Soc (2009) 46:319–323
DOI 10.1007/s12115-009-9228-3

SYMPOSIUM: PUBLIC DILEMMAS REVISITED

The Capture Theory of Regulations—Revisited

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Published online: 6 May 2009

Abstract Amidst the rekindled interest in regulating the market that has emerged since the 2008 financial crisis, most attention has been paid to the debate between those who call for more regulation of the private sector in order to protect the public good, and those who claim that such regulations would do further damage to the economy by unduly constraining business. This essay seeks to refocus the debate about regulation by examining an alternative criticism—the theory of regulatory capture—which argues that regulations are routinely and predictably 'captured' and manipulated to serve the interests of those who are supposed to be subject to them, or the bureaucrats and legislators who write or control them. Ample evidence suggests that regulatory capture is indeed widespread and takes a variety of forms, which are reviewed here. Rather than debating whether more or less regulations are needed, the paper suggests that what is needed is a way to make regulations stronger—more capture-proof. It closes with a major policy change that would help accomplish this goal.

Keywords Regulatory capture · Campaign finance · Transparency · Torts · Government oversight

Since the 2008 financial crisis, interest has been rekindled in regulating the market, and with it, in the debate between those who call for more regulation of the private sector and those who hold that such steps would be damaging to the economy. Often, the key point at issue in this debate is whether regulation successfully serves the public interest, or, in fact, injures it by distorting the market, undermining efficiency, and reducing production. This paper seeks to refocus the current debate about regulation by examining an alternative criticism—the theory of regulatory capture. Drawing on the work of leading economists, critics have shown that regulations are routinely and predictably "captured", either by those the regulators are supposed to regulate—industries, professions, businesses or other interest groups (hereafter, special interests)—or by the bureaucrats or legislators who write and control the regulation (hereafter, regulators). Regulations thus captured serve the interests of these groups instead of the public interest.

Ample evidence suggests that regulatory capture is indeed widespread. This article uses telling examples to lay out the main ways that capture occurs. Evidence of extensive capture has led several critics to promote other, "market-friendly" ways to protect consumers, workers, and communities from the market. In the second section, the article examines two of these functional equivalents and finds that they actually face many of the same risks and challenges as garden-variety regulations, that they are just as susceptible to capture, and are much weaker to boot. The article closes by pointing to a measure that would make regulations much more resistant to capture. (The term resistant is used to acknowledge that regulations may not be made complete immune to capture.)

None of this is to suggest that regulations cannot be excessive, poorly crafted or otherwise defective. More often, though, this study concludes, their main flaw is a kind of weakness that renders them vulnerable to capture. If they were made more capture-resistant, regulations could serve well the public interest.

Capture: The Main Forms, the Main Captors

Early versions of capture theory were advanced in the 1950s and 60s by political scientists, whose studies of the life-cycle of regulatory agencies disputed the classic "public interest" theory of regulation and challenged its assumption of a benevolent regulator. These scholars observed a pattern that played out in regulatory agencies as they aged: after an initial period of "youth" in which the regulations issued or promoted by a given agency work

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towards their public interest objectives, the agency enters into a phase of "maturity" marked both by increasing bureaucratization and growing distance from the group(s) initially responsible for setting the regulatory objectives. In this maturing phase, regulatory agencies were found to be drawn ever closer to the industry they were supposed to regulate and away from serving the public interest. Capture theory was embraced by critics from both the left, such as Theodor Lowi and Gabriel Kolko, and the right, such as George Stigler and Richard Posner.

What follows are illustrations of the main ways capture occurs.

(a) Special Interests Shape Regulations

One major way regulation is captured is when lobbyists representing industries or other special interests play a key role in drafting the legislation (or the rules that implement it). For instance, in the waning days of the Bush administration, the U.S. Department of Transportation enacted a rule profoundly shaped by the rail industry. (According to Rick Melberth from OMBWatch, lobbyists representing this industry did one better, providing the actual text of the rule.) The rule allowed individual railroad companies to decide acceptable routes for dangerous "security sensitive" cargoes based on their own weighing of the factors involved—including economic considerations—and to do so without any oversight at the federal, state or local levels. Critics charged that this rule would effectively preempt any protective re-routing of dangerous cargoes around major cities—including those designated by the Department of Homeland Security as likely targets for future terrorist attacks—as the railroads are unlikely to voluntarily undertake such a costly burden upon themselves.

