Preface

The Industrial Revolution, which began in the mid-1700s, brought about the largest ever increase in the material well-being of mankind. Prior to the Industrial Revolution, most people barely scraped by at a subsistence level of existence. As Thomas Robert Malthus noted, the size of the population was regulated by its ability to produce enough food to support itself, and starvation was a constant threat. In the twenty-first century, people who live in capitalist economies are more concerned about obesity than starvation, and even those below the poverty level enjoy amenities unimaginable a few decades earlier, such as mobile phones, microwave ovens, flat-screen televisions, and indoor plumbing. People who live in economies that are primarily market-oriented enjoy high standards of living, while those who do not are much poorer. Judged by its ability to produce material well-being, capitalism is an undeniable success.

Capitalism has its critics who point to periodic failures such as the Great Depression and the financial collapse that began in 2008, and, more generally, depict it as a system that leads to income inequality and allows some to use their privileged positions within the economic system to gain advantages over others. Regarding these more general criticisms, capitalism is well named, because it is the ownership of capital that conveys advantages to the economic elite. Capitalism, as an economic system, has taken the bulk of the criticism for the cronyism and favoritism that allows some to exploit the system for their own benefit.

The analysis that follows concludes that political capitalism, in which the political and economic elite control the system for their own benefit, is not market capitalism and should be analyzed as a separate economic system. The study of economic systems, a major area of inquiry in the twentieth century, when there was a vigorous debate on the merits of capitalism versus socialism, has fallen out of favor in the twenty-first, so economic analysis no longer focuses on economic systems themselves. Rather, economists analyze market economies with varying degrees of government production, intervention, and oversight. Markets lay the foundation for economic analysis, and policy questions involve how much and what kind of government control should be exercised over a market economy.

This volume returns to an emphasis on economic systems, concluding that political capitalism is not some variant or intermediate step between capitalism and socialism, and is more than just government control or oversight over market activity. It is a distinct economic system and should be analyzed as such. This is the novel part of the analysis, but a substantial part of the book is devoted to demonstrating that the building blocks for a theory of political capitalism already exist in a variety of well-established academic concepts. They have just not previously been assembled to build the theory of political capitalism. The analysis that follows does not break with past academic traditions that have analyzed political and economic systems. Rather, it shows that when these well-accepted lines of analysis are viewed together, they produce a coherent picture of political capitalism as a distinct economic system.

The problems with political capitalism, often labeled as cronyism, favoritism, corporatism, clientelism, and related terms, are well-recognized, but what are primarily recognized are the symptoms of political capitalism, not its causes. Proposed solutions often suggest cleaning up corruption or additional government regulation and oversight to prevent cronyism, but when the causes are understood to be the incentive structure inherent in political capitalism, this analysis suggests that those solutions will be ineffective and will often make the problems worse. There is widespread agreement on the symptoms, but a poor understanding of the causes, and, as a result, widespread disagreement on the solutions. This volume hopes to shed some light on the causes with the hope that if political capitalism is better understood, there will be more agreement on how it should be addressed.

I appreciate the assistance of Karen Maloney and Stephen Acerra at Cambridge University Press, and the encouragement of Peter Boettke, on this project. Andrea Castillo worked with me on a separate project on cronyism, which provided some foundation for the work in this volume, and Rob Bradley was extremely helpful in focusing my attention on relevant literature and ideas. My wife Lora has been a constant source of support, and the book would not have been written without her encouragement. I dedicate the book to her and to our three sons, Ross, Mark, and Connor, with the hope that the ideas in this book can, in some small way, make the world they and all of us inhabit a better place.

1

The Concept of Political Capitalism

Political capitalism is an economic and political system in which the economic and political elite cooperate for their mutual benefit. The economic elite influence the government's economic policies to use regulation, government spending, and the design of the tax system to maintain their elite status in the economy. The political elite who implement those policies are then supported by the economic elite, which helps the political elite maintain their status: an exchange relationship that benefits both the political and economic elite. The elite cooperate to use their political and economic power to retain their positions at the top of the political and economic hierarchies.

This concept is familiar both to the general public and to academics, but political capitalism has not been identified and analyzed as a distinct system of political economy. Some believe that this is simply the nature of capitalism: it benefits the capitalists and exploits the masses. Others view it as the result of corruption within the government. Still others see it as the consequence of creeping socialism and increased government interference on the economy. While there is an element of truth in all these views, they do not present a complete picture because they focus on symptoms rather than analyzing political capitalism as a distinct economic system that generates these symptoms.

In the twenty-first century there has been a popular backlash against cronyism, or crony capitalism, and criticisms of corporatism go back into the twentieth century, along with fascism – all of which are associated with insiders and the well connected using the system to their advantage. The Occupy Wall Street movement that began in 2011 was a backlash against government policies that were bailing out the Wall Street financiers – the 1 percent – while ignoring the problems of the masses of Americans who had lost their jobs and had their mortgages foreclosed – the

99 percent. The dissatisfaction people have with a system that appears to benefit the well connected while ignoring the interests of the general public is widespread, but the source of this dissatisfaction is not well understood. The general public does not have a clear understanding of it, and it is not clearly explained by the academics because, while they have a good understanding of the theoretical building blocks underlying political capitalism, they have not assembled those components to analyze political capitalism as a distinct economic system.

In a 2016 interview, Tom Morello, guitarist for Rage Against the Machine in the 1990s and for Prophets of Rage at the time he gave the interview, said, "The government basically has one function, and that is to serve the interests of the people who own the country."[1] While one would hesitate to place too much weight on the political and economic views of someone whose fame comes from playing the electric guitar (although Morello does have a bachelor's degree in social studies from Harvard University), Morello's statement is a good description of the concept of political capitalism in language understandable to the general public. Morello is far from alone in perceiving that government policies often benefit the well connected and the well off while neglecting the interests of the general public, or even imposing costs on them for the benefit of the well-connected elite.

A variety of strands in the academic political economy literature provide a solid foundation for the theory of political capitalism, but academicians have not assembled the well-established building blocks of a theory of political capitalism into a comprehensive and unified framework. This volume does that, first by depicting political capitalism as a distinct economic and political system, and second by describing a substantial body of economic and political theory that has already established the intellectual foundation for an understanding of political capitalism. The building blocks for a theory of political capitalism already exist. This volume brings them together.

One reason why political capitalism has not been recognized as a distinct economic system is that economists do not focus on economic systems in the twenty-first century as they did in the twentieth. "Comparative economic systems" was a common field of study in the twentieth century, mainly comparing capitalism with socialism and analyzing various methods of central economic planning. That focus fit well within the Cold War politics of the time, which pitted capitalist democracies against communist

[1] *Guitar World* 38, no. 11 (November 2016), p. 48.

dictatorships. With the collapse of the Eastern European centrally planned economies in the late twentieth century, the field fell by the wayside in favor of examining the way that markets work, and the effects – both good and bad – of various government interventions. Using well-established theories from economics and other social sciences, one can see that there are substantial insights that come from analyzing political capitalism as a distinct economic system. It is not capitalism, it is not socialism, and it is not some intermediate system that lies between the two.

Calling this system of political economy "political capitalism" raises two types of questions. First, it may appear to be just another name for a set of institutions that already has a name: "crony capitalism," a popular term in the early twenty-first century, seems to fit the definition given above, as does "corporatism." The fascist systems in Germany and Italy prior to World War II also seem to fit the definition.[2] And Karl Marx, seeing the class struggle between the proletariat and the bourgeoisie, thought that the conspiracy between the economic and political elite to benefit themselves at the expense of the masses characterized capitalism, with no adjective needed. Political capitalism may be more descriptive, and it avoids the negative associations that fascism has with the regimes of Hitler and Mussolini. One motivation is to identify political capitalism as being different from capitalism, as it is commonly understood.

This leads to a second issue with the term. Capitalism's proponents do not like the term "capitalism" to be associated with the government intervention that characterizes cronyism. They prefer the term "cronyism" to "crony capitalism," and for the same reason push back against calling this cronyism "political capitalism." Political capitalism is not capitalism, so the name is pejorative and inappropriate for the economic system that has produced such a high level of material well-being everywhere it has been implemented.[3] But there may be a tendency for free market economies to move toward political capitalism, so the term might be viewed as

[2] See, for example, Charlotte Twight, *America's Emerging Fascist Economy* (New Rochelle, NY: Arlington House, 1975), for an argument that, as far back as the 1970s, the American economy was moving toward political capitalism. Twight used the more ideologically charged term "fascism."

[3] Excellent historical accounts to back up the productivity of capitalism everywhere it has been implemented are found in David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some So Poor* (New York: W. W. Norton, 1998), Joel Mokyr, *The Gifts of Athena: Historical Origins of the Market Economy* (Princeton, NJ: Princeton University Press, 2002) and Mokyr, *The Lever of Riches* (Oxford: Oxford University Press, 1990).

cautionary as well as descriptive.[4] It is descriptive because the means of production are privately owned, which is the common identifier of capitalism, but it is cautionary because of the possibility that there is a tendency for market economies to move toward increasing political control, so the profitability of the means of production is affected by the degree to which those who control the capital have connections to the political elite. Connections count, and political capitalism provides rewards to the well connected. Is there a tendency for capitalist economies to move toward cronyism? This is one of the issues that will be explored in the following analysis.

