distributed narrowly, for example, rent control or socialized medicine. While the costs and benefits of most legislation fall between these extremes, these categories, which are depicted in Table 2:1,[86] are useful in setting up the analytical paradigm.

Table 2:1. The Four Box Static Model

	Widely Distributed Benefits	Narrowly Conferred Benefits
Widely Distributed Costs	***Legislative Characteristics:*** This desired category of legislation tends to be undersupplied as constituents express too little pressure in support; alternatively when pressure is brought on both sides, legislatures sometimes delegate to avoid the resulting conflict. ***Illustrations:*** Desired legislative responses to various environmental crises, e.g., waste management or global warming; and national fiscal management, e.g., social security reform.	***Legislative Characteristics:*** Because small organized groups exert pressure disproportionately to numbers in political processes, legislatures tend to oversupply special interest legislation. ***Illustrations:*** Tariffs, industry subsidies.
Narrowly Conferred Costs	***Legislative Characteristics:*** Given the fear that factional violence (Madison Federalist No. 10), or interest group politicking (the modern equivalent), will disadvantage unpopular minorities, congressional processes include numerous features that tend to enlarge successful coalitions above minimum winning size. ***Illustrations:*** Rent control, national health care reform.	***Legislative Characteristics:*** Because intense interests directly conflict, legislators prefer to delegate to agencies, hoping to shift blame for resulting failures while claiming credit for resulting successes; legislators can also benefit from simply threatening regulatory delegation and can benefit from monitoring agencies. ***Illustrations:*** The National Labor Relations Board.

84. Portions of the following discussion are based upon Stearns, *supra* note 12, at 402–11.

85. *See generally* JAMES Q. WILSON, POLITICAL ORGANIZATIONS 332–37 (1973); MICHAEL T. HAYES, LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS (1981). While Wilson first posited these four categories, Hayes, relying upon the works of several public choice theorists, substantially developed the original model.

86. Stearns, *supra* note 12, at 407.

The difficulty with categorizing legislation between the extremes of conferring narrowly distributed and widely distributed benefits or between imposing narrowly distributed and widely distributed costs is exacerbated by the tendency of interest groups to characterize government policy in favorable terms. Thus, it is strategically beneficial for special interest groups to characterize special interest goods, for example, a particular defense contract, as benefiting the general public, for example, by claiming that it will help the national defense. Professor Glen O. Robinson has offered a useful definition that helps to respond to this problem:

> We can roughly define "public goods" as those in which there is some symmetry in the distribution of benefits and costs (within some near-term time period), whereas "private goods" are those where distribution of benefits and costs is asymmetrical; benefits are concentrated in a particular geographic region or special group, whereas costs are distributed more broadly over the general population.[87]

The traditional, or public interest, view of Congress is that legislators follow their mandate to collectively supply goods benefiting the general public and bargain only as to detail. The irony highlighted by public choice theory is that individual members of society are least likely to lobby for such goods. Because no one can be excluded from the benefits of such classic public goods as a police force or national defense, individuals will free ride in their efforts to lobby for such legislative procurements, waiting for others to do so on their behalf. Because everyone engages in this behavior, the model predicts that goods providing benefits to the general public tend to be undersupplied. While everyone benefits from them, no one is willing to incur the necessary costs to procure them.

Alternatively, there is a stronger incentive to lobby for goods that provide narrow and direct benefits to identifiable groups. The free rider phenomenon is not eliminated altogether, but it is reduced to the extent that individuals can be excluded from the group benefiting from the legislation. The problem here is analogous to that of "cheaters" in a cartel.[88] To avoid having potential beneficiaries of narrow benefit legislation "cheat" by not contributing to lobbying efforts, special interest lobbyists will try, where possible, to make the legislative benefits divisible and excludable.

The problem with lobbying incentives is the same with respect to the costs of collectively supplied goods as it is with respect to the benefits. For public goods with widely distributed costs, one would expect minimal lobbying in opposition, just as one would expect minimal lobbying in support of goods conferring widely distributed benefits. Similarly, for goods imposing costs on a narrow group, one would expect greater

87. Glen O. Robinson, *Public Choice Speculations on the Item Veto*, 74 VA. L. REV. 403, 408–09 (1988).

88. *See supra* chapter 1, at section II.D.

lobbying in opposition, subject to the same free-rider or "cheating" problem that occurs with goods that confer narrow benefits. In sum, lobbying efforts in favor of or in opposition to legislation will increase in proportion to the degree to which benefits are narrowly conferred or costs are narrowly imposed.

The same factors driving the demand for legislation are at work in driving the supply. Just as constituents will press more vigorously for legislation conferring narrow and excludable benefits, legislators will supply legislation more readily when they can credibly claim credit with their constituents for having procured the legislative benefit.[89] An individual Congressman is aware that constituents will be dubious of claims that he or she was single-handedly responsible for a major legislative success. The Congressman also knows that constituents will be more willing to give credit for narrow and discrete legislative procurements aiding their district. In addition, one theorist claims that Congressmen expect their constituents to remember votes against their interests longer than votes in their favor.[90] This creates an obvious dilemma for legislators faced with some constituents who would benefit by proposed legislation at a price borne by other constituents. Congressmen can avoid this problem by exercising a third option beyond supplying or not supplying legislation. Specifically, Congressmen also can delegate decision-making responsibility to agencies or courts.