(b) Dilute Existing Regulations

In many instances, capture occurs later, after the rule has already been authored. Special interests often succeed in weakening or diluting regulations that are meant to control their conduct. In 2001, Enron Corporation and its accounting firm Arthur Andersen were revealed to have used irregular accounting practices to manipulate their books in order to keep a significant amount of Enron's debts and losses hidden from investors and the public. As these practices came to light in 2001, Enron's stock plummeted from over $90.00 to less than $.50 per share forcing the company to declare bankruptcy and leaving thousands of Enron employees without their retirement savings accounts and other benefits.

In response to this and other such revelations, Congress passed the Sarbanes–Oxley Act of 2002 (named after the law's main sponsors, Senator Paul Sarbanes and Representative Michael G. Oxley), establishing new, firmer accounting regulations. One part of Sarbanes–Oxley required companies to regularly audit their own internal anti-fraud and bookkeeping safeguards, and set up the Public Company Accounting Oversight Board to audit these auditors. Businesses lobbied fiercely to get this rule overturned. In 2006, after the Enron-inspired public outcry against corporate greed subsided, the SEC yielded to the special interests and dramatically curtailed the regulations involved—the regulations now run to only 65 pages rather than the original 180. Instead of requiring auditors to investigate any accounting issues that had a "more than remote" chance of turning out to be errors or fraud, the new rule only requires auditors to investigate issues that had a "reasonable possibility" of fraud.

(c) Weaken Enforcement of Existing Regulations

Regulatory capture often takes place without altering the regulations on the books by weakening their enforcement. The U.S. Sentencing Commission's attempts in the late 1980s and early 1990s to implement sentencing guidelines to ensure that the worst corporate crimes were adequately punished provides a telling example. The Commission acted after it found that corporations convicted of major crimes often got off with a mere slap on the wrist. For instance, Eli Lilly & Company, the pharmaceutical manufacturer, was fined a mere $25,000 after pleading guilty to the charge of failing to inform the government of a large number of deaths caused by its arthritis drug Oraflex, as is required by law. In November 1989, the Commission published its first-draft guidelines introducing large fines, up to $364 million, for crimes that had previously resulted in fines of just tens of thousands of dollars. The draft led to intense lobbying by major corporations and trade associations. As a result, the Commission scaled back its recommendations, reducing the suggested penalties by as much as 97%! The Commission also provided a list of extenuating circumstances that allowed offending corporations to reduce easily the remaining penalties to small amounts, if not to zero.

(d) Repeal Existing Regulations

After public interest in a given issue wanes, special interests have found ways to virtually eliminate existing regulations from the books. During the final months of the Bush administration, the coal industry successfully lobbied regulators to dismantle federal environmental restrictions on waste dumping. In October 2008, the Interior Department announced that it would overturn a 1983 regulation which bars mining companies from dumping waste within 100 feet of any river or stream, replacing it with a requirement that companies "minimize" the debris they dump.

(e) Switch or Manipulate Regulators

When special interests were unable to persuade regulators to revoke or dilute the regulations that restrict their behavior, or to weaken enforcement, they sometimes affect the regulatory regime in their favor by either switching the regulations to a new jurisdiction (e.g., from state to federal) or by playing regulators off against one another. According to the *Washington Post*, when giant mortgage lender Countrywide Financial felt “pressured” by the federal agencies charged with overseeing it, executives “simply switched regulators.” As a national commercial bank, Countrywide had been under the jurisdiction of the Office of the Comptroller of the Currency (OCC). As early as 2005, Countrywide executives engaged in talks with the Office of Thrift Supervision (OTS), known to be a much more “flexible” regulator. Less than 2 years later, in the spring of 2007, Countrywide redefined itself as a “thrift” instead of a “national commercial bank” and thus became regulated by the OTS. Over the next 2 years OTS proved to be a very lax regulator of Countrywide’s mortgage lending—as it also proved to be for IndyMac, Washington Mutual and other major lenders. Swapping regulators played a key role in the financial crisis that followed.

(f) Set prices and rates

Although regulations are often charged with hampering profitability of one industry or another, in several key cases captured regulations fulfill the opposite function—ensuring or bolstering profitability by setting higher prices and rates than the market would otherwise provide. Samuel Huntington’s study of the Interstate Commerce Commission (ICC), an agency charged with regulating the American railroad industry, provides an often-cited example of how this kind of capture occurs. The ICC was established in 1887, the result of political pressure by farmers and commercial shippers who suffered from the “exorbitant rates and discriminatory practices” of the largely unregulated railroad industry. For the first several decades of its existence, the commission served as an effective regulator, setting routes and fares that served the public interest, and rejecting most of the industry’s petitions to raise rates and fares. After the ICC lost its shipper and farmer support base in the 1920s, the commission turned towards protecting the railroad industry and serving its interests. After 1926, the ICC granted increases in rates and fares whenever the railroads requested them without exception.