GENERAL OPPOSITION

While there is a large divide in public opinion on many issues, the cronyism that characterizes political capitalism is uniformly criticized from one end of the political spectrum to the other. Ralph Nader discusses an alliance across the political spectrum of individuals committed to dismantling what he calls the corporate state.[5] The Occupy Wall Street movement that was protesting the policies that worked to the advantage of the 1 percent at the expense of the 99 percent demonstrates the view of at least a subset of the general public that the system benefits a few at the expense of the many. Their language rephrases the language of sociologists and political scientists who talk about the division between elites and masses – or, as Marx characterized it, the bourgeoisie versus the proletariat. On the right, supporters of free markets criticize corporate welfare and cronyism. The left, meanwhile, argues that more government oversight is needed to curb the abuses that result from unfettered capitalism and the unequal concentration of wealth it produces. Popular opinion sides against political capitalism from one end of the political spectrum to the other.

An interesting comparison on the widespread opposition to political capitalism can be made by looking at two books, published at about the same time, critical of government policies that tend to favor the elite over the masses. Joseph Stiglitz's book, *The Price of Inequality*, published in

[4] Many writers have suggested this tendency, including Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 2nd edn. (London: George Allen & Unwin, 1947) and Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven, CT: Yale University Press, 1982).

[5] Ralph Nader, *Unstoppable: The Emerging Left–Right Alliance to Dismantle the Corporate State* (New York, NY: Nation Books, 2014).

2012,[6] uses the Occupy language of the 1 percent versus the 99 percent to discuss government policy, while David Stockman's book, *The Great Deformation*, published in 2013,[7] talks about cronyism in government policy. While Stiglitz is commonly viewed as having political views toward the left, Stockman's views tend to be associated with the right. Yet the messages of their books (although not their policy recommendations) are very similar.[8] Even the subtitles of the book are telling. Stiglitz's subtitle is "how today's divided society endangers the future" while Stockman's is "the corruption of capitalism in America."

Chapter 2 in Stiglitz's book, entitled "Rent Seeking and the Making of an Unequal Society," places much of the blame for inequality on government policy. He argues, "We have a political system that gives inordinate power to those at the top, and they have used that power not only to limit the extent of redistribution but also to shape the rules of the game in their favor."[9] Echoing those views, Stockman says that policies that try to regulate the market "fail to recognize that the state bears an inherent flaw that dwarfs the imperfections purported to afflict the free market; namely, that policies undertaken in the name of the public good inexorably become captured by special interests and crony capitalists who appropriate resources from society's commons for their own private ends."[10]

Stiglitz and Stockman are both saying the process is rigged to favor the cronies – the 1 percent – at the expense of everyone else. Stiglitz talks about rent-seeking and Stockman about interest group capture of the public policy process. Both rent-seeking and regulatory capture are well established within the academic literature, and have separate chapters devoted to them later in this book. The fact that they use concepts in common use in the academic literature reinforces the point that there is already a solid academic foundation on which to build a theory of political capitalism.

Stiglitz discusses the lawyers and accountants working for the elite, saying, "They help write the complex tax laws in which loopholes are put, so their clients can avoid taxes, and they design the complex deals to take advantage of these loopholes."[11] Regarding the economic power the

[6] Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers the Future* (New York, NY: W. W. Norton, 2012).

[7] David A. Stockman, *The Great Deformation: The Corruption of Capitalism in America* (New York, NY: Public Affairs Press, 2013).

[8] This is discussed in more detail in Randall G. Holcombe, "What Stiglitz and Stockman Have in Common," *Cato Journal* 34, no. 3 (Fall 2014), pp. 569–579.

[9] Stiglitz, *The Price of Inequality*, pp. 39–40.

[10] Stockman, *The Great Deformation*, p. 169.

[11] Stiglitz, *The Price of Inequality*, p. 53.

elite wields to enhance its income, he says, "The simplest way to a sustainable monopoly is getting the government to give you one."[12] Stockman agrees, saying, "Like in all instances of crony capitalism, economic outcomes are as much a gift of the state as they are the fruits of capitalist virtue."[13] Stiglitz reiterates the point, saying that capitalists write rules in their favor "to extract from the public what only can be called large 'gifts.'"[14]

Stiglitz argues that the elite are writing the rules for their own benefit. "It's one thing to win a 'fair' game. It's quite another to be able to write the rules of the game – and to write them in ways that enhance one's prospects of winning. And it's even worse when you can choose your own referees."[15] Reemphasizing the idea of regulatory capture, Stiglitz says: "The problem is that leaders in these sectors use their political influence to get people appointed to the regulatory agencies who are sympathetic to their perspectives."

Stockman argues: "We have a rigged system – a regime of crony capitalism – where the tax code heavily favors debt and capital gains, and the central bank purposefully enables rampant speculation by propping up the price of financial assets and battering down the cost of leveraged finance."[16] Stockman's dismal conclusion is that "In truth, the historic boundary between the free market and the state has been eradicated, and therefore anything that can be peddled by crony capitalists . . . is fair game."[17] Stiglitz adds, "It doesn't have to be this way, but powerful interests ensure that it is."[18] Stiglitz's remark prompts the questions: if it doesn't have to be this way, why is it? And: what could be done to mitigate the favoritism for the elite to which both Stiglitz and Stockman object?

Stiglitz argues that "[w]hen one interest group holds too much power, it succeeds in getting policies that benefit itself, rather than policies that would benefit society as a whole. When the wealthiest use their political power to benefit excessively the corporations they control, much-needed revenues are diverted into the pockets of the few instead of benefiting society at large."[19] Stockman agrees, saying that our government "is no longer a system of democratic choice and governance: it is a tyranny of incumbency and money politics."[20] He goes on to say that "the gangs of

12 Stiglitz, *The Price of Inequality*, p. 54.
13 Stockman, *The Great Deformation*, p. 181.
14 Stiglitz, *The Price of Inequality*, p. 40.
15 Stiglitz, *The Price of Inequality*, p. 59.
16 Stockman, *The Great Deformation*, p. 560.
17 Stockman, *The Great Deformation*, p. 606.
18 Stiglitz, *The Price of Inequality*, p. 59.
19 Stiglitz, *The Price of Inequality*, pp. 104–105.
20 Stockman, *The Great Deformation*, p. 672.

crony capitalism will fight tooth and nail to preserve their slice of an imperiled pie, thereby disenfranchising even further ordinary taxpayers and citizens who have no voice in the Washington policy auctions."[21] Both Stiglitz, on the left, and Stockman, on the right, tell their readers that the process is controlled by the elite for their benefit, at the expense of the general public.

In a chapter entitled "A Democracy in Peril," Stiglitz argues,

> Politics is a battleground for fights over how we divide the nation's economic pie. It is a battleground that the 1 percent have been winning . . . In earlier chapters we saw how markets are shaped by politics: politics determines the rules of the economic game, and the playing field is slanted in favor of the 1 percent. At least part of the reason is that the rules of the political game, too, are shaped by the 1 percent.[22]

Stockman agrees. "Trying to improve capitalism, modern economic policy has thus fatally overloaded the state with missions and mandates far beyond its capacity to fulfill. The result is crony capitalism – a freakish deformation that fatally corrupts free markets and democracy."[23] Stiglitz observes, "There has been class warfare going on for the past 20 years and my class has won."[24] As Stiglitz sees it, rising inequality, to a large extent, "is the result of government policies."[25] Stockman concludes,

> A government which is responsible for every bob and weave of the entire national economy will quickly succumb to pure crony capitalism, a regime which cannot avoid eventual fiscal insolvency and the destruction of any semblance of a free market economy . . . More importantly, it means a fatal corruption of political democracy.[26]

The similar views of Stiglitz, on the left, and Stockman, on the right, with regard to the control the elite exercise over economic policy and political power reinforce Nader's observation that throughout the political spectrum, people agree that this is a problem. Nader calls it corporatism, Stockman calls it crony capitalism, and Stiglitz refers to the domination of the 1 percent using the language of the Occupy movement. The nearly interchangeable quotations from Stiglitz and Stockman indicate that they are lamenting the same problems, and while quotations from these two were chosen for a close comparison, they are far from alone in their

[21] Stockman, *The Great Deformation*, p. 692.
[22] Stiglitz, *The Price of Inequality*, pp. 148–149.
[23] Stockman, *The Great Deformation*, p. 52. [24] Stiglitz, *The Price of Inequality*, p. 225.
[25] Stiglitz, *The Price of Inequality*, p. 102. [26] Stockman, *The Great Deformation*, p. 614.

observations.[27] The domination of the economic and political elite is perceived, across the political spectrum, as a significant threat to both the economic and political systems.

Despite the very similar description of the problems with the political and economic system expressed by Stiglitz and Stockman, they offer very different policy recommendations. Stiglitz argues that more popular awareness of the problem can lead to policies that will enable government priorities to shift toward policies that benefit the general public. Better regulations and more government intervention in economic affairs can turn the balance. Stockman sees no reason to think that the situation can be reversed. In Stockman's view, big government is the problem, and the (perhaps unattainable) solution would be to drastically cut back government. Whereas Stockman sees less government as the solution, Stiglitz sees more government as the solution.

One might question whether circumstances are really as dire as the picture painted by Stiglitz and Stockman, but to answer that question requires an understanding of the workings of political capitalism. Rather than answer that question directly, this volume lays out a theoretical framework within which it can be analyzed. Noting the very different policy conclusions of Stiglitz and Stockman – is more government control of the economy called for, or less? – again, the question can be answered only with a good understanding of how the system works.

POLITICAL CAPITALISM: WHAT'S IN A NAME?

The term "political capitalism" was first used by sociologist Max Weber in his 1922 book, *Economy and Society*, to describe the political and economic systems of ancient Rome.[28] Weber notes five different forms of capitalistic profit-making opportunity. In one, he says, "It may be orientation to opportunities for predatory profit from political organizations or persons connected with politics. This includes the financing of wars or revolutions and the financing of party leaders by loans and supplies."[29] In another, Weber says, "It may be orientation to profit opportunities in unusual transactions with political bodies."[30] These two types, he continues, "will

[27] Holcombe, "What Stiglitz and Stockman Have in Common," gives a substantial number of others with similar views.

