The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By

WILLIAM J. BAUMOL

Regulation, Litigation, And Misdirection Of Entrepreneurship

Award Bestowed September 17, 1987

Rhodes College
Memphis, Tennessee

THE FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

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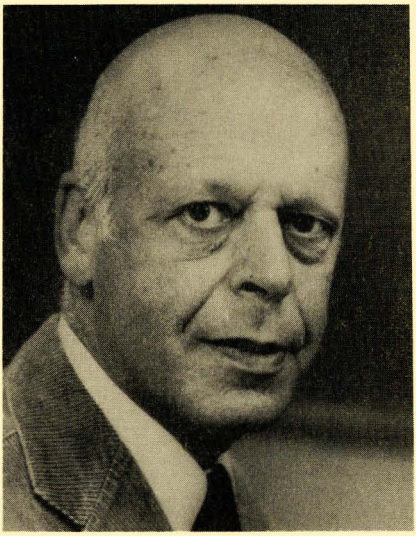

WILLIAM J. BAUMOL
RECIPIENT OF FOURTEENTH ANNUAL FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

Memphis, Tennessee, September 17, 1987

Dr. William J. Baumol, who holds a joint appointment as Professor of Economics at Princeton and New York Universities, is the recipient of the fourteenth annual Frank E. Seidman Distinguished Award in Political Economy from Rhodes College.

Included in the areas of expertise for which Dr. Baumol is so widely recognized is his work on the economics of "contestable markets," those markets in which entry and exit is cheap and easy. This model is now widely used in helping to determine what sectors of the economy merit deregulation and need no antitrust attention. The analysis is also used as a guide to determine public interest rules for regulation of those activities for which absence of competition justifies government surveillance. Contestable markets analysis has been employed in many statistical studies of multiproduct industries, and economic theory uses it to explain the process which determines the structure of the economy's industries, that is, why some of those industries have many firms, some few, while others are monopolies, etc.

Dr. Baumol is also known for the "sales maximization" hypothesis regarding the behavior of business firms with objectives other than profit maximization, and the "unbalanced growth" model, which demonstrates that the unequal opportunities for technical progress in different sectors of the economy serve to explain the chronic fiscal problems of such entities as cities, educational systems and performing arts organizations.

The author of many publications, Dr. Baumol's most recent books include Microtheory: Applications and Origins (1986), Superfairness: Application and Theory (1986), Contestable Markets and the Theory of Industry Structure (with R.D. Willig and J.C. Panzar, 1982), and Economics: Principles and Policy (with A.S. Blinder, 1979; second edition, 1982; third edition 1985; fourth edition, 1987).

Dr. Baumol received a B.S.S. degree from the College of the City of New York and a Ph. D. from the University of London. He served as a junior economist with the U.S. Department of Agriculture and was an assistant lecturer at the London School of Economics before joining the Princeton faculty in 1949. In 1971 he also joined the department of economics at New York University as a professor.

The recipient of many professional honors, Dr. Baumol is also a founding member of the World Resources Institute and was a member of the research advisory board of the Committee for Economic Development. He is a member of the editorial advisory board of the Supreme Court Economic Review and a past president of the American, Eastern, and Atlantic Economic Associations. A consultant to government and industry, Dr. Baumol has also served on the board of editors of the American Economic Review, Journal of Economic Literature, Management Science, and Kyklos.

REGULATION, LITIGATION, AND MISDIRECTION OF ENTREPRENEURSHIP

by

William J. Baumol

"The fault dear Brutus lies not in our stars..." (Cassius)

Entrepreneurs are like any other group in the degree of their dedication to morality and the general welfare. In any given period, the character of the available routes along which their objectives can be pursued effectively will determine the nature and range of current entrepreneurial activities. When some of the most promising avenues for pursuit of profit, power and prestige either contribute little to the public's well being or even threaten to damage welfare severely, one can expect with a considerable degree of confidence that some entrepreneurs will nevertheless be willing and even anxious to undertake them.

