

# PUBLIC CHOICE: THE THEORY OF THE FIRM AND THE THEORY OF MARKET EXCHANGE

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Public choice, sometimes referred to as the economic theory of legislation,<sup>1</sup> applies game theory and microeconomic analysis to the production of law by legislatures, regulatory agencies and courts. In general, microeconomic analysis, as it applies to legal problems, contains two theoretical components—the theory of market exchange and the theory of the firm. The theory of the firm posits that the transaction and information costs associated with contracting across markets will force production and exchange out of the marketplace and into organizations called “firms,” which are organizations specifically designed to reduce these costs.<sup>2</sup> One of the major problems with market arrangements arises from the difficulty of assuring contractual performance within a market setting. Increasingly economic theory has come to recognize that problems of post-contractual opportunistic behavior, particularly the danger of expropriation of firm-specific capital investments, explain why certain transactions take place within firms instead of across markets. Thus, in many cases, the principal advantage of organizing as a firm is that such organizations mitigate the costs associated with ensuring that contracting parties keep their promises.

However, just as intra-firm transactions possess certain advantages over market transactions, the converse also is true for a wide range of transactions. As Coase points out, there are reasons why all transactions are not “carried on by one big firm.”<sup>3</sup> Simply stated, the theory of market exchange posits that, as a firm increases beyond a certain size, high transactions costs, particularly the costs

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<sup>1</sup> See Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988) (using the terms “public choice” and “economic theory of legislation” interchangeably).

<sup>2</sup> Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 405 (1937). “The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of ‘organizing’ production through the price mechanism is that of discovering what the relevant prices are.” *Id.* at 390.

<sup>3</sup> *Id.* at 394.

of monitoring employee shirking, render efficient deployment of assets within the firm extremely costly. Moving transactions out of such a firm and into the marketplace reduces the need to monitor the marginal productivity of particular assets, and thereby reduces the costs of inefficient asset use.

Market exchange theory posits that market transactions enjoy two advantages over intra-firm arrangements. First, as the firm grows, it becomes more likely that the entrepreneur who organizes and coordinates intra-firm production will fail to deploy production factors to their greatest value. Thus, "as a firm gets larger, there may be decreasing returns to the entrepreneur[ial] function. . . ."<sup>4</sup> Second, in some circumstances, market transactions economize monitoring costs by eliminating the need to observe the marginal productivity of particular inputs. Thus, monitoring the marginal increase in productivity, which is often difficult within the firm, becomes easier across markets, because markets tend to evince "a high correlation between rewards and productivity."<sup>5</sup>

In sum, those factors that drive certain transactions into the firm—the "team use of inputs" and the centralization of a "contractual agent in a team productive process"<sup>6</sup>—will often render it difficult for the centralized agent to ascertain which components of the firm structure are pulling their weight. In such circumstances, market price mechanisms may be better at providing this information than the firm. To oversimplify slightly, the firm's advantage is that it mitigates costs associated with ensuring contractual performance. The market's advantage is that it reduces monitoring and agency costs due to its reliance on explicit prices.

Even though the distinction between firms and markets is imprecise—where the firm ends and the market begins defies neat categorization<sup>7</sup>—these theories provide a very useful lens through which to view the production of legal rules. In particular, many of the most interesting and empirically rich questions in public choice involve the contracting problems plaguing lawmakers as they seek to forge binding agreements among themselves. Lawmakers attempt to solve these problems by establishing a firm-like organizational structure within Congress. The purpose of such a structure is to ensure contractual performance of deals among congressmen in a

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<sup>4</sup> *Id.*

<sup>5</sup> Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 778 (1972).

<sup>6</sup> *Id.*

<sup>7</sup> The most obvious example is the shareholder in the large, publicly held corporate firm, who obtains a residual claim in a market transaction and cannot direct the allocation of inputs within the firm, but is generally considered an "owner" for many legal purposes.

setting in which agreements are not only nonbinding in a legal sense; but also where performance is non-simultaneous, in the sense that one party will be called upon to complete performance before the other has begun to perform.

Similarly, on the supply side, interest groups may be viewed as firms that are able to supply political influence to their members. An interest group will survive and flourish if the political favors it obtains increase the wealth of its members by more than the costs of membership in the group. This Article seeks to show how both the theory of the firm and the theory of market exchange play discrete and critical roles in the public choice model of legislation. Previous work uses one theory or the other,<sup>8</sup> and generally presumes that the theories are mutually exclusive tools to use in analyzing the legislative process. None of the existing literature purports to explain the relationship between the two theories. As this Article explains, the theory of market exchange is useful in studying the external market for law (i.e., the interplay among interest groups and between interest groups and Congress), while the theory of the firm is useful in studying the internal rules of Congress itself (i.e., the committee system).

The first section of this Article reviews the public choice literature that treats the production of laws as a market process. The following section turns to the emerging literature that views law as the product of an individual firm—the legislature.

## I

### THE MARKET FOR LAW

The law-as-market version of the economic theory of legislation “asserts that legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare. . . .”<sup>9</sup> In this model, all citizens are both demanders and suppliers of laws,<sup>10</sup> but certain citizens share legislative goals with highly organized interest groups which provide them with an advan-

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<sup>8</sup> Compare Weingast & Marshall, *The Industrial Organization of Congress; or Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132 (1988) [hereinafter Weingast] (employing the theory of the firm to explain certain structural elements of Congress), with Tollison, *supra* note 1 (employing the market model to model certain political outcomes).