[28] The book was originally published posthumously in German in 1922. An English translation appears as Max Weber, *Economy and Society: An Outline of Interpretive Sociology*, edited by Guenther Roth and Claus Wittich (New York, NY: Bedminster Press, 1968).

[29] Weber, *Economy and Society*, p. 164.

[30] Weber, *Economy and Society*, p. 165.

be treated together as 'politically oriented capitalism.'"[31] Weber notes, "It is clear from the very beginning that the politically oriented events and processes which open up these profit opportunities exploited by political capitalism are irrational from an economic point of view – that is, from the point of view of orientation to market advantages and thus to the consumption of needs of budgetary units."[32]

Sociologist John Love argues that Weber did not fully develop the concept. "Whereas Weber developed the ideal type of rational capitalism to a high degree . . . unfortunately the same cannot be said of his concept of political capitalism." Love goes on to define Weber's concept as "the exploitation of opportunities for profit arising from the exercise of political power (ultimately violence)."[33]

Historian Gabriel Kolko adopted Weber's term "political capitalism" to describe the American political and economic systems that developed during the Progressive Era, which he dates from 1900 to 1916.[34] The title of this volume comes directly from Kolko's use of the term, and the political capitalism he describes as characterizing the Progressive Era is a good example of the political and economic system this volume analyzes.[35]

The conventional wisdom on the Progressive Era is that government imposed regulation on business to limit the ability of those with concentrated economic power from using it to the detriment of the masses. Prior to the Progressive Era, Americans viewed the role of government as protecting individual rights. The Progressive ideology expanded the vision of the role of government beyond just protecting individual rights to also looking out for people's economic interests.[36] At its founding, the nation

[31] Weber, *Economy and Society*, p. 166.

[32] Weber, *Economy and Society*, p. 166. Weber says in a footnote on p. 1464, "The idea that Roman law promoted capitalism is part of the nursery school lore of the amateurish literati: Every student must know that all the characteristic legal institutes of modern capitalism (from the share, the bond, the modern mortgage, the bill of exchange and all kinds of transaction forms to the capitalist forms of association in industry, mining, and commerce) were completely unknown to Roman law and are of medieval, in part of Germanic origin. Moreover, Roman law never got a foothold in England, where modern capitalism originated."

[33] John R. Love, *Antiquity and Capitalism: Max Weber and the Sociological Foundations of Roman Civilization* (London: Routledge, 1991), p. 4.

[34] Gabriel Kolko, *The Triumph of Conservatism: A Reinterpretation of American History, 1900–1916* (New York, NY: The Free Press, 1963).

[35] I have also used the term as the title of my article, "Political Capitalism." *Cato Journal* 35, no. 1 (Winter 2015), pp. 41–66.

[36] A good discussion of the change in American ideology during the Progressive Era is found in Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (Oxford: Oxford University Press, 1987).

was mostly agrarian, but as the country became increasingly industrialized, economic power became increasingly concentrated. The popular opinion regarding the new captains of industry, often referred to as Robber Barons, was that they were using their economic power to take advantage of workers, farmers, and small businesspeople. Progressive Era regulation was designed to protect the economic interests of the general population against the concentrated economic power held by a few, in keeping with the new Progressive ideology.

Kolko challenged the conventional wisdom, stating:

> Progressivism was initially a movement for the political rationalization of business and industrial conditions, a movement that operated on the assumption that the general welfare of the community could best be served by satisfying the concrete needs of business. But the regulation itself was invariably controlled by leaders of the regulated industry, and directed toward ends they deemed acceptable or desirable . . . It is business control over politics (and by "business" I mean the major economic interests) rather than political regulation of the economy that is the significant phenomenon of the Progressive Era.[37]

This is what Kolko calls political capitalism. Regulation, nominally designed in the public interest, was in fact designed by the economic elite for their benefit, to aid them in maintaining their elite status by preventing competitors from rising up to challenge them. Kolko's book has its critics, and the purpose of this section is to give Kolko credit for developing the idea of political capitalism, not to defend or even analyze his recounting of the historical facts. The present volume describes the theoretical foundations of political capitalism, not its history.[38]

Political capitalism is more than just an explicit recognition that politics influences the economic system – an idea that is well recognized by both academics and the general public. Rather, it is a system in which the political and economic elite design rules so that they can use the political system to maintain their elite positions. The idea has become more prominent as a result of the economic events in the early twenty-first century. Government bailouts of firms following the recession of 2008, subsidies to firms with political connections, and even Federal Reserve policy that has aided the banking industry have been called crony capitalism. The Occupy Wall Street movement that began in 2011 recognized the concept of political capitalism, calling the beneficiaries of government policies the

37 Kolko, *The Triumph of Conservatism*, pp. 2–3.

38 Some historical details, both in the United States and elsewhere in the world, appear in Randall G. Holcombe and Andrea M. Castillo, *Liberalism and Cronyism: Two Rival Political and Economic Systems* (Arlington, VA: Mercatus Center, 2013).

1 percent and contrasting them with the 99 percent who were often left to bear the costs of policies that favored the 1 percent. The phenomenon deserves a more systematic analysis.

THE COMPONENTS OF POLITICAL CAPITALISM

During the Cold War era, it was common to analyze nations as having distinct political and economic systems. Both economic and political systems were depicted as variations along a single-dimensioned continuum. Political systems were characterized as democracies or dictatorships, with intermediate cases falling between the extremes, and economic systems were characterized as capitalist economies or socialist economies, again with intermediate cases. The political division between democracy and dictatorship remains a current part of political analysis.[39] The analysis of economic systems has fallen out of favor since the end of the Cold War. More commonly, rather than looking at where economies fall along the capitalism–socialism continuum, they are analyzed in terms of the degree to which they rely on markets and the degree to which there is government oversight and control of economic activity. There is a substantial academic literature on public policy as it relates to a market economy which provides a foundation for a theory of political capitalism, but that literature has not been developed within the context of comparative political and economic systems. It has analyzed the consequences of government interference and oversight of market activity.

One goal of the following chapters is to place that well-established literature within an economic systems context to show how it supports a theory of political capitalism as a distinct economic system. Economists (and others) will be familiar with theories of rent-seeking, regulatory capture, and interest group politics. Integrating those ideas into an "economic systems" framework points toward the system of political capitalism. It is not some combination of capitalism and socialism, or an intermediate form between them. It is a distinct economic system.

Another one of the building blocks of a theory of political capitalism is elite theory, which has a long tradition in political science and sociology. The recognition of a division between elites and masses is widespread in the general population, who decry the cronyism that gives insiders advantages not available to most people, and that favors the 1 percent over the

[39] A common source of data for empirical analysis of political regimes is the Polity IV Project, which can be found at www.systemicpeace.org/polity/polity4.htm.

99 percent. Issues with interest group politics have been raised throughout the twentieth century and into the twenty-first. Economists have done a substantial amount of research analyzing the mechanisms through which rent-seeking and regulatory capture convey advantages to some at the expense of others, but have barely recognized the significance of elite theory to their analysis.

The development of public choice theory, which accelerated in the 1960s, offers a substantial contribution to the understanding of political capitalism. In the 1800s, economics and politics were studied together under the heading of "political economy." Around the beginning of the twentieth century, the two disciplines split into economics and political science, and one result was that economics focused its attention on the way markets allocate resources, and on optimal public policies to manage resource allocation, leaving out any analysis of political decision-making. That fell under the heading of political science, a different discipline. Economists focused on how resources could, in theory, be most efficiently allocated, and when there were problems such that resources would not be allocated as efficiently as theoretically possible, economists would derive optimal solutions with the idea that the information could guide policy-makers to implement those solutions. If resources were not allocated perfectly efficiently, economists called that market failure, and the (often unstated) assumption was that government intervention could correct those market failures.[40] How would government do that? The answer to that question fell to political scientists. Economists analyzed resource allocation. Political scientists analyzed the public policy process. This division between economics and political science began to erode in the 1960s with the development of the subdiscipline of public choice, but the division remains largely intact even into the twenty-first century.

This type of economic policy analysis compares the real-world market economy, which is not perfect, with the theoretically ideal allocation of resources and calls anything that falls short of the theoretical ideal a market failure, regardless of whether that theoretical ideal could be attained in

[40] A good example of this line of reasoning is in two articles by Francis M. Bator, "The Simple Analytics of Welfare Maximization," *American Economic Review* 47, no. 1 (March 1957), pp. 22–59, and "The Anatomy of Market Failure," *Quarterly Journal of Economics* 72, no. 3 (August 1958), pp. 351–379. The first article describes how resources are most efficiently allocated. Any deviation from the welfare maximum is named a market failure, and the second article explains what causes them. The unstated but implied conclusion is that if the market fails, public policy to remedy the failure is warranted.

practice. The practical impediments to attaining that theoretical ideal fall into two categories. First, the information necessary to reach the theoretical optimum often is not available to policymakers. Second, regardless of whether the information is available, policymakers may not have the incentive to implement an optimal policy.

Conventional wisdom frequently seems to offer a better understanding of these two problems than academic analysis. One can look at public policy debates that go on between experts all the time. During a recession, some economists will argue that the government needs to apply more stimulus spending to help the economy rebound; others will argue that government intervention in the economy is slowing the economy rather than helping it. The point is that experts disagree about the best policy because the information they need to identify it is not available to them. Similarly, while people might optimistically hope that policymakers always design policies to further the public interest, it is common knowledge that elected officials often promote policies because it will help them to be reelected, and bureaucrats will often pursue policies to increase their budgets or lessen their workloads, setting aside the public interest to do what is in their own interest.