What this means for economic policy is that the profit motive, though it has long served the public interest effectively and well, can sometimes fail to achieve that purpose. Rather than chanelling entrepreneurial efforts into exclusively beneficial directions, it can instead shift the activities of at least the less fastidious of the entrepreneurs into other paths. This means, in turn, that a reasonable objective of public policy relating to entrepreneurship should be avoidance of interference with the pursuit and earning of profits that are earned though the exercise of what will be referred to here as "productive entrepreneurship." However, at the same time, it is entirely appropriate for the policy designer to seek assiduously to foreclose opportunities for the earning of profit through unproductive or destructive entrepreneurial activities.

In particular, it will be argued that one of the significant social costs of excessive regulation and of the availability of opportunities for profitable litigative activity on the part of business firms is exactly the sort of misdirection of entrepreneurial activity that has just been described. Thus, deregulation and measures that have been proposed to cut down litigation have in their favor at least the possibility that they will serve to channel the potent forces of entrepreneurial initiative into productive and, hence, socially valuable directions.

1. WHAT ENTREPRENEURS DO.

The foundation of my analysis is a revised view of the nature and scope of entrepreneurial activity. Standard economic analysis, following Schumpeter's classic work, defined the entrepreneur to be the economy's innovator, where innovation, in turn, is distinguished from the complementary act of invention, encompassing, rather, the steps required to recognize the practical uses of a new product or of a new process, as well as the activities necessary to get the novel item into the productive process. I do not dispute in the slightest degree either the value or the validity of this way of looking at the subject. Rather, I will only argue that there is more to the matter, and that the additional elements, while their pertinence is virtually self-evident once pointed out, do profoundly modify our views about policy related to entrepreneurship.

The basic point is that the ultimate product of entrepreneurship, at least so far as the entrepreneur is concerned, is not steel or telephone messages or airplane parts. Rather, that ultimate product is some compound of wealth, power and prestige. Moreover, throughout history, the nature of the activities best calculated to achieve that final product has varied dramatically. In the nineteenth century the techniques of "stock watering," the methods of "preparing the market" for a successful short sale of the securities of a victim firm and other characteristic weapons in the financial wars of the group that has been referred to as "the robber barons," were surely innovative, and surely were undertaken in pursuit of profit and power. And if so, by our definition they were indisputably entrepreneurial. Granted that (and I do not see how any of the argument so far can reasonably be denied except, perhaps, on some semantic ground) the rest of the analysis and its conclusions follow, virtually inexorably. If Jay Gould was a bona fide entrepreneur, then so is Ivan Boesky; and if that is true of Mr. Boesky, then the same must hold even for types such as Al Capone, or his more recent narcotics emperor successors.

Of course, entrepreneurs treading more commendable paths will resist being classified with individuals such as these, just as idealistic lawyers seek to avoid association with ambulance chasers, great doctors dissociate themselves from quacks, and professors of repute seek to avoid tarnish by the brush of those who falsify the results of

their research. But that is not the point. The dregs of our professions are nonetheless lawyers, doctors and professors, even if their colleagues derive little pride from their sharing of profession. The same is patently true of entrepreneurs who come, as we all do, in all sizes and shapes, so far as moral principles are concerned.

While the emphasis on the extreme cases in the preceding paragraphs was intended to help the reader break away from slavish adherence to conventional ways of thinking about the subject, such outre´ examples are in an important sense misleading. Neither the Mafia godfathers nor the traders on inside information in "risk arbitrage" are the prototypical entrepreneurs. Nor indeed, are they the primary source of the economic problem that can derive from the exercise of entrepreneurship with which I am here concerned.

The essence of the matter is that many activities that are legal and even quite legitimate under the rules of the game current in a particular period are, nevertheless, apt to constitute entrepreneurship that is unproductive or is even effectively destructive of the economy's output and wealth. An example will make the point and bring the discussion back to the subject of regulation.