<sup>9</sup> Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982).

<sup>10</sup> See Tollison, *supra* note 1, at 343 (arguing that in the interest group theory, those who supply legislation are “individuals who do not find it cost effective to resist having their wealth taken away . . . . The supply of legislation is, therefore, grounded in the unorganized or relatively less-organized members of society.” Thus, citizens in this model may be viewed as coerced suppliers.)

tage over other citizens in the procurement of favorable legal rules. The basic thrust of the model is that legislatures use "taxes, subsidies, regulations, and other political instruments . . . to raise the welfare of more influential pressure groups. Groups compete within the context of rules that translate expenditures for political pressure into political influence and access to political resources."<sup>11</sup>

The model holds that politicians maximize the aggregate political support they receive from all interest groups. At the margin, a legislature will alter a rule if the resulting gain in political support from some group outweighs any expected loss in support from a rival group. Thus, contrary to popular belief, the public choice model is, in fact, inconsistent with the rather primitive "capture theory" of economic regulation which posits that one particular interest group rather than a group of interest groups drives legislation or regulation.<sup>12</sup> Competition among rival pressure groups with drastically differing views about what the legal landscape ought to look like leads to legislative compromise, not because compromise is in the public interest, but because it is the most effective strategy politicians have for maximizing political support. This is because politicians can please certain of these groups only by alienating others, and will attempt to customize law to maximize the total support they receive by alienating as few groups as possible.<sup>13</sup>

The major portion of government activity is devoted to the transfer of resources among citizens. The political support maximizing regulator or legislator serves both as broker and as entrepreneur. As a broker he gains political support by transferring resources among the various groups in society. As an entrepreneur he seeks to create groups that he can benefit, in order to receive political support from them. The discussion above implies not only that certain sorts of groups are more effective in obtaining desirable legislation, but also that certain sorts of issues will be most attractive to entrepreneurial politicians.

#### A. Groups and Issues Likely to Drive Legislation in the Public Choice Model

Individuals in search of political influence face two sorts of costs in organizing an effective political coalition: information costs

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<sup>11</sup> Becker, *Pressure Groups and Political Behavior*, in CAPITALISM AND DEMOCRACY: SCHUMPETER REVISITED 124 (1985).

<sup>12</sup> See generally Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974).

<sup>13</sup> See generally Peltzman, *Toward a More General Theory of Regulation*, 2 J. L. & ECON. 211 (1976).

and organization costs.<sup>14</sup> The information costs to an individual consist of ascertaining the effects of an issue on his own individual welfare; identification costs are the costs of identifying other similarly situated individuals who will join him in his quest for legislation.<sup>15</sup> Individuals have very little incentive even to inform themselves about the relevant issues in a political campaign much less to inform themselves about the legislative process on an ongoing basis, or to spend resources to affect that process. This is because, "[t]he probability that an individual's vote will be decisive in . . . [the legislative process] is effectively zero."<sup>16</sup> The point here is that, even before we get to the issue of the relative efficiency of interest groups in the political sphere, we must realize that for most people it simply does not pay to become sufficiently informed on most issues to have an opinion, much less to attempt to affect the outcome. Where a piece of legislation will cost a taxpayer \$50.00, and the net cost of obtaining information about the effects of the legislation (including the opportunity costs of the taxpayer's time, and the start-up costs of identifying the issue) are greater than \$50.00, no rational taxpayer will obtain the information necessary to begin to affect legislative outcomes.<sup>17</sup>

Thus, individuals who want to affect the legislative process will find it advantageous to organize into political pressure groups in order to economize on the high costs of obtaining information about the welfare affects of impending legislation. Clearly, groups that have already organized for one reason or other, and therefore previously have internalized the costs of organization "will have a comparative advantage in seeking transfers and will therefore be more successful in procuring transfers as a result."<sup>18</sup> Thus labor unions, trade associations, and corporations, which are already or-

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<sup>14</sup> R. McCORMICK & R. TOLLISON, *POLITICIANS, LEGISLATION AND THE ECONOMY* 16 (1981) [hereinafter R. McCORMICK].

<sup>15</sup> *Id.* at 17.

<sup>16</sup> Lee, *Politics, Ideology, and the Power of Public Choice*, 74 VA. L. REV. 191, 193 (1988).

<sup>17</sup> The term for the concept presented here is "rational ignorance." The "net costs" referred to in the text are the actual costs of obtaining the information (including opportunity cost of time) divided by the probability of success in opposing the legislation.

The gain to a citizen-taxpayer from obtaining a particular political outcome in an election is equal to the difference between the value to the taxpayer of obtaining his preferred outcome and the value of obtaining his non-preferred outcome, multiplied by the probability that a change in an individual's vote will alter the outcome of the election. Because this probability is very low, it often does not pay for voters to acquire information.

In addition, free-rider problems provide disincentives to the acquisition of information since individual members of groups will receive only a small share of the gains from such information acquisition. See A. DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* 238-76 (1957); M. OLSON, *THE RISE AND DECLINE OF NATIONS* 25-35 (1982).