The academic subdiscipline of public choice uses economic methods to analyze political decision-making. Rather than just assuming – unrealistically – that policymakers will implement the optimal policy, public choice examines the information available to policymakers and the incentives they face to analyze the types of decisions that will actually be made by real-world policymakers, comparing the real-world public sector with the real-world private sector. Even if there are market failures following the economist's definition, that does not mean that government can do any better. Government failures can be worse than market failures.[41]

The public choice literature has identified two problems with government intervention in the economy that are especially relevant to political capitalism: rent-seeking and regulatory capture. Rent-seeking occurs when private interests try to get policymakers to enact policies that produce benefits for themselves at the expense of the general public. Regulatory capture occurs when regulatory agencies, which nominally regulate for the public interest, are captured by those they regulate so

[41] This line of reasoning is explained by James M. Buchanan, "Public Finance and Public Choice," *National Tax Journal* 28, no. 4 (December 1975), pp. 383–394. See also Randall G. Holcombe, *Advanced Introduction to Public Choice* (Cheltenham, UK: Edward Elgar, 2016) for an introduction to the fundamental concepts of public choice theory.

that regulations work to the advantage of those who are regulated rather than for the public interest. The public choice approach to analyzing public policy provides an analytical framework for understanding why public policy often favors some groups and individuals over others. Rather than assuming that government acts as an omniscient benevolent dictator, public choice takes into account the information and incentives facing those who design public policy.[42]

Government is not omniscient. Policymakers do not have all the information necessary to allocate resources to match the theoretically optimum welfare maximum. Government is not benevolent. People in government look out for their own interests just as people do in the private sector. Their incentives need to be taken into account to understand how public policy works in the real world. And, government is not a dictator. In democratic governments, no one person can make public policy alone. There are always compromises that must be made to implement policy through the political process. Even in dictatorships, the dictator cannot implement policy without the support of other groups, often including the military, but also incorporating others who might have the power to disrupt the regime.

The public choice approach to public policy takes into account the way the political process actually works, and its analysis of interest group politics, rent-seeking, and regulatory capture provides building blocks for a theory of political capitalism. But whereas public choice has clearly recognized that public policy often favors some interests over others, it has not incorporated the elite theory that has a long tradition in other social sciences to recognize that some people have the connections that allow them to be consistently favored, whereas others are among the masses who bear the costs of those policies. The theoretical building blocks are there, but have not been assembled into a coherent theory of political capitalism.

POLITICAL CAPITALISM AND THE WELFARE STATE

While there is a close association between political capitalism and big government, they are not the same thing. Both political capitalism and the welfare state find their origins in the Progressive Era ideology that expanded the popular view of the role of government beyond just

[42] I have discussed this idea further in Randall G. Holcombe, "Make Economics Policy Relevant: Depose the Omniscient Benevolent Dictator," *The Independent Review* 17, no. 2 (Fall 2012), pp. 165–176.

protecting individual rights to also looking out for people's economic well-being. The welfare state is designed to provide a safety net for those who face economic difficulties, so implies transfer programs and the provision of services like health care and education. The ideological foundation of political capitalism rests on the idea that government intervention can manage some of the problems associated with capitalism, ranging from the concentration of economic power to externalities resulting from economic activity to economic instability. The foundation of the welfare state is transfers, whereas the foundation of political capitalism is government management of economic activity.

The motivations of these two different types of economic policy are clearly different, but one might question whether, ultimately, they are different in their effects. Taking into account the political process that produces public policies, in both cases groups of people have the incentive to create policies for their own benefit. Both types of policies are likely to create unintended negative consequences. The idea that the welfare state reduces people's incentives to engage in productive activity is well known, and the creation of welfare traps, where people would find themselves materially worse off if they left welfare and took jobs, can keep people in poverty.[43] Viewing political capitalism as an unintended consequence of policies designed to manage the economy paints a slightly different picture. The unintended consequences of the welfare state mostly harm those whom the policies are intended to help (although the disincentive effects of higher taxes affect everyone), and nobody enjoys unintended positive consequences. The unintended consequences of political capitalism also tend to be negative for those whom the policies are designed to help, but they have positive consequences for the people they are trying to restrain: the economic elite.

There is no direct connection between big government or the welfare state and political capitalism. The welfare state is more associated with government spending while political capitalism is more closely associated with the regulatory state. But there may be an indirect connection in that more government spending offers more of an opportunity for cronies to negotiate for a share, and higher taxes also give cronies an incentive to lobby for tax breaks targeted for their benefit. More government spending also offers a greater opportunity for subsidies to the economic elite. Government subsidies overwhelmingly benefit the 1 percent rather than the 99 percent.

[43] Charles Murray, *Losing Ground: American Social Policy, 1950–1980* (New York, NY: Basic Books, 1984) was a very influential book on the subject.

Looking at government corruption that may be associated with cronyism, it appears that those activities are more closely associated with government regulation than with government spending. Scandinavian countries, for example, apparently have relatively little corruption despite their high levels of government spending. But while Scandinavian countries have large public sectors and generous welfare states, they have relatively low levels of regulation of economic activities.[44] Regulations designed to constrain people's economic activities inevitably set up incentives for bribery and corruption to avoid them. Under-the-table payments are not recorded, so audits will not reveal them. On the spending side, embezzlement, or redirection of government funds to cronies, often will be detectable through audits and public records. One can see why regulation is more likely to lead to favoritism and corruption than government spending.

IS POLITICAL CAPITALISM A NATURAL EVOLUTIONARY EXTENSION OF CAPITALISM?

One objection to the term "political capitalism" is that it unfairly maligns capitalism by misrepresenting its nature. This objection has some merit, especially if, as argued in Chapter 2, political capitalism is a distinct economic system that is not actually capitalism. The objection loses some of its force if there is a tendency for market capitalism to evolve into political capitalism over time. One of the questions about political capitalism is whether there is such a tendency.

The issue is related to some degree to whether there is a tendency for government to grow in capitalist economies. Everything government does ultimately is always backed by force. No matter how much citizens approve of what their governments do, the use of force backs up a government's demands that citizens pay their taxes and abide by government regulations.[45] Government is not an abstract entity. People are entrusted with the power that government has to force its policies on its citizens. If government has a tendency to grow – an interesting question in itself – then the power wielded by those within the government will also grow. As it does, there may be a tendency for the people who have the power to

[44] For some evidence, see Christopher J. Boudreaux and Randall G. Holcombe, "Regulation and Corruption," *Public Choice* 164, no. 1 (July 2015), pp. 75–85.

[45] This point is emphasized by Leland B. Yeager, "Rights, Contract, and Utility in Policy Espousal." *Cato Journal* 5, no. 1 (Summer 1985): 259–294, and *Ethics as a Social Science: The Moral Philosophy of Social Cooperation* (Cheltenham, UK: Edward Elgar, 2001).

use it for their own benefit. If that power is held by an elite group with limited membership, cronyism is the likely result.

Government growth leads to increasing private sector rent-seeking for special interest benefits. The larger government is, the more power it has to favor the interests of certain groups, providing an incentive for businesses to shift their search for profits toward the seeking of politically conveyed privileges.[46] As political capitalism becomes more firmly entrenched, it also leaves business leaders with little alternative than to try to build those connections that can allow them to attain government favors. In an economic system in which profitability is determined by political connections and cronyism, participation in the system is a condition of economic survival.

Mancur Olson, in his *The Rise and Decline of Nations*, concludes that as political systems mature, interest groups become increasingly well connected to those with political power, leading to an economy that is driven more by political favoritism than by economic efficiency.[47] That growth in interests leads to the decline of nations. Market institutions become compromised by interest group politics, and if those interests are dominated by insiders and cronies, the result is political capitalism. It may also be, as Olson suggests in his book *Power and Prosperity*, that economic growth brings with it government growth, because more complexity in economic contracts and transactions requires more government protection and oversight.[48]

Is there some way to design political and economic institutions to prevent this from happening? One long-standing answer is democracy. If government is accountable to the people, it will represent their interests rather than the interests of the elite. Another answer is constitutional constraints on the power of government. A government with limited powers will have a limited ability to exploit the general public for the benefit of the elite. Both of these mechanisms were a part of the design of

[46] William J. Baumol, *Entrepreneurship, Management, and the Structure of Payoffs* (Cambridge, MA: MIT Press, 1993) and "Entrepreneurship: Productive, Unproductive, and Destructive." *Journal of Political Economy* 98, no. 5, Part 1 (October 1990), pp. 893–921, has emphasized the importance of institutions in directing entrepreneurial individuals toward productive rather than destructive activities.

[47] Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven, CT: Yale University Press, 1982).

[48] Mancur Olson, Jr., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York, NY: Basic Books, 2000). This idea also appears in Geoffrey M. Hodgson, *Conceptualizing Capitalism: Institutions, Evolution, Future* (Chicago, IL: University of Chicago Press, 2015).

the government of the United States, so evidence exists to evaluate how well these institutions can function to limit political capitalism.[49]

While one might hope that public policymakers enact policies that are in the public interest, policymakers have their own interests that may at times be at odds with the public interest,[50] and even if they really try to promote the public interest, there may be unintended negative consequences of the policies they enact. The general public is well aware that elected officials often pursue policies that help them to be reelected rather than those that might be in the public interest, and government bureaucrats too have limited incentives to pursue the public interest.[51] Anyone who deals with them can attest to that fact. So, an academic study of political economy should be hard pressed to just assume that policymakers act in the public interest and ignore these facts that are common knowledge.