Congressmen can be expected to exercise this third option in instances in which one constituent group benefits directly at the expense of another, whether the costs and benefits of the legislation are widely or narrowly distributed. Legislators can use delegation as a means to let both sides claim victory in the legislative process, while blaming the agency at some future date for imposing the legislative cost. Frequently, regulation results in the interest groups "capturing" the agency such that the ensuing regulation is closer to the model of legislation under the old pluralist theory typified in E.E. Schattschneider's study of the Smoot–Hawley Act.[91] In essence, the interest groups win at the expense of the general public.

As shown in table 2:1, Wilson and Hayes combine these demand and supply configurations to create four legislative categories. While the distributed benefits/distributed costs category is the category of legislation that Congress was traditionally expected to provide, public choice theorists posit that, in fact, it is the one most likely to be undersupplied. Because this legislative category involves a conflicting demand pattern in which all

89. *See generally* DAVID R. MAYHEW, CONGRESS: THE ELECTORAL CONNECTION 52–54 (2d ed. 1974). Mayhew explains that because individual Congressmen cannot convincingly take credit for grandiose legislation, and because constituents are aware of immediate legislative procurements, Congressmen seek legislation that provides "particularized benefits" to their constituents. Particularized benefits must be given to an identifiable group and on an *ad hoc* basis so that a Congressman can have an identifiable role in their procurement.

90. *See* MORRIS P. FIORINA, REPRESENTATIVES, ROLL CALLS, AND CONSTITUENCIES 38–39 (1974) (explaining influence on Congressmen of "the ungrateful electorate").

91. *See supra* notes 11–12 and accompanying text (defining pluralism and collecting authorities).

constituents receive a slight benefit and incur a slight cost, and because lobbying efforts are not likely to be intense on either side, legislators will respond with inaction, or with symbolic action in the form of delegation. One method Congressmen can use to increase the likelihood that a proposed bill in this category will secure enough votes for passage is to agree to attach to the bill legislation from another category in which the incentive for lobbying is stronger. This explains not only how non-germane riders come into being, but also why the Wilson–Hayes matrix is arguably most important for its dynamic implications for legislative bargaining.

The distributed benefits/concentrated costs category is characterized by weak lobbying in support of legislation and strong lobbying in opposition, and is thus conflictual. One example involves proposals to nationalize the provision of health care services. Because everyone at some point requires medical services, the benefits of such a regime medicine would be distributed widely. The costs, in contrast, would be more narrowly contained, falling, at least in the near-term, on those providing medical services. Not surprisingly, the American Medical Association (AMA) has had a long history of lobbying, with considerable success, against proposals to nationalize health care in the United States.[92]

Legislators faced with this conflicting demand configuration are likely either to do nothing or to delegate. The United States system of lawmaking contains numerous protections against the formation of majoritarian factions, including such constitutional protections as bicameralism, presentment, and constitutional judicial review. In addition, numerous internal practices, including complex committee structures and calendaring rules, make the passage of legislation more difficult, and thus make majoritarian interest group politics more costly and thus less likely. These and other institutional protections or impediments to the passage of legislation are especially important in this context. In fact, one could argue that these protections, referred to as "negative legislative checkpoints," or "veto gates"[93] are in place to slow down or to stop legislation that benefits the public at large at a cost borne largely or entirely by a narrow interest group.

B. MINIMUM WINNING COALITIONS AND NEGATIVE LEGISLATIVE CHECKPOINTS

In effect, these negative legislative checkpoints or veto gates serve to increase the size of coalitions necessary to succeed in passing legislation.[94] William Riker, who developed the theory of "minimum winning coalitions," reasoned that, in theory, the most stable coalition in a legislative body will be comprised of one more than fifty percent. A larger coalition can benefit its membership by excluding others from the generalized benefits until a simple majority is achieved.[95] Riker's theory is most easily understood as the public choice analogue to Madison's theory of factions. In essence, these congressional processes and the constitutional impediments to the rapid formation of successful majority factions reduce the possibility that a simple majority will be a successful coalition.[96]

Protection against minimum winning coalitions is especially important in the distributed benefit/concentrated cost category. It is in this category that the interests of distinct minority groups are in the greatest danger of being thwarted by the legislative process. The benefits of negative checkpoints as a device to prevent minimum winning coalitions from prevailing are even more pronounced in comparison with state and municipal legislatures that lack them to the same degree as Congress.[97] Although the American Medical Association has historically been successful in lobbying against proposals to fundamentally redistribute access to health care (such as through nationalizing medical access), landlords, for example, have in many instances been less successful in opposing rent control in cities throughout the United States, such as New York City. While the interests of the two groups, medical doctors opposed to nationalized health care and landlords opposed to rent control, bear important similarities, the difference in legislative results might reflect the absence of such constitutional and structural impediments to the passage of legislation at the state or local level, as compared with their presence in Congress.

The concentrated benefits/distributed costs paradigm is characterized by strong demand for legislation and weak lobbying in opposition. When this occurs, public choice theory predicts enactment of legislation favorable to the active lobbying group. The most important legislative byprod-

92. Proposals on this issue were a major focus of debate both during the Democratic primaries and in the general election leading up to the current Obama Administration. *See* Ceci Connolly, *Support for Health Reform Is Growing: But Deep Rifts Remain over How to Pay for Coverage*, WASH. POST, Mar. 29, 2009, at A1 (describing proposal endorsed by a coalition of health industry organizations, including the AMA, which rules out nationalized health care and suggests an alternate system of government-supported insurance).