In the bad old days of regulation (whose termination was, of course, very recent) the Interstate Commerce Commission once described its role, with commendable candor, as that of a "giant handicapper." That is, the Commission was determined not to allow such minor considerations as relative inefficiency to determine which enterprises would survive in a given market. Instead, the Commission was determined, in effect, to ensure the survival of every incumbent in a market that fell under its jurisdiction. Among the weapons adopted to carry out that policy were various criteria used to prevent more efficient suppliers from charging prices that were low because of the low pertinent costs. Railroads were prevented from undercutting barges along routes where the former were the most efficient suppliers, and the compliment was returned in other situations where the positions were reversed. Now, in these circumstances it was natural for the operators of the railroads, the barges and the trucks to expend enormous resources in the struggles before the regulatory agency to obtain regulatory price terms as favorable to themselves as possible. The successful entrepreneur was not the business leader who introduced the most novel and efficient transport techniques, but rather the one who provided the most

innovative and effective means to co-opt the protective proclivities of the regulatory agency. Economists, following the contribution of Professor Tullock, refer to this as "rent-seeking," meaning that it is pursuit of earnings derived not from one's own net contribution to the economy's productive activity, but rather from acquisition of a larger share of outputs derived from other sources.

Now, one point of this example is that the entrepreneurial activity it involves, while clearly unproductive in the literal sense of that word, was neither illegal nor immoral. If fault there was, it was not that of the business persons immediately involved. Instead, it was the fault of the rules of the game, or, rather, of those who had participated in their adoption. Once those rules were in effect, the managements of the affected firms had a clear duty and little choice on the matter. Each was required by the circumstances to fight as hard as possible for the most favorable regulatory terms available, that is to say, for the most effective handicaps upon his competitors; for failure to do so would only leave the firm vulnerable to similar acts by those rivals. Duty to stockholders clearly precluded selfless and unilateral abstention from such rent-seeking steps, which would in any event merely have been quixotic, gaining nothing of substance for the public interest.

2. ON THE ROLE OF SOCIAL RESPONSIBILITY IN BUSINESS DECISIONS.

The position that is taken in this paper is itself likely to be taken to be tainted with amorality, if not with outright immorality. Within the business community itself there are repeated calls for the inculcation of ethics into business practice, while outside the business group a variety of well intentioned individuals demand that business "live up to its social responsibilities." It is expected that the managements of firms will voluntarily take costly steps to protect the environment, go out of their way to hire members of minority groups who are relatively unskilled by virtue of past or current discrimination, and that these firms will even undertake to play a role in the formation of the country's foreign policy by boycotting countries whose behavior merits condemnation.

It is a curious tradition for an economy deemed to be guided to prosperity and service to consumers by the profit motive, a tradition

which calls for decision making to be guided instead by altruism. Business firms are not alone in being subjected to this expectation. Medical doctors, for example, are expected to sacrifice selflessly, and their fees are consequently singled out for special disapprobation. Perhaps the most curious manifestation of this syndrome is rent control, which must presumably be adopted with the implicit expectation that landlords are a group who can be relied upon to provide full service altruistically, even when their revenues are forced by legislation to sub-market levels. The irony, of course, is that this very arrangement ensures a natural selection process in which only the scum of the earth may be able to succeed financially as the landlords of the poor, and shocking slums become the inevitable result. Perhaps more curious still is the business community's own distrust of the profit motive when it comes to its own employees. How many firms offer innovator-employees financial rewards anywhere near commensurate with the contributions the innovations provided by such individuals make to the prosperity of the firm?

The fact is that doctors, landlords and corporation presidents are all human and manifest the full range of human failings. I may be able to trust some landlords to do the right thing even under unfavorable financial conditions, but I surely cannot rely upon all of them to do so.