More ominously, Friedrich Hayek suggests that the power of government attracts the people who are most willing to use it to coerce others into complying with their mandates. In Hayek's words, the worst get on top.[52] There are reasons to think that growing government will bring with it a loosening of constraints on those who hold government power, that those who hold that power will use it to maintain their positions of power, and that public policy will increasingly drift toward providing benefits for cronies and insiders at the expense of the general public, pushing market capitalism increasingly toward political capitalism. If this is the case, then while market capitalism and political capitalism are different economic systems, they are closely enough related that the name should serve as a warning.

CONCLUSION

Gabriel Kolko referred to the economic and political system that emerged during the Progressive Era as "political capitalism," using the term the same way as it is used here. In the twenty-first century there is widespread popular opinion siding against cronyism and policies that favor the

[49] I have questioned how well these institutions have worked in *From Liberty to Democracy: The Transformation of American Government* (Ann Arbor, MI: University of Michigan Press, 2002).

[50] This argument is made by James M. Buchanan, "Public Finance and Public Choice," cited earlier.

[51] William A. Niskenen, *Bureaucracy and Representative Government* (Chicago, IL: Aldine-Atherton, 1971) explores the broader implications of incentives facing bureaucrats.

[52] "Why the Worst Get on Top," Chapter 10 in Friedrich A. Hayek, *The Road to Serfdom* (Chicago, IL: University of Chicago Press, 1944).

1 percent over the 99 percent, essentially arguing that the capitalist system has evolved into political capitalism. To really analyze the issue requires a more detailed examination that describes how the system works and develops a theory of political capitalism. A theoretical foundation for understanding political capitalism already exists in the academic literature in economics and political science, but it exists in a number of separate concepts that have not been linked together to produce an integrated theory. The first step, then, is to link them together to provide a better understanding of political capitalism which can then be used to address a number of policy questions.

2

Political Capitalism as an Economic System

During the Cold War era, "comparative economic systems" was an area of inquiry within economics that received serious academic attention. Most universities offered a course in comparative economic systems at the undergraduate level, and a number of college textbooks were published for use in such courses. Comparative economic systems focused mainly on the differences between capitalism and socialism – that is, between a market allocation of resources and government allocation of resources. *Comparative Economic Systems*, published in 1973 by Willian Loucks and William Whitney, is typical of the textbook offerings at the time.[1] After an introductory section, it contains one part on capitalism and four parts on socialism, showing the emphasis in this area of inquiry on an analysis of central economic planning. Some books also analyzed fascism as a distinct economic system in addition to capitalism and socialism.[2] The major questions were how central economic planning was undertaken in practice, and whether government planning was a better way to allocate resources than markets, with the caveat that all real-world economies have elements of both.

After the collapse of the Berlin Wall in 1989 followed by the breakup of the Soviet Union in 1991, comparative economic systems fell out of favor as an area of study within economics. Capitalism had won the battle of economic systems, not because it scored an intellectual victory, but because of the breakdown of the centrally planned economies. Indeed, intellectual

[1] William N. Loucks and William G. Whitney, *Comparative Economic Systems*, 9th edn. (New York: Harper & Row, 1973). The first edition of this textbook was published in 1939, with Loucks as the sole author, indicating that this was a longstanding area of economic inquiry.

[2] George P. Adams, Jr., *Competitive Economic Systems* (New York: Thomas Y. Crowell Company, 1955) is an example.

opinion was divided, but leaned in favor of central planning right up until the time that historical events demonstrated its practical problems. The focus of economic systems shifted in the 1990s to the study of economies in transition – those former centrally planned economies that were transitioning to market-based economies. Decades later, the issue of transition has receded, and the idea of economic systems plays, at best, a minor role in economic analysis. All economies are analyzed as a combination of a market sector combined with government oversight and some government production. Government is viewed primarily as a means for mitigating some undesirable effects of market activity rather than as a way to plan economic activity centrally.

FROM ECONOMIC SYSTEMS TO GUIDING THE MARKET

Almost until the collapse of the centrally planned economies, there was a substantial economic debate on the merits of central economic planning. The strongest opponent of central economic planning was Ludwig von Mises, who published his book *Socialism* in 1922, shortly after the formation of the Soviet Union in 1917. Mises claimed that rational economic calculation could not take place without markets and market prices.[3] Perhaps the most articulate spokesman for Mises's position was his student Friedrich Hayek, who presented compelling academic arguments about the necessary role that markets and market prices play in effectively allocating economic resources.[4] Milton Friedman was perhaps the best-known proponent of capitalism during the Cold War era. Friedman had not only a substantial academic influence but also influenced Ronald Reagan, Margaret Thatcher, and other political leaders.[5] While Friedman was well respected among both academics and policymakers, his ideas were often viewed as extreme, and this was even more true of Hayek and especially Mises, who was marginalized in the economics profession for ideas that many economists considered discredited.

Friedman's position that capitalism works better than central planning to allocate resources was more moderate than Mises's claim that rational

[3] The book was originally published in German and translated into English. See Ludwig von Mises, *Socialism* (New Haven, CT: Yale University Press, 1951).

[4] See Hayek's well-known article, "The Use of Knowledge in Society," *American Economic Review* 35 (1945), pp. 519–530, and his book, *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1944).

[5] Friedman's book, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), is probably his best-known defense of capitalism.

economic planning is not possible under central economic planning. Friedman's claim was that markets produce better outcomes than central economic planning, not that rational allocation of resources was not possible without markets and market prices. After the publication of *Socialism*, Mises received almost immediate pushback from the proponents of central planning. Oskar Lange and Fred M. Taylor published a book, *On the Economic Theory of Socialism*, in which they offered a demonstration of how, in theory, central planners could exactly mimic the way a market economy allocates resources.[6] In the preface they sarcastically thank Mises for emphasizing the important issue of how central planners can allocate resources. They develop a framework to claim that while central planning could mimic a market allocation, the advantage of central planning is that planners can overcome some problems of the market to increase economic growth, so central planning is an even better way to allocate resources. Abba Lerner followed up with a well-known book, ominously titled *The Economics of Control*, further explaining how central planning can improve the allocation of economic resources, and touting the advantages of central economic planning.[7] These economists argued that economies can allocate resources more efficiently when they are directed by experts rather than just leaving things up to the decentralized decisions of a multitude of consumers and producers in a market system.

Both Friedman and Hayek were critical of this analysis, arguing that the proponents of central planning ignored many of the important functions of markets, especially regarding their ability to best utilize the decentralized information that all market participants have and to coordinate economic activity in an economy with continually changing information.[8] This debate between the proponents and opponents of central economic planning, known as the socialist calculation debate, focused directly on the question of how central economic planning can allocate resources. Economists since the time of Adam Smith had a good idea of how markets allocated resources, which turned most issues in the socialist calculation debate toward the design of a centrally planned economy.

[6] Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (Minneapolis, MN: University of Minnesota Press, 1938).

[7] Abba Lerner, *The Economics of Control: Principles of Welfare Economics* (New York: Macmillan, 1946).

[8] See Milton Friedman, "Lerner on the Economics of Control," *Journal of Political Economy* 55, no. 5 (October 1947), pp. 405–416, and Hayek, "The Use of Knowledge in Society," cited earlier.

The conventional wisdom among economists during the Cold War era leaned heavily toward the side of central economic planning. Economists generally thought that the theoretical arguments supporting economic planning refuted Mises's claim, and on the practical side, proponents pointed toward the Soviet Union as evidence that not only could central economic planning work in theory, it was working in practice. Nobel Laureate Paul Samuelson, one of the most influential economists in the second half of the twentieth century, argued in the 1973 edition (the year Ludwig von Mises died) of his best-selling introductory economics textbook that while per capita income in the Soviet Union was only about half that of the United States, their superior economic system produced more economic growth. Samuelson projected that the Soviet Union would catch up to the United States in per capita income perhaps as soon as 1990 but almost surely by 2010.[9] By the 1980 edition, that prediction was pushed back to having the Soviet Union catching up perhaps by 2000 and almost surely by 2020, although noting that the Soviet Union's growth had slowed. By 1985 Samuelson said, "There remains a large gap between the most advanced capitalist countries and the Soviet Union, and that gap is not closing."[10] Samuelson's position slowly evolved toward skepticism, but even a decade before the collapse of the Berlin Wall, he saw central economic planning as the more productive system, a view shared by a substantial fraction of the economics profession.

The emphasis on economic calculation naturally points toward a comparative approach in studying economic systems. The role of the market forces of supply and demand had long been a staple of economic analysis, and the way that the invisible hand of the market leads individuals who are pursuing their own interests to act in the interest of everyone has been a part of economic analysis since Adam Smith used the phrase in 1776.[11] Meanwhile, economists since Lange, Taylor, and Lerner were refining the theory of central economic planning, coming up with new algorithms for allocating resources and drawing off the experiences of the centrally planned economies that had been operating for decades. The focus of comparative economic systems was comparing the effectiveness of markets within capitalism versus central economic planning within socialism in the allocation of economic resources.

[9] Paul A. Samuelson, *Economics*, 9th edn. (New York: McGraw-Hill, 1973), p. 883.

[10] This appeared in the 11th edition of *Economics*, in 1985, p. 776. This is the first edition of the book that is coauthored with William D. Nordhaus.

[11] Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937 [orig. 1776]).

The collapse of the centrally planned economies put a quick end to that line of analysis. The former proponents of central economic planning, who had ridiculed Mises during his lifetime for his view that the rational allocation of economic resources cannot take place under central economic planning, were now looking back and concluding that Mises was right.[12] The 1990s saw a wholesale ideological movement toward advocating the market allocation of resources, and into the twenty-first century the few remaining nations relying on central economic planning – North Korea, Cuba, Venezuela – provided further evidence on the problems with central economic planning. Comparative economic systems as a field of study fell by the wayside because there was nothing left to compare.