Functional Equivalents

Libertarians, laissez-faire conservatives, and major academic economists opposed to government “interventions” in the market (which regulations, of course, are) have suggested various alternatives to regulations. Two of these are considered here.

(a) Transparency/Disclosure

One often-proposed alternative is the provision of transparency or disclosure, in which the public is provided with information about the products and services involved. This information, in turn, it is said, allows the public to purchase those products that are healthy, safe, and otherwise meet its preferences, and to deny business to those that make products that are dangerous, unhealthy, etc. The labels that disclose caloric content are a case in point, as are the inserts provided by drug stores about the risks of various medications.

As I see it, champions of transparency ignore that very often it is nothing but a form of regulation and thus carries many of the same limitations—above all, it is often captured! Although it is true that in some cases transparency is provided independently of government by corporations that consider such disclosure good business, in most cases transparency does not take place unless it is required by law (e.g., labels on foods, medications, and cigarettes, accounting standards for annual reports by corporations, etc.). And, unless the veracity of the information released is protected by the government (e.g., laws against false advertising), it often cannot be trusted. In short, as a rule, transparency is legislated and specified through a process very much akin to garden-variety regulations, and must be backed up by government enforcement.

Second, the assumption that transparency would enable consumers to make rational decisions is deeply flawed, as scores of studies by behavioral economists have shown. People are unable to process the large amount of information involved, to decipher the framing used, or to discern the hidden catches. Thus, statistics about hospitals might suggest that community hospitals are the best, because the fewest deaths occur therein, but this merely reflects that most severe cases are admitted to hospitals in major academic centers. Nor can consumers find out that some hospitals improve their data by transferring dying patients to hospices and nursing homes. Airline tickets notoriously had very small print on their backs that required legal training to understand until the government required the text to be simplified. And so on and on.

Finally, transparency is captured in the same basic ways other regulations are. In 2000, the Food and Drug Administration (FDA) was preparing to publish information about the mercury content of various foods, and canned tuna was high on its list of dangerous products. The tuna industry learned about the FDA’s impending publications and successfully lobbied the FDA to recalibrate its categorization so that canned tuna would not be included in the list of high-mercury foods. Clark Carrington, an FDA official, admitted that in constructing the three categories of mercury-danger (low-, medium- and high-mercury), agency staffers had deliberately designed them in such a way as to ensure that canned tuna fell into the “low” category, “in order to keep the market share at a reasonable level.”

None of this is to suggest that transparency cannot play a role in the regulation of the marketplace. Rather, my argument is that relying on transparency *per se* will not obviate the need for other regulations, and is but a form of regulation itself.

(b) Torts

Advocates of libertarian and laissez-faire viewpoints and leading economists often point to torts as another way to countervail market forces that may harm consumers, workers, and the public interest. Those harmed by corporations, they argue, can sue them for damages, punishing and thus effectively deterring bad behavior without recourse to government regulations.

Advocates of this position ignore that torts themselves reflect the law, and in this sense are regulated. What one can sue a corporation for, the nature of the evidence required, the level of compensation one can garner are all affected by various laws—and hence subject to capture. For example, special interests lobbied Congress to pass the "Class Action Fairness Act" of 2005, which made it substantially more difficult for consumers to file class-action suits and exact penalties that would approach the level of profit industries gain from harming them.

In other cases, special interests persuade lawmakers to protect them from liability. For instance, many states, under pressure from various medical special interest groups, have adopted limits on the amount that patients can sue doctors for in malpractice cases. Although the media pays much attention to the large wins for consumers, most of these awards were scaled-back later. Studies show that for everyone who sues, a large percentage exists that should, but do not.

This is not an argument against torts, but suggests that, by themselves, they do not suffice and that they themselves are subject to the same problems that regulations, in general, are.

Curbing Capture

Given that capture of regulations indeed undermines their purpose, and that the proposed alternatives to regulation are subject to the same basic pitfalls as regulations themselves, the question stands: what actions can be taken to make regulations much more resistant to capture and more likely to serve the public interest? This question has acquired special acuteness given that it is widely agreed that the severe financial crisis of 2008 was generated to a large extent by excessively lax regulation of banks, mortgage-lenders, hedge-funds and other financial institutions.