<sup>18</sup> R. McCORMICK, *supra* note 14, at 17.

ganized, will have an advantage in the political process, even though political advantage was not the reason for their initial formation.<sup>19</sup>

Free-rider problems inhibit the efficacy of interest groups in achieving their ends in the political arena. This is because of the public good nature of law. Those who stand to benefit if a particular law is enacted do not suffer a diminution in benefits if they fail to lobby for its enactment. Organizations not only benefit their members by overcoming the informational problems faced by individuals in the political process, they also benefit their members by employing a variety of devices to mitigate the free-rider problems that inhibit the wealth transfer process.<sup>20</sup>

These insights predict that politically successful groups will tend to be small, relative to the size of the groups taxed to pay their subsidies. The small size not only helps to overcome free-rider effects, it also concentrates the benefits of legislative enactments so as to provide individuals with high incentives to press for legislative results. This prediction seems consistent with the evidence from the agricultural industries in different countries. Where agriculture is a small component of a country's economy as in Japan, Israel, and the United States, it is heavily subsidized. But where agriculture is a large component of the country's economy, as in Poland, China, Thailand, or Nigeria, it is heavily taxed.<sup>21</sup>

Note that in the public choice model, the ideological underpinnings of the governments whose actions are being studied play no role in determining the substantive legislative outcomes generated.

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<sup>19</sup> Once organization and information costs are taken into account, it is possible to understand the nature of the "benefits" that accrue to those citizens who supply wealth transfers to interest groups. Such people do not of course receive the price paid by the interest groups who demand the legislation. This price (which comes in the form of political support, i.e., money and votes) goes to the politicians/brokers/entrepreneurs who engineered the wealth transfer. The suppliers benefit because they "avoid the time and trouble of organizing to resist the power of the brokers to take away their dollars and give them to other groups." R. McCORMICK, *supra* note 14, at 21.

<sup>20</sup> Members of special interest groups have incentives to free-ride on the efforts of others in their group, because doing so allows group members to capture any benefits obtained by others in the group at zero cost. Of course, interest group members will anticipate this problem *ex ante* and attempt to develop ways to overcome the potential free-rider problem. For example, rational labor union members will vote for compulsory dues in order to prevent free riding on collective bargaining agreements by non-dues paying workers. Similarly, other organized groups such as nursing home operators, mid-wives, doctors, accountants and lawyers will press for licensing requirements, mandatory testing, and other mechanisms that not only deter entry, but also provide enforcement mechanisms to reduce free-rider problems. In addition to these formal enforcement mechanisms, a variety of informal devices, from social ostracism to physical harassment, are available to mitigate the ever-present spectre of the free-rider. See M. OLSON, *supra* note 17, at 17-29.

<sup>21</sup> Becker, *supra* note 11, at 137; R. BATES, *MARKETS AND STATES IN TROPICAL AFRICA* 122-28 (1981); Petersen, *International Farm Prices and the Social Cost of Cheap Food Policies*, 61 AM. J. AGRIC. ECON. 13 (1979).

Rather, regardless of governmental form, the nature of the interest groups' pressure on lawmakers determines the shape of the law.<sup>22</sup> In other words, under any form of government, there is a market for laws.<sup>23</sup> Taking interest groups' preferences as fixed,<sup>24</sup> interest groups and politicians will bargain in a "Coasean world," i.e., in a world where the only factor that will vary outcomes across ideological systems is the level of transaction costs faced by the parties. And it is the system's constitutional structure that fixes the level of transaction costs which interest groups face. Thus, a country's constitutional framework, not its ideology, is the most important exogenous variable in determining the level of interest group outcomes that will be generated under any given configuration of interest group coalitions.<sup>25</sup>

The interest group model also has important implications for laws generally considered to be public-regarding. Pollution control legislation provides a paradigmatic example. At first blush, public choice theory would seem to predict that we would never observe environmental protection legislation because the benefits of such legislation are spread broadly over the population, while the costs are borne by a few polluters who enjoy lower production costs if they can operate their factories free of pollution controls. But keep in mind that individuals will have even less influence on the imple-

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<sup>22</sup> Cf. Becker, *supra* note 11, at 141 (assuming that both capitalism and socialism are subject to interest group pressure, and expressing the belief that capitalism is not "especially vulnerable to pressure groups."); Tullock, *Industrial Organization and Rent Seeking in Dictatorships*, 142 ZEITSCHRIFT FÜR DIE GESAMTE STAATSWISSENSCHAFT (J. INSTITUTIONAL AND THEORETICAL ECON.) 4 (1986) (discussing the level of interest group wealth transfer activity in dictatorships).

<sup>23</sup> Clearly the method of expression by interest groups of their preferences for legislation, and indeed the medium of exchange between interest groups and politicians, will vary across governmental systems. For example, in the Soviet Union interest groups control both the party membership apparatus and the upper echelons of the military. See Payne, *Marxists, They Love a Man in Uniform*, 17 REASON 39, 42-43 (Oct. 1985) (arguing that the military priorities of the Soviet bloc countries are determined by interest group pressures). In the United States, by contrast, various politicians, who are elected in varying ways, are subject to widely varying interest group pressures. Congressmen are particularly sensitive to the preferences of interest groups operating within their home jurisdictions, while the President is concerned with his national constituency. The political support maximizing equilibrium for Congress (and indeed for individual congressmen) is different from that of the President for virtually every issue. See M. FIORINA, *CONGRESS: KEYSTONE OF THE WASHINGTON ESTABLISHMENT* (1977); D. MAYHEW, *CONGRESS: THE ELECTORAL CONNECTION* (1974).