While capitalism won out over socialism, almost everybody would agree that government should play an important role in the economy.[13] First and foremost, following the ideology that led to the American Revolution, government is the protector of individual rights. In addition to protecting individual rights, the Progressive Era ideology, which took root in the late 1800s, also viewed looking out for people's economic well-being as a vital role of government.[14] Antitrust laws and regulation of business characterized the government interventions in the late 1800s and early 1900s. The Great Depression left people with a greater feeling that the government has a role to play in managing the economy.[15] Meanwhile, the theoretical framework of welfare economics provided a benchmark for judging the allocation of economic resources. In theory, a competitive market economy allocates resources as efficiently as possible.[16] Any

[12] Robert L. Heilbroner, "The Triumph of Capitalism." *The New Yorker* (January 23, 1989): 98–109.

[13] There is a free market anarchist movement that promotes the idea that market institutions could do everything government does, and do it better. A key work in this movement is Murray N., *For a New Liberty: The Libertarian Manifesto* (New York: Macmillan, 1973). See also David D. Friedman, *The Machinery of Freedom: Guide to Radical Capitalism* (Chicago: Open Court Publishing Company, 1973).

[14] Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (Oxford: Oxford University Press, 1987) gives a good accounting of the effects of this ideological shift.

[15] The ideas of John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace and Company, 1936), were influential in guiding both academic and popular opinion on this subject. Not all economists have been supportive of Keynes's influence. See James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

[16] A proof of this proposition, authored by two Nobel Laureates, appears in Kenneth J. Arrow and Gerard Debreu, "Existence of an Equilibrium for a Competitive Economy," *Econometrica* 27, no. 3 (1954): 265–290.

deviation from this theoretical ideal is labeled a market failure, and economists were able to identify many deviations.

After the collapse of the centrally planned economies, the issue was no longer capitalism versus central economic planning, but what policies are best suited toward guiding a market economy toward an efficient and stable allocation of resources. The visible hand of government can be applied to augment the invisible hand of the market to improve economic welfare. Partly, this is a matter of controlling economic downturns and allocating resources more efficiently, but partly it is also a matter of fairness and compassion. Capitalist economies may generate economic inequality that is generally viewed as undesirable, and there is widespread support for policies that improve the economic well-being of those at the bottom end of the income distribution.

Since the 1990s, the emphasis on economic systems has faded. The market system is the economic system, and the economic policy emphasis has become how government interventions can improve the performance of a market economy. Rather than taking a comparative systems approach, these interventions are analyzed as individual policies to address specific problems. Some policies are designed to address externalities and environmental issues. Other policies are designed to regulate and control potential abuses of big business. Different policies address potential instability in the banking and financial sector. Inequality and assistance to those at the bottom end of the income distribution warrant another set of policies.

Interventions are analyzed not together as a system for managing an economy, but individually, as corrections for individual problems. All of these various policies have common elements in that they increase the scope of government, and because they are designed by those with political power, they enhance the discretionary power of the political elite. When aggregated, they modify the market economy by interfering with the market mechanism that allocates resources, augmenting it with a political mechanism. They push the economic system of capitalism toward the different and distinct system of political capitalism, but government interventions are not seen this way because each policy is analyzed individually rather than envisioned as a part of a larger system.

POLITICAL AND ECONOMIC SYSTEMS

Economics and politics were studied together as political economy through the end of the 1800s, but after the division of political economy into economics and political science at the beginning of the twentieth century, economic systems and political systems were analyzed separately. Both political and economic systems were analyzed as existing somewhere along a single-dimensioned continuum. The taxonomy of political systems ran from dictatorship to democracy, and the taxonomy of economic systems ran from capitalism to socialism. Real-world economic and political systems were mixtures of the ideal types. Economies tended to be a mixture of the market systems that characterized capitalism and government control of the economy that characterized socialism, for example, and similarly, real-world nations differed in the degree to which they were democratic or dictatorial. Economic and political systems were viewed as independent of each other, so nations could find themselves with any combination of economic and political systems. Figure 2.1 illustrates this two-dimensional Cold War-era taxonomy of political and economic systems.

The horizontal axis measures where nations lie in the capitalism–socialism economic dimension and the vertical axis shows where they are in the democracy–dictatorship dimension. Using that taxonomy, the United States was the prototypical capitalist democracy, and the Cold War-era Soviet Union was the prototypical socialist dictatorship. Any combination of political and economic systems was viewed as possible. Nations could be more or less capitalist, and more or less democratic. Envisioning ideal types, late-twentieth-century Sweden was commonly

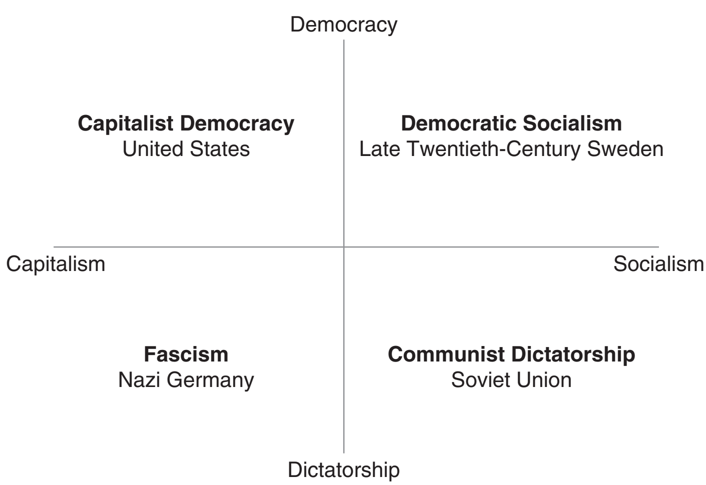

Figure 2.1 Economic and Political Systems

viewed as an example of democratic socialism while the fascism that characterized Nazi Germany was viewed as an example of a capitalist dictatorship.[17]

Any taxonomy like this is surely an oversimplification that obscures differences among systems, and reasons why this is an oversimplification will be discussed below. But first consider the value of this taxonomy in the context of the Cold War systems debate. For the most part, the Cold War divided many nations into Eastern bloc nations and Western bloc nations. The Eastern bloc consisted of the Soviet Union and its Eastern European client states behind the Iron Curtain, along with China, Cuba, North Korea, and other communist dictatorships. Western bloc nations were the United States, Western Europe, and their political allies. The ideological battle pitted nations in the upper-left quadrant of Figure 2.1 against those in the lower-right. Ideologically, that upper-left to lower-right division breaks down to more economic and political freedom versus less. Consider again the title of Abba Lerner's book, *The Economics of Control*. The Eastern bloc represented governments exercising more economic and political control, while the Western bloc represented more economic and political freedom.

The West promoted market economies and democratic governments both before and after the fall of the Berlin Wall, but clearly promoted democracy more than capitalism. As already noted, central economic planning had a fair amount of support among academic economists prior to the fall of the Berlin Wall, as did the welfare state, as distinct from central economic planning. In the 1990s the message from the West to the transitioning former Eastern bloc countries was that they should transition to democratic governments more than to capitalist economies. Government intervention into the economy remained politically popular in the West. Even as the Cold War progressed, Western bloc countries had growing governments, measured both by expenditures and by regulatory intervention into the economy. Government intervention continues to be supported among academic economists who see reasons for economic policies to correct the failures of the market.

The taxonomy in Figure 2.1 presents a good overview of the twentieth-century vision of political and economic systems, but there are enough nuances that it is worth examining the ideal types in more detail. There is more variety in political and economic systems than that diagram reveals.

17 I have discussed this taxonomy in more detail in Randall G. Holcombe, "Liberty and Democracy as Economic Systems," *The Independent Review* 6, no. 3 (Winter 2002), pp. 407–425.

DEMOCRATIC SOCIALISM

The popularity of the welfare state has been at least a part of the foundation of the support for democratic socialism. The idea of the welfare state is an extension of the Progressive ideology that the role of the government is to look out for people's economic well-being in addition to protecting their rights. More than just a government safety net, the welfare state was (and is) viewed as a set of humane institutions that can allow marginalized individuals to be full participants in their societies. Sweden was viewed as the prototype of this type of society, in which government oversaw economic activity for the benefit of all its citizens.[18]

Government spending as a share of GDP in Sweden steadily grew from the 1960s through the early 1990s and peaked at more than 70 percent of GDP. With government controlling that much of the economy, it is easy to characterize Sweden as a socialist economy, and indeed, with the welfare state and state-owned corporations, the characterization seems to fit. There was a significant difference between the Swedish economy and the Soviet economy, however, in that it was always easy to start private businesses in Sweden, and Swedish firms were selling their products in global markets and so had to remain competitive, in contrast with Soviet firms that were producing primarily for domestic consumption or for trade with other Eastern bloc centrally planned economies. Swedish firms always competed in the global market and were always accountable to it. Neither was true of Soviet firms.

The Swedish economy was hampered by high taxes and the welfare state reduced incentives to work, but underlying those impediments was an economy that participated in the global market economy, and that relied on market prices and profits and losses to guide its economic activity. This was very different from a Soviet economy that ran based on five-year economic plans that were directed from the central government. The Swedes themselves recognized how heavy taxation and government spending was impeding their economy and by 2015 government spending had been reduced to just above 50 percent as a share of GDP. But government intervention in the Swedish economy was designed to implement a substantial welfare state, not to engage in central economic planning of the type that characterized the Soviet Union. Regarding economic systems,

[18] See, for example, Richard F. Tomasson, *Sweden: Prototype of Modern Society* (New York: Random House, 1970), Anartya Sen, *Commodities and Capabilities* (Amsterdam: North-Holland, 1985), and Martha Nussbaum, *Creating Capabilities: The Human Development Approach* (Cambridge, MA: Harvard University Press, 2011).

it would be inaccurate to characterize Sweden and the Soviet Union as sharing the same type.