93. *See* Stearns, *supra* note 12, at 410 (defining "negative legislative checkpoints"); McNollgast, *Legislative Intent: The Use of Positive Political Theory,* LAW & CONTEMP. PROBS., Spring 1944, at 3, 7 (defining "veto gates"). The following discussion uses these terms interchangeably.

94. *See generally* WILLIAM H. RIKER, THE THEORY OF POLITICAL COALITIONS 32–46 (1962).

95. Riker's theory includes specific limitations. *See id.* at 32 ("In person, zero-sum games, where side-payments are permitted, where players are rational, and where they have perfect information, only minimum winning coalitions occur.").

96. *See* Harold H. Bruff, *Legislative Formality, Administrative Rationality*, 63 TEX. L. REV. 207, 219–20 (1984) (explaining that devices such as House Rules Committee agenda controls and threat of presidential veto serve to increase size of winning coalitions); RIKER, *supra* note 94, at 89–101 (observing that historically, successful coalitions are larger than minimum winning size); PETER H. ARANSON, AMERICAN GOVERNMENT: STRATEGY AND CHOICE 367 (1981) ("To pass, bills usually require more than simple majorities, because unconvinced lawmakers can use any number of lethal and dilatory strategies for defeating, or delaying, or substantially modifying them.").

97. *See* ARANSON, *supra* note 96, at 65 (asserting that according to available evidence, winning coalitions in state legislatures, as opposed to in Congress, become increasingly stable as they approach minimum winning size).

uct of this category is the rider, often one that is not germane to the overall substance of the underlying legislation to which it is attached. The skewed lobbying incentives in this category result in the legislative process of logrolling, with the effect of broadly conferring quasi-private goods as a means of achieving legislative compromise. Logrolling is the process by which legislators trade votes for each others' concentrated benefit/distributed cost items in exchange for their own. The predicted result is a proliferation of pork barrel appropriations, the sum total of which may leave everyone worse off than had no legislation been passed at all. Not surprisingly, perhaps, the logrolling problem is exacerbated in large part by the very veto gates designed to protect special interests from general benefit legislation enacted at their expense. The same legislators empowered to slow down or stop bills encroaching on the rights of particular interest groups also can use their power to coerce items conferring narrow benefits on other special interest groups.

The final category, concentrated costs/concentrated benefits, like the first configuration, is conflictual. But unlike with the first configuration, lobbying efforts here are intense on both sides. This is a classic situation in which legislators will opt out by delegating their authority to either an agency or to courts. Examples include the National Labor Relations Act,[98] establishing the National Labor Relations Board, and the Labor Management Relations Act,[99] vesting federal district courts with authority to resolve disputes over labor-management contracts. Delegation allows legislators to claim credit for creating legislative benefits while blaming the agency or courts for imposing the costs.

While rent seeking is often associated with the procurement of quasi-private goods through the legislative process, it is important to recognize that public goods often generate rent-seeking behavior and thus result in rent dissipation. Part of the problem is definitional. While "national defense" is generally characterized as a public good, the government does not provide national defense generically. Instead, it selects particular tanks, planes, or ships to buy, companies to contract with, and localities in which to place various bases. Embedded in the provision of the public good of national defense, therefore, are many decisions that have the potential to substantially enrich particular industries, firms, or communities, especially those in districts of influential politicians. Large defense contractors actively lobby and contribute to political campaigns in the hopes that their firms will be selected for lucrative defense contracts. For the same reasons that the Wilson–Hayes model predicts a tendency to oversupply quasi-private goods, it also tends to suggest that once the decision to supply a public good is made (such as national defense) there will be a strong tendency toward "privatizing" substantial aspects of the public goods provision.

98. 29 U.S.C. § 153 (2006).

99. 29 U.S.C. § 185 (2006).

The Wilson–Hayes model has implications for several public policy proposals. While we will reconsider these issues throughout the book, for now consider whether the tendency to favor special interest over general interest legislation provides support for such proposals as the item veto, single subject amendments, or the balanced budget amendment. Does the same tendency favor greater judicial scrutiny of legislation, especially special interest legislation? To what extent do these questions require one first to assess the proper baseline for evaluating the proper extent of interest group influence on the political process?[100]

C. BAPTISTS AND BOOTLEGGERS

One insight that emerges from the foregoing analysis is that for interest groups and lobbyists to successfully work political processes, they cannot be entirely selective in choosing with whom to negotiate. The frequent observation that politics makes strange bedfellows has found a theoretical analogue in public choice. Consider Bruce Yandle's "Baptists and Bootleggers" model of regulation.[101] In Yandle's analysis, regulations can emerge out of the confluence of the narrow economic self-interest of groups working together with more public-spirited parties. Yandle offers the example of so-called Sunday Blue Laws which have long existed in many states (especially in the southern United States, but also in Massachusetts), forbidding the sale of alcoholic beverages on Sundays.

Yandle observes that two very different groups, indeed groups that one would not expect to associate with each other, might agree to offer strong support for such regulation. First, there were those who he refers to as the "Baptists," morally motivated teetotalers who support these laws out of a sense of moral and religious conviction concerning the social benefits of temperance. Yandle observes, however, that there is a second group who might support these laws for less charitable or altruistic motives, the so-called Bootleggers, producers of illegal "moon-shine whiskey," who essentially had a monopoly on the sale of liquor one day a week. While one might have assumed that "Baptists" and "Bootleggers" are ideological opponents—as indeed they generally are—on this one issue the two groups share a strong common interest, albeit for nearly opposite reasons.