<sup>24</sup> Clearly, different socialization processes within different countries and cultures may shape individual preferences (and hence the willingness to associate with particular interest groups) in different ways. Where such preference molding occurs, however, it is not the type of government that affects preferences, but rather the educational and cultural systems.

<sup>25</sup> See Macey, *Transactions Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471 (1988).

mentation and enforcement of legislation than on its initial enactment.<sup>26</sup> In addition, it is clear that, for an individual with a small stake in the legislative outcome, the marginal cost of casting a vote is extremely low. The combination of these two influences should result in precisely the state of affairs that we observe: a lot of environmental legislation (it is a highly publicized problem and it costs voters little to "ask" for action on it in the electoral process) combined with significant influence by interest groups on the specific nature and implementation of the environmental programs we observe. In other words, we will get a lot of environmental legislation, but it not only will be less effective than it otherwise could be,<sup>27</sup> it also will serve to benefit certain interest groups at the expense of others.<sup>28</sup> As Dwight Lee has observed:

Organized groups often do little to oppose legislation that is potentially adverse to their interests, especially when public opinion strongly favors the legislation. Well-organized groups often will "get on board" and "support" legislation that is inimical to their economic interests. But, as opposed to individuals who voted for the legislation and who quickly forgot it once it was passed, the affected organized interests will be unrelenting in their efforts to influence the day-to-day details of the legislation's implementation. This influence will typically not be exerted on behalf of the broad public interest. Government attempts to help the poor, protect the consumer, and regulate business pricing and practices provide additional examples of supposedly general interest legislation that is subverted by organized interest groups. The initial motivation for the legislation may have been dominated by ideological considerations, but narrow economic concerns motivate the special interest influence that does so much to determine its effect.<sup>29</sup>

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<sup>26</sup> *Contra* Lee, *supra* note 16, at 196.

<sup>27</sup> R. CRANDALL, H. GRUENSPECHT, T. KEELER & L. LAVE, *REGULATING THE AUTOMOBILE* 85-116 (1986); A. KNEESE & C. SCHULTZE, *POLLUTION, PRICES AND PUBLIC POLICY* (1975); Lee, *supra* note 16, at 197.

<sup>28</sup> *BUREAUCRACY VS. ENVIRONMENT, THE ENVIRONMENTAL COSTS OF BUREAUCRATIC GOVERNANCE* (J. Baden & R. Stroup ed. 1981); J. THOMASIAN, *THE CLEAN AIR ACT, THE ELECTRIC UTILITIES, AND THE COAL MARKET* (1982); Ackerman & Hassler, *Beyond the New Deal: Coal and the Clean Air Act*, 89 *YALE L.J.* 1466 (1980) [hereinafter Ackerman]; Pashigian, *The Effect of Environmental Regulation on Optimal Plant Size and Factor Shares*, 27 *J. L. & ECON.* 1 (1984).

To take a specific, and striking example, observe the Clean Air Act Amendments of 1977, Pub. L. No. 95-95, 91 Stat. 685 (codified as amended at 42 U.S.C. §§ 7401-7626 (1982 & Supp. IV 1986)). These amendments contained a "provision guaranteeing that new sulphur dioxide emission controls for coal-fired utility plants [sic] would not cause economic harm to eastern and midwestern producers of high-sulphur coal. In effect this was an 'off-budget' subsidy to regional coal interests, paid for by the nation as a whole." Robinson, *Public Choice Speculations on the Item Veto*, 74 *VA. L. REV.* 403, 417 n.44 (1988); see also B. ACKERMAN & W. HASSLER, *CLEAN COAL/DIRTY AIR* 44-48 (1981).

<sup>29</sup> Lee, *supra* note 16, at 197.

The proposition that interest groups express themselves through seemingly public-regarding legislation also flows from the fact that legislation which appears to benefit voters can be enacted at lower cost than legislation that appears only to benefit some narrowly defined special interest group. As such, interest groups will *prefer* to obtain their goals through the enactment of legislation that is *seemingly* public-regarding.<sup>30</sup> For example, legislation enacted under the guise of protecting the public from unscrupulous competitors or from the hazards of some vaguely described public policy danger might in fact be intended to erect barriers to entry and to impose higher production costs on certain market participants than on others.

### B. The Role of Congressmen in the Public Choice Model

Some exponents of the public choice model reduce the role of the politician to that of a passive broker in the political process. These politician/brokers merely translate the aggregated revealed preferences of previously organized interest groups into law by pairing "those who want a law or a transfer the most [as expressed by willingness to pay] with those who object the least."<sup>31</sup>

This Article posits that a more accurate view portrays the legislator, not only as a passive broker, but also, and more importantly, as a political entrepreneur who actively works to gain political support by overcoming the information and organization costs that conspire against him. This view suggests that politicians would discover new issues and seek to explain to constituents how it would be in their interest to support the politician in his quest to develop the issue into a legislative agenda. So politicians can be expected to be in the forefront of the fight for environmental quality and a strong national defense, because controlling such issues on the legislative agenda enables the politician to capture a large portion of the political support from those groups who will benefit by such laws.

Not only will politicians actively seek out issues to bring to voters to overcome the problem of information costs, but politicians can be expected to organize their own interest groups (Jesse Jackson's Rainbow coalition, and Claude Pepper's Gray Panthers come to mind) in order to ameliorate the organizational costs and the free-rider problems that confront individuals who seek to form

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<sup>30</sup> See Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223 (1986).