The economic systems of Sweden and the Soviet Union were different, although that is not captured in the taxonomy of Figure 2.1, and in this sense it is misleading to characterize Sweden as a democratic socialist country with the thought that central economic planning is consistent with democratic government. Because Swedish firms exported much of their production and Swedish consumers imported much of their consumption, the Swedish economy has always been market-oriented, despite the burdens of heavy taxation to finance its welfare state, whereas the Soviet economy was insulated from market forces and run by government directives.

Whether democracy and socialism are compatible is an interesting question. Milton Friedman said that economic freedom is necessary to maintain political freedom, suggesting that they are not.[19] Friedman's argument was that central economic planning required an autocratic government that had the ability to impose its policies on those who might be reluctant. More government direction of the economy required more government regulation and oversight, increasing the power of government and sacrificing economic freedom. The top-down direction of the economy implied a top-down political process to run it.

The substantial government spending that has characterized Sweden for decades might lead its economy to evolve into political capitalism, but it would appear that Sweden is more free of cronyism than most governments (as are Scandinavian governments in general). One hypothesis that has some empirical support is that cronyism and corruption are more associated with the regulatory aspects of the state than with its level of government spending.[20] The Scandinavian countries are big government countries if measured by government spending, but are small government countries as measured by their economic regulation. This may be an explanation for why Scandinavian countries appear less corrupt, and less prone to political capitalism, than other countries with substantially lower government spending. Regulation often allows the elite more direct control over economic activity than government spending, especially when that spending consists largely of widely distributed transfer payments.

19 Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).
20 Christopher J. Boudreaux and Randall G. Holcombe, "Regulation and Corruption," *Public Choice* 164, no. 1 (July 2015), pp. 75–85.

CAPITALIST DICTATORSHIPS

An examination of capitalist dictatorships again shows that the taxonomy shown in Figure 2.1 understates the variety of economic systems. Consider three cases: Chile under Augusto Pinochet; South Korea under General Park Chung-hee; and Nazi Germany between the World Wars. Pinochet was a ruthless military dictator who dramatically shifted Chile's economic policies from a socialist economy to a market economy which cut government expenditures and oversight in the economy, encouraged private investment, and was open to free trade. During Pinochet's rule from 1973 to 1990, Chile shifted toward the prototypical capitalist economy within the comparative economic systems context. Chile under Pinochet is probably as close as one can get to a prototypical capitalist dictatorship.[21]

South Korea under General Park's leadership following a military coup in 1961 until his assassination in 1979 showed rapid economic development by using an industrial policy similar to that used in Japan. The Korean government targeted exporting industries for development, with the goal of making those industries competitive on world markets. Far from a free market system, General Park nationalized Korean banks and set export targets, rewarding firms that exceeded their targets. High performers were rewarded with economic support such as low-interest loans and government assistance in procuring land for expansion. Imports were restricted, exports were subsidized, but exporters were allowed to import their inputs duty-free. The South Korean economy was heavily directed by the Korean government, and with impressive results. In 1962 South Korea was among the world's poorest economies, with a per capita income less than Zaire, Congo, or Sudan, and in the next three decades saw per capita income rise by about 20 times.[22]

The degree to which South Korea's industrial policy was responsible for its substantial economic development is subject to debate. The Korean won was devalued three times in 1960 and 1961, making Korean exports more

[21] Singapore under Lee Kuan Yew might also provide an example. Despite having elections, Lee's party always won in elections that were not seriously contested. For an interesting take on that period of Singapore's history, See Christopher Lingle, *Singapore's Authoritarian Capitalism: Asian Values, Free Market Illusions, and Political Dependency* (Fairfax, VA: Locke Institute, 1996), and Lingle, *The Rise and Decline of the Asian Century: False Starts on the Path to the Global Millennium* (Barcelona: Editions Sirocco, 1997).

[22] See Young Back Choi, "Industrial Policy as the Engine of Economic Growth in South Korea: Myth and Reality," in Peter J. Boettke, ed., *The Collapse of Development Planning* (New York: New York University Press, 1994), pp. 231–255 (Chapter 9).

attractive on world markets[23] while making consumer goods and services more expensive for Korean citizens. Working-class Koreans were subsidizing export-led Korean economic growth. In 1973 Korea's policy changed from supporting exporting industries to focus on the chemical industry and heavy industry. This gave rise to the chaebols – the family-owned conglomerates – that have dominated the Korean economy.[24] Amazingly, by 2012 Samsung accounted for 20 percent of South Korea's GDP.[25] One interpretation of the Korean economic miracle is that economic policy was designed to support the firms that had already proven themselves successful in global markets, a strategy that is sure to lose its advantage as firms become increasingly reliant on government support for their successes. Because of heavy government involvement in their development process, South Korea does not fit comfortably within the free market capitalism category.

Korean industrial policy is seeing some pushback in the twenty-first century as working-class Koreans argue that the benefits of Korea's economic development have gone disproportionately to the families who own the chaebols – the economic elite – and that those gains should be more broadly shared by shifting economic policy toward what dissenters call economic democracy. Industrial policy is designed to benefit the 1 percent; economic democracy, through transfer programs, labor laws, regulations, and social programs, would shift those benefits toward the 99 percent.[26]

Defining political capitalism as a system in which the economic and political elite cooperate for their mutual benefit, so they can remain at the top of the political and economic hierarchy, South Korea's economy seems to fit that definition well. In that context, the stellar performance of the Korean economy stands out. However, their economic strategy follows the Japanese industrial policy model that was widely admired in the 1980s, prior to decades of relatively stagnant economic growth. With Samsung accounting for 20 percent of the nation's GDP, it is easy to see that should Samsung follow the path of Sony, the Korean economy will likely follow the

[23] Jungho Yoo, "Myth About Korea's Rapid Growth," presented at the International Conference on Institutions and National Competitiveness, Seoul, Korea, August 2009, notes several factors, including the devaluations, which jump-started Korea's export-led growth.

[24] See Larry E. Westphal and Kwang Suk Kim, "Industrial Policy and Development in Korea," in Bela Balassa, ed., *Development Strategies in Semi-Industrial Economies* (Baltimore: Johns Hopkins University Press, 1982), pp. 212–279.

[25] See Jordan Weissmann, "Whoa: Samsung Is Responsible for 20% (!?) of South Korea's GDP," *The Atlantic*, July 31, 2012.

[26] See Randall G. Holcombe, "South Korea's Economic Future: Industrial Policy or Economic Democracy?" *Journal of Economic Behavior & Organization* 88 (April 2013): 3–13.

path of Japan. Regardless of South Korea's economic future, the call for "economic democracy" to replace industrial policy in Korea echoes the message of the Occupy movement in the United States that the system is rigged to benefit the 1 percent at the expense of the 99 percent.

In both Korea's and Sweden's cases, the government oversight was designed to produce products competitive in world markets, so there was some market discipline underlying their policies. Sweden was less a case of central economic planning than both government and private firms responding to global market forces, whereas Korea had a more top-down economic policy that targeted particular firms and industries for development. But the differences between Sweden's, Chile's, and Korea's "capitalist dictatorships" shows that within that basic framework, the concept of capitalism really refers to very different economic systems. One potential problem that an industrial policy like Korea's or Japan's opens up is that it targets specific firms and industries for preferential treatment. Setting aside the fact that it would be difficult for governments to identify ahead of time which firms and industries might be most likely to succeed in world markets, such policies open up the possibility that government assistance will be targeted toward those businesses that have political connections, leading the economy from industrial policy toward political capitalism. That is just the accusation of Korea's proponents of economic democracy.

The South Korean example shows both a case of widespread recognition of cronyism and a political debate that pits one group of interests against another. One side argues that government policy should be designed to provide benefits to the masses; the other argues that government policy should continue to support industrial development, presumably with the idea that policies that initially benefit the 1 percent will provide wider benefits that will trickle down to the 99 percent. Nobody is arguing for less government involvement in the economy and a movement toward laissez-faire capitalism. South Korea is a good example of a nation in which the economic elite and the political elite design policies that benefit each other and act to prevent others from competing for their elite status – political capitalism.

Nazi Germany provides a cautionary tale about what can happen when the profitability of private firms is dependent on government policy. While Nazi Germany is sometimes given as an example of a capitalist dictatorship, the Nazi economy was more of a centrally planned economy than a market economy.[27] The Third Reich exerted a huge amount of control

[27] See Peter Temin, "Soviet and Nazi Economic Planning in the 1930s," *Economic History Review* 44, no. 4 (1991), pp. 573–593.

over the economy, eventually embodied in the Four-Year Economic Plan in 1936 that included price controls, quotas, and licensing regulations that in some cases prevented economic transactions from legally occurring until government oversight bodies approved them.[28] Party officials could bend or rewrite the rules, giving business people the incentive to cultivate relationships with those in power. Favoritism was both institutionalized through direct legislation and carried on informally, creating a system of cronyism that revolved around membership in the Nazi party.

The Nazi party awarded contracts to those who were well protected and could shut competitors out of markets and put them out of business. The Ministry of Economics required all firms to join a trade cartel which provided a mechanism for ministries to regulate industries and protect the well-connected. In addition to indirectly regulating nonconnected firms out of business, the Nazi state often directly seized assets from its political enemies. In 1938, the Third Reich passed a law that stripped all Jewish Germans of all claims to property and businesses, and distributed the confiscated assets to top party members and their allies and relatives.