Similarly, prior to its demise, the notorious Enron Corporation was a staunch supporter of the Kyoto Treaty on Global Climate Change, primarily because Enron was heavily invested in alternative energy sources. Although one would expect Enron and various environmentalist groups to typically oppose one another on issues of environmental regulation and policy, the Kyoto Treaty benefited Enron because it raised the costs of

100. *Cf.* Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31 (1991).

101. BRUCE YANDLE, THE POLITICAL LIMITS OF ENVIRONMENTAL REGULATION: TRACKING THE UNICORN 23–28 (1989).

rule. The median voter theorem suggests that when preferences align along a single dimensional scale, and when there is no first choice majority candidate, voters will be willing to continue supporting candidates slightly in their ideological direction even as the candidates converge upon the median position. While the median voter outcome has the potential to coincide with the plurality outcome, it need not always do so.

Let us now consider an example in which outcomes predicted by the median voter theorem and plurality rule diverge. Imagine an electoral distribution in which fewer voters occupy the median position *B* than either of the extreme positions *A* or *C*.[20] Assume that the liberals (*A*) hold 40% of the electorate, the moderates (*B*) hold 25% of the electorate, and the conservatives (*C*) hold 35% of the electorate. Figure 3:3 depicts this distribution of voters above the incremental policy positions one through nine:

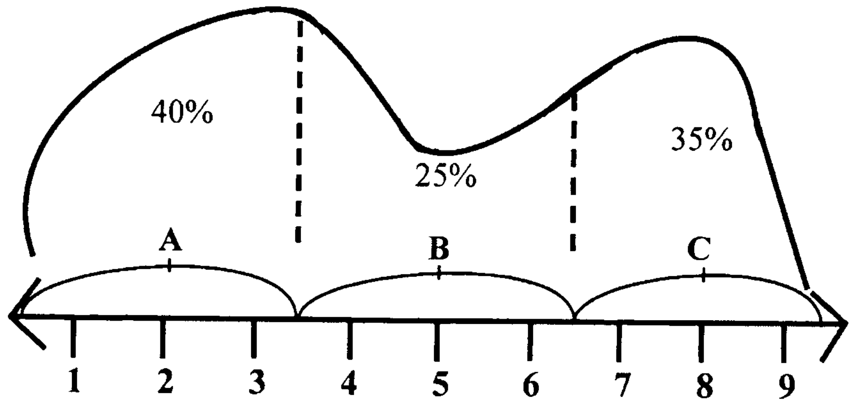

Figure 3:2

Assume as in the prior voting example that the policy positions divide into rough ideological clusters *A*, *B*, and *C*, and that the voters occupying each position can rank order their choices over the remaining positions. In Figure 3:2, while the median voter occupies position four rather than position five, that position remains moderate at *B*. And yet, option *A* obtains a plurality of 40% of the votes as compared with option *B*'s 25% and option *C*'s 35%. Under plurality rule, option *A* would prevail. Applying the analysis from the earlier discussion, however, in which we assume that those occupying the extreme positions *A* and *C* rank position *B* as a second choice, it might appear that the median outcome, *B*, is the better choice.[21]

20. The same analysis would apply if the median position received the second largest number of votes.

21. As explained below, *see infra* pp. 101–05, option *B* is the Condorcet winner, named for the French philosopher who described this result in 1785. *See also* Stearns, *Misguided Renaissance*, *supra* note 1, at 1221.

Given the preferences, which platform, *A* or *B*, is the optimal social choice? Why? As previously noted, in the actual *Casey* opinion, option *L* received two votes, option *M* received three votes, and option *C* received four votes. Which rule, plurality voting or the median voter theorem, is more suitable in that setting?[22] Which voting rule, plurality or median voter, is generally preferred? Is it possible that each is preferred in some contexts, while disfavored in others? If so, what might those contexts be? To answer these questions, we must once again revisit the concept of rationality. The analysis that follows will demonstrate that the median voter theorem depicts a special case of preferences in the absence of a first-choice majority candidate. Identifying the circumstances that are or are not conducive to generating a dominant median outcome is important in developing a social choice analysis of institutions and rules.

C. RATIONALITY REVISITED: CYCLICAL AND NON-CYCLICAL PREFERENCES

We begin, once more, with a deceptively simple insight that underlies the social choice understanding of rationality. Imagine that three persons are choosing among three options *A*, *B*, and *C*. The options can represent virtually anything, including policy positions for political candidates, the amount of federal bailout money for the automobile industry, or even something as trivial as the flavor of a cake. Once again, we generally assume that *A* preferred to *B* preferred to *C* implies *A* preferred to *C*. In selecting ice cream flavors, for example, if Alice likes mint more than chocolate, and chocolate more than vanilla, we would infer that she also likes mint more than vanilla. This does not, of course, mean that Alice is forever barred from selecting vanilla when mint is available, as very well might occur if Alice has had mint ice cream several nights in a row.[23] But if asked whether she likes mint more than vanilla, most would think it odd if Alice instead picked vanilla.