More than that, the market mechanism severely restricts the scope for business altruism. The invisible hand, which penalizes excessive spending by a firm as unacceptable waste, rendering the enterprise vulnerable to the competition of more efficient rivals, equally rules out those expenditures that are not required for standard business purposes but which are rather undertaken in altruistic pursuit of the general welfare. Business does and should perform well in terms of the public interest where the rules of the game decree that substantial profits will be earned when and only when that firm's activities promote that interest.

It must be emphasized that this is no novel doctrine. Rather, it is nothing other than the central theme in the Wealth of Nations. Perhaps, the most curious feature of the book which is undeservedly reputed to be the consummate classic of apologetics for the capitalists, is its repeated and intemperate dilation upon the moral unreliability of the members of the business community. Smith tells us that in the

usual course of affairs "the (self) interested sophistry of merchants and manufacturers confound(s) the common sense of mankind," (p. 46) and that "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." (p. 128). Examples of such passages can easily be multiplied.

However, Smith's purpose in calling attention to the untrustworthiness of business morals was not to impugn the character of businesspersons, some of whom were among his closest friends. Rather, his objective was to show that there was a better way--the rules of the game governing the means by which personal wealth could be acquired, as enforced by the competitive market mechanism.

This is clearly the main implication of the justly noted invisible hand passage, as a rereading of that passage unequivocally confirms. He tells us of the economic decision maker, "He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it...by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it." (p. 423)

3. MORE ON THE ROLE OF REGULATION AND LITIGATION.

One of the crucial costs to society of over-regulation and the explosion of litigation that have justly attracted so much attention recently is the fact that they transfer a considerable share of the control of the nation's productive mechanism from the engineers to the lawyers. In saying this, I should not be misconstrued to be manifesting prejudice against the practitioners of the law. On the contrary, I am, if anything heavily predisposed in their favor. I literally believe that there is no other occupation on which society is

more heavily dependent for its welfare. It is the rule of law that is responsible for our civil liberties, and the accompanying security of person and freedom of thought and expression that have no parallel in pre-nineteenth century history. Nevertheless, this is surely no justification for assumption of control over industrial activities by the nation's attorneys, which is as questionable a development as if the economists were to acquire a role in surgical decisions.

More than that. The shift of the focus of control toward the regulatory hearing room and the court house automatically changes the nature of the decisions that are most appropriate, and modifies severely the accompanying allocation of resources. It is inevitable that the chairman of Texaco, faced with bankruptcy as a result of recent legal actions against his firm, will devote more of his attention, and a far greater share of the firm's resources than would otherwise be used in this way, to litigative activities, than, say, to oil exploration. The resulting impediments to productivity can take many forms, some of them surprising. In one private antitrust suit where I was present the jury was offered by each of the two sides, as evidence of the moral and operative degeneracy of its opponent, two perfectly legitimate self-critical studies which each management happened to have commissioned from an outside consulting firm and which seemed to merit commendation rather than censure. Yet the lawyers, having dug them out of their opponent's files, held them up as proof positive of the culpability of the other side. I happened to overhear the chairman of the board of one of the contending parties vow immediately after this obscene maneuver that so long as he retained his post his firm would never again permit a written critical evaluation of its own activities.

More generally, it has many times been shown that redundant regulation impedes business decision-making directly and systematically. It forces firms to continue in unprofitable lines of activity, that is, activities in which demands demonstrate themselves to be insufficient to justify the costs that the supply of the products in question entails. A clear example is provided by the many money-losing routes that the nation's airlines and railroads were for many years prohibited from abandoning. Regulation also systematically delays business decisions, often requiring months, and not infrequently even years, to approve an adjustment of prices or productive techniques to evolving market conditions.

Perhaps most noteworthy is the impediment that regulation imposes upon the process of technological innovation. There are many ways in which it does this, only two of which will be noted at this point. First, regulatory lag seriously affects the profitability of innovation by preventing its introduction at the optimal moment for its innauguration. The delays in question are by no means characteristically minor. In at least one noteworthy case, the introduction of a new and more efficient type of railroad car was delayed by the regulatory process for more than a decade, and more recently, some innovative telecommunication techniques have had to wait several years before their adoption was permitted. In each case, of course, the period of delay entailed a continuing expenditure on the accompanying legal battles.