<sup>31</sup> Tollison, *supra* note 1, at 343 ("[t]he individuals who monitor the supply-demand process are politicians, bureaucrats, and other political actors. These individuals may be conceived of as brokers of legislation, and they essentially act like brokers in a private context—they pair demanders and suppliers of legislation").

groups capable of obtaining governmental wealth transfers. This analysis helps to explain lawmakers' strong political support for the policies and practices of virtually every organized interest group from the securities industry, to the American Bar Association, to the labor unions. In addition, entrepreneurial politicians can enact laws that benefit interest groups by helping them to overcome free-rider problems.

A multitude of laws reduce the difficulty of organizing activities of such groups by criminalizing certain practices for those who do not (or cannot) join these groups.<sup>32</sup> Licensing requirements for lawyers and doctors have been particularly effective at facilitating interest group solidarity.

A final manifestation of the entrepreneurial politician is reflected in the rent-extraction model of political behavior recently constructed by Fred McChesney.<sup>33</sup> In this model, the politician can extract the specific and expropriable capital that is an inevitable by-product of the economic activities of firms and individuals. This extraction takes place where politicians obtain political support, not by regulation on behalf of interest groups, but rather by *threatening* to regulate in ways that will expropriate their specific capital unless side payments are made in exchange for regulatory forbearance.<sup>34</sup>

## II

### LEGAL RULES AND THE THEORY OF THE FIRM

Individual and group preferences define the supply and demand curves for legal rules. An important variable in the equation is the organizational form of Congress itself, which influences those preferences. Although the Constitution places important constraints on Congress' ability to make law,<sup>35</sup> it is also clear that the rules governing the internal organization of Congress play an important role in the legislative outcomes generated by the political process. Consistent with public choice theory, Congress' organizational rules are designed to further the rational self-interest of the legislators themselves.<sup>36</sup> Interest groups and politicians who wish

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<sup>32</sup> For example, not only is it illegal to practice law, medicine, or dentistry without a license, it is also illegal to build a building without a permit, or to serve as an electrician, plumber, architect, cab driver, bartender, beautician, or securities salesman without a license. Federal law also makes it easier for unions to organize, thus increasing their power and political clout.

<sup>33</sup> McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987).

<sup>34</sup> See also Tollison, *supra* note 1, at 361.

<sup>35</sup> See Macey, *Competing Economic Views of the Constitution*, 56 GEO. WASH. L. REV. 50 (1987) [hereinafter Macey, *Competing Economic Views*].

<sup>36</sup> D. MAYHEW, *supra* note 23, at 31:

The organization of Congress meets remarkably well the electoral needs

to enact interest group oriented legislation in exchange for political support face several problems. First, individual politicians cannot enact legislation alone. They must gain the cooperation of their fellow lawmakers. Second, severe non-simultaneity-of-performance problems exist both among politicians, and between politicians and their constituents. In other words, periodically elected politicians' election campaigns are not always contemporaneous with interest group demands upon Congress to render services in exchange for political support. Similarly, *logrolling*—the common legislative practice of giving support to another politician on one issue in exchange for receiving support on another issue—provides a means of gaining the cooperation of fellow lawmakers, but it also presents serious non-simultaneity-of-performance problems; legislators frequently are called upon to support the agenda of a fellow politician before the other legislator is compelled to return the favor. Consequently, “problems of enforcement over time are critically important for understanding legislatures and cannot be assumed away.”<sup>37</sup> The industrial organization of Congress is specifically designed to solve these sorts of organizational problems to maximize the levels of political support attained by individual legislators.<sup>38</sup>

Perhaps the most obvious implication of the foregoing analysis is that congressmen, *even those whose own reelection is assured*, will favor rules that strengthen the position of incumbents because patterns of repeat dealings provide strong incentives for congressmen to adhere to previously formed agreements.<sup>39</sup> Even a Congressman certain to be reelected will still want to deal with others whose reelection is assured, because their actions are more predictable. Unfortunately, due to unforeseen contingencies, private information, and moral hazard problems, it is clear that repeated interaction often is insufficient to prevent the breakdown of cooperation.<sup>40</sup>

As Weingast and Marshall recently have observed, the committee system in Congress is designed to solve the enforcement problems that confront political-support-maximizing legislators. In particular, suppose you have two groups of legislators; one of these groups is seeking passage of a discrete piece of legislation such as the building of a dam, and the other is seeking to have an adminis-

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of its members. To put it another way, if a group of planners sat down and tried to design a pair of American national assemblies with the goal of serving members' electoral needs year in and year out, they would be hard pressed to improve on what exists.

<sup>37</sup> Weingast, *supra* note 8, at 139.

<sup>38</sup> *Id.*

<sup>39</sup> R. AXELROD, *THE EVOLUTION OF COOPERATION* (1984); Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Telser, *A Theory of Self-enforcing Agreements*, 53 J. BUS. 27 (1980).

<sup>40</sup> Weingast, *supra* note 8, at 142.

trative agency established to benefit its constituency.<sup>41</sup> The first group, after building its dam, might pass a new bill revoking the law establishing the administrative agency. This possibility plainly makes it less likely that either law will be enacted since the two groups of legislators may be unable to bind themselves to a mutual exchange of political support. A non-binding agreement will be worthless to the legislators.