Social choice theory reveals that this simple assumption respecting individual rationality, namely that persons generally hold transitive preference orderings, does not universally hold for groups seeking to transform individually rational (or transitive) preferences into collective outcomes. Stated differently, the median voter theorem, which illustrates how, in the absence of a majority candidate, group preferences along a single dimensional continuum tend to converge on the median position, rests on a special set of assumptions about group preferences. As a result, the median voter model fails to capture all of the important dynamics of social choice.

22. Keep this question in mind as you read the discussion of the narrowest grounds doctrine, *infra* chapter 7, section I.C.1.B, *see also infra* note 141, and accompanying text.

23. It also does not mean that at some future time, Alice might not change her mind and acquire a taste for a flavor that she once disliked, thus transforming her preferences. But once this occurs, we would once again presume that she holds her now updated preferences in a similar transitive fashion.

To keep the analysis simple, let us assume that three persons (represented as P1, P2, and P3), are choosing among three options, or alternatively that each person represents a constituency such that any two-group combination contains sufficient votes to form a majority.[24] Assume that after the members disclose their first choices over options *ABC*, they discover that none holds the same preference and thus there is no first choice majority winner. After the participants discover the absence of a first choice winner, they each candidly disclose their ordinal preference rankings from most-to-least preferred, as follows:

P1: *ABC*

P2: *BCA*

P3: *CAB*

Since there is no first choice majority candidate, the members take a series of pairwise votes, meaning votes between two available options, in the hope of selecting a winner. Assume further that each member votes sincerely, meaning consistently with the above rankings in each direct comparison.

As between options *A* and *B*, *A* wins, with P1 and P3 defeating P2. As between options *A* against *C*, *C* wins, with P2 and P3 defeating P1. Thus far, the regime of pairwise voting has revealed that *C* is preferred to *A* and *A* is preferred to *B*. Notice that if an individual held these preferences, as does P3, we would infer that she also prefer *C* to *B*. And yet, social choice reveals that when the group aggregates the preferences of all three persons in a regime of unlimited binary comparisons, the group as a whole achieves a different result than the one P3 would achieve acting alone. With these preference orderings, the group as a whole prefers *B* to *C*, with P1 and P2 defeating P3. The final pairwise contest thus reveals an intransitivity, or cycle, over options *ABC*, such that *CpApBpC*.

This example illustrates the voting paradox, also called the Condorcet paradox after a French philosopher who described it in an essay in 1785.[25] Simply put, the paradox is that transitivity, assumed to be a basic tenet of individual rationality, cannot be assumed for groups of three or more individuals selecting among three or more options. Assume that each member satisfies the condition of transitivity, such that consistent with the above-listed preferences, P1 prefers *A* to *C*, P2 prefers *B* to *A*, and P3 prefers *C* to *B*. When we take the options pairwise by majority vote, the result is nonetheless an intransitivity, or cycle, for the group as a whole.

In addition to writing about the paradox, Condorcet proposed an important, if partial, solution to the problem concerning how to transform individual preferences that lack a first choice majority outcome into a normatively defensible outcome for the group as a whole. As we will see, Condorcet's proposed voting rule rests substantially on, and anticipates,

24. Notice that this held true with the final example in the median voter theorem discussion in which liberals held 40%, moderates held 25%, and conservatives held 35% of the electorate. *See supra* p. 100.

25. *See* Stearns, *Misguided Renaissance*, *supra* note 1, at 1221.

the intuition that underlies the median voter theorem.[26] Condorcet proposed that when an available option would defeat the remaining options in direct pairwise comparisons, an option now referred to as the Condorcet winner, that option should be selected.

To illustrate, consider once more three persons selecting among options ABC, except this time with the following slightly modified preferences: P1: ABC; P2: BCA; and P3: CBA. Other than switching P3's second and third ordinal ranking (as between *B* and *A*), the remaining preferences are unchanged. As before, each person holds a different first choice and thus there is no first choice majority candidate. Now apply Condorcet's proposed method. As between *A* and *B*, *B* wins, with P2 and P3 defeating P1; and as between *B* and *C*, *B* wins, with P1 and P2 defeating P3. The choice between *A* and *C* is irrelevant (*C* wins, with P1 losing) because option *B*, the Condorcet winner, defeats each of the remaining alternatives in direct comparisons. Institutions or rules that ensure that available Condorcet winners prevail are said to satisfy the Condorcet criterion.

The Condorcet criterion is an important benchmark for evaluating the decision-making competence of institutions. That is because, as demonstrated in the median voter theorem, the criterion is closely linked to the concept of majority rule and one person, one vote. As Professor William Riker observed, "when an alternative opposed by a majority wins, quite clearly the votes of some people are not being counted the same as other people's votes."[27] Consider, once again, the discussion of an electorate in which a plurality of 40% most prefer the liberal platform, *A*; 25% most prefer the moderate platform, *B*; and 35% most prefer the conservative platform, *C*. While plurality rule would select a liberal platform, this outcome would suppress a majority (moderates and conservatives) who prefer the moderate platform to the liberal platform, just as a conservative platform would suppress a majority (liberals and moderates) who prefer the moderate platform to the conservative platform. Because the liberals and conservatives each rank the moderate platform *B*, which obtains only 25% of the vote, as their second choice (with preferences *ABC* and *CBA* respectively), that option nonetheless defeats options *A* and *C*, with 40% and 35% of the vote respectively, in direct comparisons. And for that reason, consistent with the median voter theorem, selecting option *B* is more consistent with majority rule than is selecting plurality option *A*.