Second, the regulatory process impedes innovation even more severely and more directly by virtually precluding any financial reward for the risk and outlay of effort that innovation entails. Regulation almost inevitably has this effect because of its understandable dedication to the prevention of the earning of excessive (i.e., monopolistic) profits. Since it is virtually impossible to show whether unusual profits are attributable to the firm's extraordinary efficiency and its record of innovation, or whether those profits are instead ascribable to the illegitimate exercise of market power, regulation, traditionally, has proceeded by ruling out <u>all</u> profits that exceed what it considers to be a normal level. The result, of course, is virtually to preclude all opportunity for profitable innovation, that is to say, for the exercise of productive entrepreneurship.

Along with the foreclosing of opportunities to the productive entrepreneur, invariably, new opportunities are provided by regulation to the <u>un</u>productive entrepreneur. We have already seen how barge lines and railroads were each induced to employ ingenuity and innovation in the erection of impediments to the competitiveness of their rivals. Illustrations of the novel approaches introduced for this purpose are easy enough to supply, but their relative complexity renders it inappropriate here to devote to them the space that a clear description would require. Rather, it is worth emphasizing one ironic feature of the invitation provided by overregulation and private anti-trust litigation for the substitution of competition via trial by legal combat for competition through superior efficiency and better products.

One of the most tempting gambits for the unproductive entrepreneur who chooses litigation as a primary competitive weapon, pits him in direct opposition to the efforts of a rival productive entrepreneur. After all, there is nothing more threatening to the tranquility and even the survival of the inefficient enterprise offering no particularly attractive products, than successful process or product innovation by its rivals. A more efficient process will permit the innovating firm to underprice its competitor, and a new and more attractive product can undermine the loyalty of the latter's customers. Rather than responding in kind, the laggard enterprise may, and often does, find it more promising to transfer its efforts to a legal forum. There, all too often, innovation is described as a manifestation of "unfair competition," as "predatory" or "destructive."

Regulators and judges are no fools, and they do often see through such acts of unproductive entrepreneurship, rejecting them, as the public interest requires. The widely accepted maxim that the law undertakes to provide protection to the competitive process rather than to individual competitors is a manifestation of such good judgement on the part of the courts. But by the time the regulator or the court can get around to rejecting the claim that an innovation which threatens an inefficient rival is "anticompetitive," it is already likely to be too late. The inevitable delays and costs inherent in the legal process, because they are a requisite of fairness and full hearing of the issues, may already have undermined the profitability of the proposed innovation. At the very least, they will have allowed success to a delaying action which extends the period during which the less efficient competitor is permitted to escape the financial punishment that fits its crime. In addition, it may have given that firm time enough finally to rouse itself from its lethargy, belatedly meeting the innovative threat to its financial well-being. But, clearly, that too will have reduced the reward that innovation offers to the firm that moves first.

As we know, one of the primary purposes of regulation and the anti-trust laws is to promote and to defend competition. Indeed, one of the criticisms offered by opponents of deregulation is that it has opened the way to less competitive industry structure and conduct. But we see here that there is another side to the story, and that regulation itself, even with the best of intentions, can have consequences that are profoundly detrimental to competition, and along

with this serve as an incentive for unproductive entrepreneurship and as a major handicap for entrepreneurship that pursues productive avenues instead.

4. WHAT IS TO BE DONE?

The importance of the rules of the game has been emphasized throughout this paper. These are the rules imposed by the prevailing laws and institutions that determine which avenues of entrepreneurial activity are effective channels for the accumulation of wealth and power and which are not. These rules have been emphasized not because they are the only determinants of the directions currently taken by entrepreneurial activity, a contention which is patently implausible and almost certainly untrue. Rather, the discussion has focused exclusively upon them because these rules are amenable to amendment through appropriate policy measures. Once more, an explanation is most easily provided by example.