The answer, to a large extent, lies in a measure that, at this stage, does not have wide public support; namely, greatly limiting the role private money can play in the ways elections campaigns for national, state and local offices are financed. By far the most important reason regulation is captured is because legislators are dependent on special interests for the funds essential for running for office. Indeed, was it not for the fact that legislatures can raise money from special interests much more easily than from individual citizens, lawmakers would be expected to tilt toward the many (the public at large) against the few (the special interests).

True, sometimes those with few funds win elections against those with strong financial support by special interests, but as a rule those with the greater financial support win the elections in Congress and state assemblies. And there is very strong evidence that once elected, those in office reward those who supported them (and whose support is required for their reelections) with legislation that favors these special interests, especially by allowing them to capture regulations that affect their industry.

A few illustrations will serve to make this point: Rep. Charles Rangel met with officials at A.I.G. in April of 2008 to discuss a $10 million donation to the "Charles B. Rangel Center for Public Service" at the City College of New York. Less than a month later, one of the senior executives present at the meeting sent Rangel a letter asking for his support for a proposed tax-cut for the insurance industry that was coming before the Ways and Means Committee that Rangel chairs. Rangel, who had previously opposed the tax-cut, allowed it to be added to a bill he sponsored.

In 2001, Randy Best, the founder of the Voyager Expanded Learning literacy program, a new and unproven educational program aimed at Washington, DC kindergarteners and first-graders, sought out congressional funding for his program. He met with Sen. Mary Landrieu, chair of the appropriations subcommittee in charge of DC appropriations, to make his case. In subsequent weeks, Best threw Landrieu a campaign fundraiser at his home in Dallas and Landrieu received approximately $30,000 in donations from Voyager employees and their relatives. Days after these contributions, Sen. Landrieu added a $2 million earmark for Best's program to the DC appropriations bill.

In 1999, Rep. John Doolittle received $130,000 from gambling tribes with ties to lobbyist Jack Abramoff. In exchange, Doolittle helped Abramoff obtain a high-paying lobbying job with the Commonwealth of the Northern Mariana Islands (CNMI) and then worked at the behest of this group to defeat worker protection legislation. Doolittle, a self-described opponent of gambling, also sent numerous letters on behalf of Abramoff's tribal casinos. Many more such examples can be readily cited.

Those who argue that one cannot form a system in which legislators would be much less dependent on private funds should examine the European democracies. European election campaigns are much shorter than in the United States, lasting weeks rather than years, and hence cost much less. Moreover, the amounts politicians can spend are greatly limited by law. Campaigns in Britain run just a few weeks. The Conservative and Labour parties there are each restricted to spending a total of about £19 million (or approximately $33 million) per party for all their candidates, and these funds are provided by the state. In contrast, in the U.S. 2001–02 congressional campaign, 2,097 candidates spent a total of $936 million in primary and general elections. Moreover, once elected, members of British parliament (and their staff) cannot wheel and deal because on most issues they must vote the party line. American legislators, in contrast, must raise staggering amounts of funds if they seek to run for office or be reelected. Although some of the funds are collected from small donations by individuals, most funds come from special interests—who, for shelling out, expect pay-offs in terms of legislation favorable to them.

This form of legal bribery, the main tool of capture, is even more widely used on the state and local levels. In many states, legislators work only part-time for the public and, hence, are openly and legally entitled to earn money elsewhere. This sounds innocent enough until one learns (as I did when I served as the staff director of a commission that had been appointed by then-Governor Hugh Carey of New York to investigate abuses in nursing homes) that the legislators, many of whom are lawyers, are on retainer from the industries they are supposed to regulate. There is no revolving door here, as there is in Washington, through which legislators pass when they leave office to work for special interests; in state and local offices, legislators work on both sides of the door at the same time. This is above and beyond campaign contributions of the kind members of Congress garner. Capture is much more common and far reaching in most states than on the federal level. (Only Maine, Arizona, and Connecticut have introduced full public financing for state-wide elections.)

In conclusion, the threat of regulatory capture has led many politicians, ideologues and scholars to call for limiting regulation and to favor more market-friendly functional alternatives such as transparency and torts. The proper response to regulatory capture is not to weaken regulations, but rather to make them much more capture-resistant. This requires, first of all, greatly restricting the role of private money in public life, mainly through reforming campaign-finance laws. Unless this change is adopted, regulations will continue to be captured on a large scale and will continue to serve special interests rather than the public at large.

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