Returning to the presentation of *Casey* in Table 3:1,[28] we can apply this intuition to a Supreme Court decision. By specifying the membership in each of the three camps in *Casey*—liberal, moderate, and conservative—we can see once more a potential divergence between outcomes dictated by

26. Indeed, the preferences set out below track those depicted in the opening illustration *supra* p. 99, in which liberals preferred *ABC*, conservatives preferred *CBA*, and the moderates preferred either *BAC* or *BCA*.

27. WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE 100 (1982).

28. *See supra* pp. 98–99 (presenting stylized discussion of *Casey*).

the competing logic of the Condorcet criterion and plurality rule. As previously noted, two justices, Blackmun and Stevens, embraced the liberal position, voting to strike down all of the restrictive Pennsylvania abortion provisions. Three justices, O'Connor, Kennedy, and Souter, embraced the moderate position, voting to sustain all provisions except the spousal notification provision. And four justices, Rehnquist, Scalia, White, and Thomas, embraced the conservative position, voting to sustain all challenged abortion provisions. While a majority of five justices (the liberals and the moderates) voted to strike down the spousal notification provision, in a regime of plurality rule, the conservative dissenters, with the largest coalition of four justices, would instead control, thus sustaining the spousal notification provision along with the remaining challenged provisions.[29] By contrast, applying the Condorcet criterion, the coalition expressing the median position along the spectrum of how far abortion rights extend expresses the holding, with the result of striking down the spousal notification provision (with the liberal and moderate justices controlling) but sustaining the remaining provisions (with the moderate and conservative justices controlling).

Despite the Condorcet criterion's normative appeal, as a result of two important limitations, some important institutions have rules that thwart the Condorcet criterion. For example, while *Casey* illustrates how the Condorcet criterion applies in the Supreme Court, we will see other Supreme Court decision-making rules that thwart the Condorcet criterion and its commitment to majority rule in favor of other normative considerations.[30] The Condorcet criterion suffers from two weaknesses. First, as we have already seen, depending upon the preferences of the group members, there might not always be a Condorcet winner. When there is no Condorcet winner, rules that meet the Condorcet criterion and thus allow separate majority votes over all available pairwise comparisons produce an intransitivity or cycle. Second, as we saw in the simple example involving the choice of vanilla or chocolate cake where one child was allergic to cocoa, majority rule fails to account for the differing levels of interest that participants have in the outcome due to the disparate intensities with which they hold their preferences. The Condorcet criterion is grounded in majority rule, meaning one person, one vote, regardless of individual stakes in the outcome and, as such, it too fails to account for intensity of preference.

To illustrate, imagine a decision concerning how much money to allocate for a park renovation, with three proposals: low, moderate, and

29. The discussion in the text simplifies the form of the opinions in the actual case by avoiding partial concurrences and partial dissents. Omitting this detail does not change the analysis. The discussion further assumes sincere voting, implying that a change in the voting regime will not change the position each justice takes on the merits of each challenged provision. For a discussion of how a change in voting protocols threatens to compromise this assumption, see STEARNS, *supra* note 1, at 117–22. *See also* Maxwell L. Stearns, *How Outcome Voting Promotes Principled Issue Identification: A Reply to Professor John Rogers and Others*, 49 VAND. L. REV. 1045 (1996).

30. *See infra* chapter 7, (presenting outcome voting and stare decisis as non-Condorcet rules).

high. Each proposal is of comparable quality and the differences are due to the scope and ambition of the proposed renovation. Assume that there are three city council members, each holding a different first choice and each agreeing that the only issue is the scope of the project. We might imagine convergence toward the moderate expenditure, with those preferring the low and high expenditures ranking the moderate position as a second choice and the opposite extreme expenditure as a third choice. In this example, the moderate outcome emerges a Condorcet winner. Imagine, however, that only the high expenditure will include access ramps to the various activities for children suffering certain physical limitations, including reliance upon wheel chairs. Assume that while the members whose first choices are the low and moderate expenditures would prefer to save resources for some other public works project, they are not as strongly opposed to the larger expenditure as the one member whose constituency includes parents of physically impaired children hoping to enjoy the newly renovated park is in favor of the expenditure. In this case, while the moderate Condorcet result operates more consistently with majority rule, when we account for intensities of preference it is possible that the socially preferred outcome is the high expenditure and the most ambitious renovation. While the Condorcet criterion is important, it remains only one of several potentially competing benchmarks to be used in evaluating collective decision-making processes.

As this example (along with the earlier ice cream cake example) illustrates, the Condorcet criterion generalizes the principle of majority rule outside the limited context in which group preferences include a first choice majority candidate. As such, the Condorcet criterion carries with it the same strengths (including operating consistently with democratic norms) and weaknesses (including failing to account for preference intensities) as simple majority rule.

D. CYCLING, PATH DEPENDENCE, AND AGENDA SETTING

As previously explained, one limitation of voting rules that satisfy the Condorcet criterion is the risk of cycling. A cycle implies that for any possible outcome, another is preferred in a regime of direct pairwise comparisons by simple majority rule. Because this result holds for all possible outcomes, when members hold such preferences, rules that satisfy the Condorcet criterion fail to guarantee a stable outcome. We can think of rules that satisfy the Condorcet criterion as having the characteristic feature of unlimited majority veto. Pairwise comparisons remain available until there no longer exists a majority whose preferences would be thwarted by the proposed outcome. As we have seen, however, when group preferences cycle, this is not possible because some majority always prefers another outcome. To illustrate, reconsider the first set of preferences above: P1: *ABC*; P2: *BCA*; and P3: *CAB*. Even assuming that each participant's preferences are internally rational (transitive), a regime of unlimited pairwise voting yields an intransitivity for the group as a whole. Thus, the group prefers *A* to *B* (with P2 losing) and *B* to *C* (with P3 losing), but *C* to *A* (with P1 losing), or *ApBpCpA*. Given unlimited majority veto, the cycle starts anew and as a consequence no outcome is stable.