Japan offers a record of private antitrust litigation which is remarkable for the rarity of that sort of undertaking in comparison with the frequency of its occurrence in the United States. One explanation commonly offered is that Japanese culture discourages litigiousness, a view of the matter which probably has considerable truth. But closer examination reveals that there is more to be said. In Japan the law requires any firm which proposes to sue another on antitrust grounds to obtain permission in advance from the Japanese Federal Trade Commission. Such permission is rarely granted, and once denied, the complaining firm is offered no avenue for appeal. Such rules obviously provide powerful reinforcement to any propensity toward avoidance of litigation.

In the same way, we can look to European legal institutions for a partial explanation for the absence there of a litigation explosion comparable to our own. In the European tradition an unsuccessful plaintiff is expected to bear the legal costs incurred by the defendant. This clearly undermines much of the incentive for frivolous suits brought in hope that a bit of income may conceivably be derived by those who initiate the lawsuit.

These examples illustrate, then, that the rules of the game <u>can</u> matter. But they illustrate more than that. For they suggest directly

how these rules can lend themselves to changes that promise to help to redirect entrepreneurs toward the productive activities which no one can carry out better than they. I am not arguing that we should necessarily do so, but it is clear that adoption by the United States of the Japanese and European rules that have just been cited as illustrations is a possible candidate measure that may serve to promote this objective.

Other examples are readily gleaned from the pertinent literature. From what has already been said, deregulation itself is a prime illustration of such a step. To the extent that regulation has provided an effective forum for the creative imaginations of rent-seeking entrepreneurs hoping to shackle the competitive initiatives of their rivals, deregulation must help to entice entrepreneurs to move in more productive directions when pursuing their personal objectives.

A second example that is rather less obvious is the proposal for "decoupling" in the execution of the treble damage provisions of the antitrust laws (see, e.g., Polinsky, 1986, or Baumol and Ordover, 1985, pp. 263-265). The idea (which apparently is to be attributed to Schwartz, 1980, pp. 1092-1096) is that while defendants who are found guilty of violation of the antitrust rules to which such damage provisions apply would continue to be subject to the same penalties they face today, the successful plaintiffs in such a private antitrust suit would receive some smaller amount, with the difference presumably going into the public treasury. The purpose of the proposed continuation of the trebled penalties upon the defendant is, of course, to provide a suitably strong deterrent in a world in which some proportion of violators of the law can, regrettably but confidently, be expected to get away with their crimes. On the other hand, the reduction in compensation offered to the victim to some amount closer to the magnitude of the damages suffered, can serve to discourage frivolous suits undertaken as fishing expeditions.

5. CONCLUDING COMMENT.

While entrepreneurship is potentially one of the prime contributors to an economy's productivity and to the economic well-being of the general public, these are not generally the primary goals of those who practice it. When current economic institutions decree that unproductive means are surer ways to wealth, power and

prestige than those that are socially beneficial, one can be confident that at least some entrepreneurs will adopt them. In such circumstances it is neither helpful nor even fully appropriate to blame the entrepreneurs, or simply to appeal to their sense of ethical behavior. Rather, the most promising and dependable step to consider is amendment of the rules that govern how wealth and power are currently most readily accumulated, facilitating pursuit of these goals through productive means, and forclosing or at least discouraging the unproductive options.

Today, when we are so deeply concerned about the competitiveness of the United States in the international market place and about the rate of growth of its productivity, the view of the role of the entrepreneur that has been offered here seems to merit urgent consideration. Not the least of the reasons for this is that this view of the subject may for the first time suggest ways in which public policy can undertake systematically to promote the exercise of useful entrepreneurship. Obviously, such a program must proceed with caution that tempers its enthusiasm. We must not, for example, dismantle the protection to the general welfare offered by the antitrust laws. However, one can hope that exercise of judgement will ensure progress on the one front without retreat on the other.

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