Nevertheless, a committee system, where each group retains control over the committee charged with creating laws that benefit its own constituencies, solves the non-simultaneity of performance problem.<sup>42</sup> After the dam is built, the politicians who got the credit for building it will be unable to enact legislation to dismantle the regulatory agency *even if a majority prefers that the regulatory agency be dismantled*. This is because, by hypothesis, the legislators who want the administrative agency to be established are the legislators on the committee responsible for reporting out the legislation concerning the administrative agency. As committee members, they are in charge of determining whether any legislation banning the administrative agency ever makes it to the floor for a vote. If the proponents of the administrative agency think they will lose the vote they will not let the matter reach the floor. In this way they can guarantee that the dam builders will not renege. To summarize, "the restricted access to the agenda [caused by the committee system] serves as a mechanism to prevent ex post renegeing."<sup>43</sup> The power of the committee members is greatly enhanced by a system for committee membership that allows current members to retain their positions because the politicians know that, so long as they continue to be reelected, they can keep the hypothetical administrative agency

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<sup>41</sup> The example here is drawn from Weingast, *supra* note 8, at 144. An implicit assumption is that the legislature has techniques that enable it to influence administrative decision-making. This assumption seems correct. Members of Congress have several mechanisms, both statutory and non-statutory, for causing administrative agencies to bend to their will. Statutory enforcement of the congressional will may be accomplished by specifying guidelines for the agency in legislation or by using appropriations bills as reward or punishment for past agency behavior. Nonstatutory techniques include the use of committee reports and hearings to convey congressional views on how the agency should be run. See R. D. ARNOLD, CONGRESS AND THE BUREAUCRACY: A THEORY OF INFLUENCE (1979) [hereinafter R. D. ARNOLD]; R. FENNO, JR., THE POWER OF THE PURSE (1966); HARRIS, CONGRESSIONAL CONTROL OF ADMINISTRATION 15-45 (1964); KIRST, GOVERNMENT WITHOUT PASSING LAWS (1969); A. WILDAVSKY, THE POLITICS OF THE BUDGETARY PROCESS (1964); Arnold, *Political Control of Administrative Officials*, 3 J. L. ECON. & ORGANIZATIONS 279, 280-81 (1987).

<sup>42</sup> Here I am assuming that both pieces of legislation are passed. Clearly there is still a slight non-simultaneity-of-performance problem if both bills are reported out of their respective committees but not voted on simultaneously. But the timing problem here is slight. The ongoing problem has been solved.

<sup>43</sup> Weingast, *supra* note 8, at 144.

in operation by preventing legislation adverse to the agency's interests from reaching the floor.

The committee system can best be seen as an ingenious method for solving the non-simultaneity-of-performance problem that exists in Congress. It provides a way in which congressmen can forego influence in certain areas for additional influence in other areas, thereby increasing the aggregate demand for their services from the particular interest groups most influential in their home jurisdictions. A natural corollary of this analysis is that "legislators [will] seek assignment to those committees that have the greatest marginal impact over their electoral fortunes."<sup>44</sup> For this reason, it is not surprising that committee memberships in Congress do not randomly reflect the general membership of the legislature. Legislators use their committee memberships to strengthen their political base. Thus it is not surprising that there is a very high correlation between the jurisdictions of particular committees and the levels of support shown by the committees' membership for the interest groups benefitted by the committee. Congressmen on committees dealing with defense, consumer protection, labor, and the environment all show high degrees of solidarity with the views of the interest groups most immediately affected by those committees.<sup>45</sup> In other words, "legislators opt for committees relevant to their constituents' interests . . . so as to give their members greater control over policies with their jurisdiction."<sup>46</sup>

The above analysis has yielded a rich array of empirical insights. First, we would expect that members of committees would be disproportionately successful in bringing to their own jurisdictions the pork barrel projects generated by legislation originating in their committees. Consistent with this prediction, Ferejohn found that each member of the Public Works Committee obtained .63 additional projects for his state above that of non-members.<sup>47</sup> Similarly, Arnold found that if a member wants a water and sewage grant for his or her home state, the chances of success are 80 percent higher if the member sits on the relevant appropriations subcommittee and 60 percent higher if he or she is a member of the relevant authorizing committee.<sup>48</sup>

Similarly, members of the Armed Services Committees received a statistically significantly greater share of defense spending than

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<sup>44</sup> *Id.* at 145.

<sup>45</sup> *Id.* at 151.

<sup>46</sup> *Id.* at 151-52.

<sup>47</sup> J. FEREOHNS, PORK BARREL POLITICS: RIVERS AND HARBORS LEGISLATION, 1947-1968 (1974).

<sup>48</sup> R. D. ARNOLD, *supra* note 41. Arnold found that if you are on neither committee your chances of obtaining passage were .176. For members of the Appropriations Sub-

nonmembers.<sup>49</sup> And, consistent with the model presented here, and with McChesney's ideas about regulatory forbearance, Faith, Leavens, and Tollison found that firms located in congressional districts with representation on the Federal Trade Commission's oversight subcommittees were systematically underrepresented in suits brought by the FTC.<sup>50</sup>

In sum, the committee system allows committee members to direct their attention to the interest groups most affected by the activities of their committee. This in turn enables them to maximize the political support they receive in exchange for enacting regulation and in exchange for regulatory forbearance.

The committee system in Congress, like the rules benefitting incumbents, is designed to make Congress operate more effectively, not for the public good, but for the good of its membership by reducing the contracting problems that arise due to the non-simultaneity-of-performance attributes of the logrolling process.