Although groups possessing such preferences cannot select a winner without thwarting the preferences of a majority in one potential pairwise comparison, we do not intend to suggest that groups characterized by such preferences forever remain in the throes of cycling. Rather, assuming the group does not opt for inaction, thus "choosing" the status quo, the cycle is somehow embedded in whichever outcome the group ultimately selects. To explain why, we must identify a characteristic feature of rules that satisfy the Condorcet criterion. Such rules allow the same number of pairwise contests as available alternatives (in this instance, three pairwise votes over three alternatives). In contrast, when decision rules limit the number of such pairwise contests relative to available options and when member preferences cycle, provided the members vote sincerely, the substantive outcome will turn on the order, or path, in which options are voted. To be sure, such path-dependent outcomes can be stable. They might even be predictable, for example, if we have a clear sense of the preferences of the person who controls the agenda, referred to as the "agenda setter", and if participants are somehow prevented from voting strategically. At the same time, however, path-dependent outcomes thwart the preferences of at least one majority who would have preferred an alternative outcome in a suppressed binary, or pairwise, comparison.

To illustrate we return once more to the example with cycling preferences (*ABC*, *BCA*, *CAB*). If we permit only two votes over the three options, and if we assume that members vote sincerely, then we will induce a path toward a determinate result. If we begin with *A* versus *B* (*A* wins) followed by *C* versus *A* (*C* wins), the path leads to *C*. Only by bringing back option *B*, which was defeated in the first round, and pitting it against option *C* do we formally reveal the cycle. If we knew the ordinally ranked preferences in advance of voting, we could intuit that option *C* thwarted the majority preferences of P1 and P2, who form a majority preferring option *B* to option *C*. Once again, although path dependence leads to a stable outcome, with full disclosure or the subsequent discovery of suppressed preferences, we can discover an embedded cycle. Of course participants will not always possess or have the means to acquire such information. As a result, non-Condorcet rules have the potential to produce path-dependent results that give the appearance of having majority support. After all, the outcome ultimately selected follows a series of separate majority votes. The voting process might therefore lend normative legitimacy to the eventual outcome even if that outcome thwarts the preferences of a majority that would have favored an alternative in a direct pairwise comparison.

Path dependence is the flip side of agenda setting. Assuming that the members vote sincerely according to their ordinal preferences, then when

preferences are intransitive, a rule that only allows two votes over the three options will allow the agenda setter to control the outcome. By positioning the votes such that the option that would defeat her first choice is itself defeated in the first round of voting, the agenda setter can produce a voting path that leads directly to her first choice.[31] Not surprisingly, therefore, in devising rule making procedures, an important consideration is controlling the power of the person who sets the voting path.

To what extent are judicial or legislative outcomes likely to be path dependent? Can you identify an institution that grants agenda setting power to one or more participants? If so, can you identify mechanisms that limit such agenda-setting power? Do you recall having been disadvantaged or benefited by agenda setting? If you were disadvantaged, can you identify strategies that might have facilitated a better result?

E. A BRIEF COMMENT ON ARROW'S THEOREM

While we provide a more detailed introduction to Arrow's Impossibility Theorem (or simply "Arrow's Theorem") later in this chapter,[32] for the discussion that follows, a brief summary will be helpful. Arrow's Theorem generalizes the voting paradox.[33] In effect, the theorem proves that any decision-making rule designed to "solve" the potential impasse resulting from cyclical preferences necessarily violates some other important norm associated with fair, or democratic, decision making. Kenneth Arrow posited a group of conditions, which in a simplified version of the proof William Vickrey reduced to four,[34] and proved that no institution can simultaneously satisfy those conditions while also guaranteeing the ability to translate the individual preferences of members into rational, or transitive, orderings.[35] At its most basic level, Arrow's Theorem exposes an inevitable tension confronting collective decision-making bodies between the desire to ensure rational (transitive) outcomes and the objective of adhering to a set of fair or democratic norms.

Before briefly describing these fairness conditions, it is worth noting their somewhat technical quality. In Arrow's proof, he set out his condi-

31. We have already seen the path leading to *C*. If, instead, the agenda setter most prefers option *A*, she would first present *B* versus *C* (*B* wins), then *B* versus *A* (*A* wins). Option *C*, the sole option that would defeat *A* in a direct pairwise contest, was defeated in the first round. And if the agenda setter most preferred option *B*, she would first present *C* versus *A* (*C* wins), and then present *C* versus *B* (*B* wins). Option *A*, the sole option that would defeat option *B* in a pairwise contest, was defeated in the first round.

32. *Infra* section V.

33. *See* RIKER, *supra* note 28, at 116.

34. STEARNS, *supra* note 1, at 81, 344–45 n.91. *See also* William Vickrey, *Utility, Strategy, and Social Decision Rules*, 74 Q.J. ECON. 507 (1960), *reprinted in* WILLIAM VICKREY, PUBLIC ECONOMICS 29 (Richard Arnott et al. eds., 1994).

35. For a discussion of the relationships between the criteria described in this chapter, based upon William Vickrey's simplified proof, and the original Arrow's Theorem criteria, see STEARNS, *supra* note 1, at 344–45 n.91, 346–47 n.104, 337 n.22, 347–48 n.112.

tions with mathematical precision. What follows is a verbal summary adapted from William Vickrey's simplified proof. Even these descriptions are easier to understand with specific applications, which we will provide when we present a more detailed overview of the theorem later in the chapter. Our immediate purpose is more limited. By introducing Arrow's fairness conditions, we hope to convey that the problem of cycling (or rationality) is but one dimension in an inevitably complex set of tradeoffs that Arrow's Theorem reveals for the study of institutions and rules.

Arrow's fairness conditions can be expressed as follows: (1) *range*: the collective decision-making rule must select its outcome in a manner that is consistent with the members' selection from among all conceivable ordinal rankings over three available alternatives; (2) *independence of irrelevant alternatives*: in choosing between paired alternatives, participants are assumed to decide solely based upon the merits of those options and without regard to how they would rank options that might be introduced later; (3) *unanimity*: if a change from the status quo to an alternate state will improve the position of at least a single participant without harming anyone else, the decision-making body must so move; and (4) *nondictatorship*: the group cannot consistently vindicate the preferences of a group member against the contrary will of the group as a whole.[36]

We will not revisit these technical terms until the end of the chapter. Throughout this chapter, however, we will apply several concepts to describe institutions that we later translate into the framework of Arrow's Theorem. This preliminary introduction is helpful in revealing potentially inevitable tradeoffs that institutions confront when formulating decision-making rules. Avoiding cycling, on the one hand, or promoting majority rule, on the other, represents only one potential tradeoff between normative values in conflict. Others include, for example, the desire to ensure that decision makers sincerely express their preferences, or that institutions allow members to register cardinal utility rather than mere ordinal preferences. Arrow's Theorem helps to expose the possibility of unavoidable conflicts among independently valuable normative criteria used to analyze institutions and rules.

The inability of any single institution to satisfy all of these conditions while ensuring rational or transitive outputs raises one obvious and important question: Which normative concerns should any given rulemaking system seek to protect? Remember that Ralph Waldo Emerson deemed "a foolish consistency . . . the hobgoblin of little minds."[37] Similarly, we might imagine that rationality, which demands consistency in the form of insisting upon adherence to transitivity of collective preferences as a precondition to generating outcomes, is less important than it first appears. If so, perhaps we can sacrifice rationality as the price of satisfying the various fairness conditions.

36. STEARNS, *supra* note 1, at 84–94.

37. RALPH WALDO EMERSON, *Self-Reliance*, *in* ESSAYS: FIRST SERIES 37 (Everyman's Library ed. 1906) (1841) ("A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines.").

Let us now revisit this chapter's opening question: Why is rationality at least potentially important, and how should it be traded off against other fairness considerations grounded in democratic norms? One reason for the importance of rationality is that institutions that do not demand rationality cannot ensure stable, or at least socially significant, outputs. That is not to suggest that stability of outputs (or that ensuring socially significant outputs in the sense of ensuring that available Condorcet winners prevail) is vital to all institutions, but it certainly is important to some. As we have previously observed, path-dependent outcomes are potentially stable, but such outcomes embed thwarted majorities. If such majority preferences were disclosed through the formal decision-making process, then the institution would discover that for any proffered outcome, a majority prefers yet another. If the institution required a collective decision without regard to collective preferences and to the possibility of cycling, the resulting endless veto power of potentially thwarted majorities might threaten that obligation. The resulting process might further threaten the legitimacy, and thus the willingness to accept, any outcome eventually selected. In effect, institutions that facilitate path-dependent outcomes elevate the concern for ensuring outputs that give the appearance of legitimacy, even if they also embed cyclical preferences, over at least one of Arrow's fairness conditions. Do you see why this result is inevitable?

Because Arrow's Theorem proves that no institution can simultaneously ensure transitive outputs and satisfy the specified fairness conditions, it exposes inevitable tradeoffs between the need for certain and stable outcomes, on the one hand, and rule-making features designed to ensure fair collective processes, on the other. One critical implication of Arrow's Theorem, for example, is in exposing an inevitable tradeoff between rules that ensure transitive outputs and rules that prevent minorities from exerting power disproportionate to their numbers.[38] If unlimited majority veto has the potential to block outcomes as a result of underlying cycling preferences, at some point it is possible that the only method by which to allow an institution to ensure stable outputs is to vest ultimate decision-making power in a minority. A set of rules designed to avoid the danger of indecision resulting from cycling, for example, might instead produce a regime that allows an individual or group to set (or manipulate) the agenda for the decision-making body as a whole. In effect, collective decision-making difficulties implicate not just the paradox of voting, meaning the possibility that collective preferences might cycle, but also implicate more broadly the tradeoff between rationality and the fairness conditions that Arrow's Theorem demonstrates are at least theoretically in tension.

38. To be clear, we do not mean to suggest that outcomes cannot favor numerical minorities, racial or otherwise, without violating Arrow's fairness criteria. Quite the contrary, an institution meeting some combination of Arrow's fairness plus rationality conditions is potentially capable of furthering any normative policy whether involving antidiscrimination, affirmative action, or something else entirely.