The point here is that Congress, to the extent that it can set its own rules for internal governance, can greatly affect the demand for its own services from interest groups. Moreover, Congress can also use its power to make external rules (*i.e.* laws) to control the free-riding and information cost problems that impede the ability of interest groups to deliver political support to politicians. Seen in this way, Congress can be viewed as a firm (a partnership) that designs both its internal rules and external rules so as to maximize the political support received by its members.

### C. Moving the Model Beyond Congress

To this point the Article has treated Congress as though it were the sole lawmaking entity in the governmental structure. Clearly this is not the case. The President has the constitutional power to veto bills generated by Congress, and the federal courts have the power to declare congressional acts unconstitutional. Consistent with the Coase theorem, as well as with the intentions of the Framers who designed the constitutional system of checks and balances,

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committee, the chances were .313, and for members of Banking and Currency, .281. The differences were found to be significant at the .001 level.

If you are interested in a Model Cities Project, it is even more important that you find membership on the right committees. For these projects, congressmen on neither relevant committee had a probability of selection of .29. Congressmen on the Banking and Currency Subcommittee had a probability of selection of .62, more than twice that of nonmembers. Members of the Appropriations Subcommittee had a probability of selection of .86, nearly triple that of nonmembers. *Id.*

<sup>49</sup> Weingast, *supra* note 8, at 153 (reporting results of an unpublished study by Michael T. Malone entitled "The Political Determinants of the Flow of Federal Funds to States and the Impact of Federal Funds on Business Location Decisions").

<sup>50</sup> Faith, Leavens & Tollison, *Antitrust Pork Barrel*, 25 J. L. & ECON. 329 (1982).

these other governmental branches can raise the transaction costs faced by interest groups and politicians engaged in the wealth transfer process.<sup>51</sup>

As for the federal courts, the possibility that a statute will be intentionally or unintentionally misconstrued during the process of statutory construction clearly lowers the value to interest groups of obtaining legislative wealth transfers in the first place.<sup>52</sup> When courts invoke such public-regarding tenets of statutory construction as the plain meaning rule and the rule that "statutes in derogation of the common law shall be rigorously construed," the odds of misconstruction of special interest legislation go up.<sup>53</sup> Where techniques of statutory construction raise the probability that certain interest group oriented statutes will be invalidated by courts, or will be construed by courts in such a way that the special interest group does not receive the full benefit it expected from the legislation, the value of—and hence the demand for—special interest legislation declines. Similarly, of course, as the probability that a statute will be invalidated as unconstitutional goes up, the willingness of interest groups to pay for it goes down.<sup>54</sup> As judicial deference to legislatures goes up, as it has in recent years,<sup>55</sup> one would expect the demand for legislation by interest groups to rise as well.

The analysis of the role of the federal courts presented above applies in an even more straightforward fashion to the presidential veto power. As the odds of a presidential veto of a particular bill go up, the value of the legislation to the relevant interest groups will be expected to decline, due either to a reduction in the expected benefits or an increase in transaction costs, according to the possibility of purchasing executive acquiescence.

The problem with respect to administrative agencies is analogous to that discussed above for the judiciary. Here again, the statute may not be given the effect as bargained for in the "contract" made between the special interest group and the legislature. The

<sup>51</sup> See Macey, *supra* note 25; Macey, *Competing Economic Views*, *supra* note 35. As such, the activities of these branches must be distinguished from the activities of administrative agencies whose actions reduce the costs of invoking the wealth transfer process.

<sup>52</sup> It is also possible that the court will construe the statute so as to give a windfall to the special interest group. In any case, this does not change the analysis. The possibility of deviation from the terms of the agreement between the legislature and special interest group is simply another factor to be taken into consideration in the cost/benefit analysis performed by the parties (i.e., the effect described here is quantitative rather than qualitative).

<sup>53</sup> Macey, *supra* note 30, at 264-66.

<sup>54</sup> The possibility of judicial misconstruction or invalidation of statutes is one form of transactions costs.

<sup>55</sup> Cf. Riker & Weingast, *Constitutional Regulation of Legislative Choice: The Political Consequences of Judicial Deference to Legislatures*, 74 VA. L. REV. 373 (1988) [hereinafter Riker].

value of the legislation to the special interest group changes as the discrepancy between the expected action and the actual administrative action increases. However, it seems clear that, to the extent administrative agencies interject themselves into the lawmaking process, their activities do not upset the contractual agreements between interest groups and Congress to the same degree as the actions of the executive and judicial branches.<sup>56</sup>

Nevertheless, Congress is not powerless to reduce the probability of judicial invalidation or presidential veto of its statutes, or to constrain administrative divergence from its mandate. With regard to judicial invalidation, the problem Congress faces is that a particular statute (like the environmental statutes discussed above) that *appears* to be public regarding in character (but is in fact a hidden wealth transfer) will be taken by courts at face value, and the courts will fail to enforce the legislative bargain that lies nascent within the statute. The skillful use of legislative history by Congress can raise the probability that the statute will serve its true special interest purpose while keeping the political costs of the statute low.<sup>57</sup>

The congressional response to the president's veto power has reached even higher levels of sophistication. Congress generally can ensure that the deals it makes will not be vetoed by including provisions that are "full of dubious grants and subsidies" within major legislative packages containing measures supported by the President.<sup>58</sup> The President "often feels compelled to sign such bills . . . rather than risk a breakdown in the work of whole departments."<sup>59</sup> The lack of a line item veto power appears to facilitate this gamesmanship by Congress.<sup>60</sup> If the President could veto particular items within a bill, then he could enact only those portions of legislative

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<sup>56</sup> See Aranson, Gellhorn & Robinson, *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1 (1982); Macey, *supra* note 30, at 263-64.

<sup>57</sup> See Macey, *supra* note 30, at 262-64.

<sup>58</sup> C. ROSSITER, *THE AMERICAN PRESIDENCY* 254 (2d ed. 1960).

<sup>59</sup> *Id.*

<sup>60</sup> *But see* Robinson, *supra* note 28, at 411-12 (arguing that the President's reluctance to veto major legislation because of particular items reflects indifference rather than helplessness). Professor Robinson's conclusion here appears to be driven by the erroneous presumption that exercise of an item veto would entail a net cost to the President because it would involve lost political support from those legislators and their constituents who would be adversely affected. *Id.* at 412. But as the above analysis shows, statutes that lack majority support are often enacted through the logrolling and agenda setting process in Congress. See also Riker, *supra* note 55, at 382-88 (emphasizing that the agenda setting ability of congressional committees, who, "by virtue of their control over voting order, can manipulate the outcome of voting bodies"). Thus in many cases, exercise of a line item veto by the President will garner him a net gain in political support).

In addition, the fact that the President represents a different constituency from the agenda setters in Congress is relevant here. Over a wide range of issues, passing a par-

packages that he prefers to see become law. While it stands to reason that Congress would engage in bargaining with the President in the presence of a line item veto, under the current system such bargaining is rarely necessary. At the margin, the need to engage in this sort of bargaining over legislative deals would raise the cost of interest group legislation and result in diminished supply.

In the case of a rebellious or confused administrative agency, Congress has several means to compel or direct desired performance. First, there are several traditional statutory and nonstatutory means of control.<sup>61</sup> Additionally, Congress may enact rules and procedures that confine administrative discretion. Such administrative rules may take two forms: broad procedural rules such as the Administrative Procedures Act or the Freedom of Information Act, or policy-specific procedural requirements such as the environmental impact statement or the federal funding of consumer advocates.<sup>62</sup>

The point here is that the existence of an independent judiciary, the presidential veto power, and delegation of authority to administrative agencies does not detract from our model of Congress as a firm. Congress will view each of these political entities as exogenous constraints whose roles it must take into account when arriving at the political support-maximizing solution to a particular legislative problem. To Congress, these institutions simply present transaction costs to be overcome in the cheapest way possible.

#### CONCLUSION

This Article has shown the relationship between the theory of the firm and the theory of market exchange in the emerging public choice theory of the legislative process. The theory of market exchange describes the process by which organized special interest groups seek laws that transfer wealth from weaker political coalitions to themselves. The model posits that interest group activity determines the shape of the demand curve for legislation. Individual citizens and less organized groups comprise the supply curve. Politicians act as brokers and as entrepreneurs in the market exchange portion of the public choice model. Their goal is to maximize their own political support, not only by passing legislation designed to appeal to particular groups, but also by defining issues around which newly formed groups can coalesce, and by devising

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particular bill will maximize support for members of a particular congressional committee, while vetoing the bill will maximize the political support of the President.

<sup>61</sup> See R.D. ARNOLD, *supra* note 41; McCubbins, Noll & Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J. L. ECON. & OR. 243 (1987).

<sup>62</sup> See Lee, *supra* note 16, at 198.

laws that overcome the organizational problems of high information costs and transaction costs such as free rider problems among interest group members that plague wealth-transfer seeking interest groups.

The market exchange model predicts that the legal system will respond to exogenous factors that alter either the preferences of established interest groups or else the actual configuration of the interest groups themselves. The model also posits that the level of interest group demand for legislation will be directly proportional to the transaction costs of obtaining a legislative enactment in the legislative marketplace. The Constitution fixes the level of transaction costs. A bicameral legislature, an independent judiciary, and the possibility of a presidential veto each incrementally raise the transaction costs facing interest groups seeking to obtain legislation.

Where interest groups compete in a political marketplace, legislative institutions behave like firms whose output is law. As such, the theory of the firm, rather than the theory of market exchange, guides the public choice analysis of legislative institutions such as Congress. Like all firms, Congress organizes its internal affairs to minimize the costs of assuring contractual performance. In particular, a congressman who engages in vote trading with another congressman may overcome acute non-simultaneity-of-performance problems by means of the committee structure, which makes it very difficult for the bargaining congressman to renege. Similarly, the committee system itself is a method of organizing team production to maximize the electoral needs of individual congressmen who face competition for their seats from nonincumbents.

To develop testable implications for the public choice model requires that we distinguish between application of the theory of the firm on the one hand and the application of the theory of market exchange on the other. Nevertheless, both aspects of the theory share important common features. Both assume that individuals making political decisions are not fundamentally different than those making any private decision about the allocation of resources. Both theories posit that Congress will design legal rules to benefit the narrow preferences of discrete interest groups rather than those of the "public at large." Finally, both theories imply that constitutional rules play a major role in setting the level of transaction costs incurred as a prerequisite for a statute's passage. The preferences of the "majority" are virtually irrelevant in determining legislative outcomes. Instead, law is made by legislators whose primary goal is to aggregate the political support they receive from competing special interest group coalitions. Legal rules are generated by a process

that conforms to standard microeconomic models of rationally self-interested behavior.