While productive assets were nominally privately owned under the Nazi government, their profitability was directly determined by government policy and the economy was centrally directed as in the Soviet Union. A major difference was that explicit ownership rights in Nazi Germany directed the profits to specific well-connected individuals. The Nazi system shows the shortcoming of the two-dimensional depiction of economic systems as running between capitalism and socialism. Fascism embodied heavy doses of central economic planning with private ownership of productive assets, channeling profits derived from favoritism toward insiders. Because the means of production were privately owned, it was not socialism, but because economic activity was so centrally directed, it was not market-based capitalism either. Fascism was an altogether different type of economic system.[29]

MARKET CAPITALISM

Capitalism is a politically charged term, so academic economists rarely use the term except when they want it to convey political connotations.

[28] See Arthur Schweitzer, "Big Business and Private Property under the Nazis," *Journal of Business of the University of Chicago* 19, no. 2 (April 1946), pp. 99–126.

[29] For further discussion, see Randall G. Holcombe and Andrea M. Castillo, *Liberalism and Cronyism: Two Rival Political and Economic Systems* (Arlington, VA: Mercatus Center, 2013), chapter 5.

Economists talk about markets and market economies rather than capitalism, but the formal study of economics approximately corresponds with the beginnings of capitalism, roughly during the 1700s.[30] The discipline has primarily studied capitalism – or market economies – since its beginning. Adam Smith's great treatise, *The Wealth of Nations*, published in 1776, described the way that suppliers and demanders interacted to determine the market prices of goods, and famously described the invisible hand that led individuals pursuing their own interests to work for the benefit of everyone. While Karl Marx is often viewed as the father of socialism, his magnum opus, *Das Kapital*, is about capitalism as an economic system.[31] (This did leave his followers in a quandary when they wanted to design their socialist economies based on his theories, because he never explained how a socialist economy would actually work. His theoretical contributions were critiques of capitalism, not blueprints for socialism.)

As political economy divided into the disciplines of economics and political science, the depiction of the market economy as an economic system became more rigorous. Leon Walras's *Elements of Pure Economics*, published in 1874, depicts a market economy as a general equilibrium system of simultaneous equations,[32] a vision of the market system further refined by Paul Samuelson, who was influential in developing economic theory in the language of mathematics in the second half of the twentieth

[30] There is a difference between the existence of markets and a market economy. Markets and market exchange have existed for thousands of years, but within the context of an economy in which most production and consumption was undertaken outside of markets, and certainly in an economy that had limited if any markets for capital. Robert L. Heilbroner, *The Making of Economic Society* (Englewood Cliffs, NJ: Prentice-Hall, 1962) says that capitalism is a system that has markets for factors of production, and in particular, markets for capital, which only was the case in the last few hundred years. If Adam Smith is viewed as the father of economics following the publication of his *The Wealth of Nations* in 1776, then economic analysis dates back to the beginning of capitalism. Some economists persuasively argue that economic analysis began prior to Smith's great book, and that Smith was unoriginal, taking ideas that had already been developed by his predecessors. Two economists with that viewpoint are Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954) and Murray N. Rothbard, *Classical Economics: An Austrian Perspective on the History of Economic Thought, Volume II* (Cheltenham, UK: Edward Elgar, 1995). Contrary viewpoints notwithstanding, we are not stepping much outside the conventional wisdom by dating the beginning of the study of market economies and capitalism to Adam Smith's 1776 book.

[31] An English translation is Karl Marx, *Capital* (Chicago: Charles H. Kerr and Company, 1906).

[32] Leon Walras, *Elements of Pure Economics* (Homewood, Il: Richard D. Irwin, 1954 [orig. 1874]).

century.[33] This mathematical depiction of a capitalist economy allowed economists to derive conditions under which a market economy would allocate resources optimally, which in turn allowed them to depict both problems that stood in the way of this optimal allocation of resources and conditions under which those problems could be corrected.[34]

This is how resource allocation in a capitalist economy was depicted in the comparative economic systems approach, which then allowed a comparison with central planning under a socialist system. Capitalism was equated with a market allocation of resources. Capitalism has always been analyzed as an economic system, from Adam Smith on up through the twenty-first century. The difference is that with the decline in socialism and loss of interest in comparative economic systems as a field of study, the system is now depicted as consisting of markets with various shortcomings that can be corrected through government intervention. Those interventions have not been analyzed in a systematic way which recognizes that, considered together, those interventions in a market economy change the nature of the system and ultimately produce a different system. Interventions of a certain type result in the evolution of market capitalism into political capitalism.

Corporatism is an economic system often associated with fascism, going back to pre-World War II Italy and Germany. Corporatism might be defined as "an institutionalized pattern of policy-formation in which large interest organizations cooperate with each other and with public authorities not only in the articulation (or even 'intermediation') of interest, but – in its developed forms – in the 'authoritative allocation of values' and in the implementation of such policies."[35] Corporatism is not market capitalism, but critics of capitalism often associate the two. Still, the idea that businesses and business associations using their influence to direct government policy for their benefit constitutes an economic system distinct from capitalism and socialism survived under the heading of corporatism well beyond World War II.

Manfred Streit discusses political entrepreneurs who "will most probably trade cooperation for compensatory privileges."[36] Streit says

[33] Paul A. Samuelson, *Foundations of Economic Analysis* (Cambridge, MA: Harvard University Press, 1947).

[34] These theoretical foundations, noted in the previous chapter, are summarized in Francis M. Bator, "The Simple Analytics of Welfare Maximization," *American Economic Review* 47, no. 1 (March 1957), pp. 22–59, and Bator, "The Anatomy of Market Failure," *Quarterly Journal of Economics* 72, no. 3 (August 1958), pp. 351–379.

[35] This definition is given by Gebhard Lehmbruch, "Liberal Corporatism and Party Government," *Comparative Political Studies* 10, no. 1 (April 1977), p. 94.

[36] Manfred E. Streit, "The Mirage of Neo-Corporatism," *Kyklos* 41, no. 4 (1988), p. 613.

neo-corporatism is characterized by "elite consensus-building,"[37] which sounds much like the political capitalism Kolko described, in which the political and economic elite cooperate for their mutual benefit. Mancur Olson critically examines the idea that bilateral bargaining between government policymakers and industry trade associations can work toward the public interest, and concludes that the incentives facing all parties are likely to work against the public interest.[38]

Despite some recent literature,[39] academic interest in corporatism as an economic system has faded along with interest in the general topic of economic systems. In the twenty-first century corporatist ideas have been recast as government intervention in a market economy, or as crony capitalism, rather than viewing corporatism as a distinct economic system. An idealistic view of corporatism casts it as a system in which business associations and government cooperate to further the public interest, but whether such cooperation actually is in the public interest is the issue raised by political capitalism.

The incentives of the economic and political elite are to cooperate for their benefit, which is not necessarily the same as the public interest. This was recognized by Adam Smith, who in 1776 said, "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 . . . But though the law cannot hinder people of the same trade from sometimes assembling together, it ought do nothing to facilitate such assemblies; much less render them necessary."[40]

THE INSTITUTIONS OF CAPITALISM

While capitalism has consistently been depicted as an economic system, as economic analysis developed through the twentieth century, it increasingly depicted capitalism as a self-equilibrating system that coordinated the preferences of consumers with the production

[37] Streit, "The Mirage of Neo-Corporatism," p. 614.

[38] Mancur Olson, "A Theory of the Incentives Facing Political Organizations: Neo-Corporatism and the Hegemonic State," *International Political Science Review* 7, no. 2 (April 1986), pp. 165–189.

[39] Eva Hartmann and Paul F. Kjaer, *The Evolution of Intermediary Institutions in Europe: From Corporatism to Governance* (New York: Palgrave Macmillan, 2015).

[40] Adam Smith, *The Wealth of Nations* (New York: Random House, Modern Library, 1937 [orig. 1776]), p. 128.

capabilities of producers without explicitly depicting the institutional structure within which consumers and producers interacted. The general equilibrium approach to describing an economy shows mathematical conditions for an equilibrium when consumer preferences and production technology are represented as mathematical functions. Institutions must be in place to facilitate exchanges, but they are (at best) implied in the model rather than explicitly represented. Rather than depicting the process of exchange, general equilibrium models depict the outcome after all exchanges have been made. The assumption is that all exchange takes place at equilibrium prices rather than depicting the process by which market participants discover those prices. More significantly, the general equilibrium framework ignores the institutions that are necessary for exchanges to be made when exchanges are not self-enforcing.

In the simplest type of self-enforcing exchange, two parties trade one good for another at the same time. An exchange in which one party provides something of value to the other, contracting for the other party to transfer something of value later, is not self-enforcing because the second party might not follow through. Someone might pay a craftsman ahead of time to produce an item to be delivered later, or a seller might deliver goods now on credit, agreeing to take payment later. An even more complex undertaking, such as building a shopping center, requires a substantial set of institutions, ranging from a property registry to assure the eventual owners of the shopping center they have clear title, and title insurance in case there is a problem, to banking institutions to advance loans for construction, institutions to adjudicate disputes if any arise with contractors, and much more.

Some institutions are developed in the market sector of the economy, but many are run by government. Economist Hernando de Soto (not the explorer!) has persuasively argued that the reason why less developed economies tend to stay that way rather than catch up with developed economies is that they do not have the institutional foundations that allow those complex types of transactions to occur.[41] Mancur Olson has called these government institutions that facilitate market exchange market-augmenting government.[42]

[41] Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper & Row, 1989) and *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).

[42] Mancur Olson, Jr., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

Whether these institutions need to be provided by government might be subject to debate,[43] but the fact is that throughout the world they are. As the economy becomes more complex, the institutional structure underlying economic activity also becomes more complex, and that includes government institutions. The analysis that follows considers the degree to which the growing government that has accompanied economic growth causes market capitalism to evolve toward political capitalism.

The characterization of economic analysis as institution-free probably fits the discipline best around the 1970s, when Samuelson's influence was at its peak and this mathematical approach to economics was often viewed as a sign that the discipline is scientific.[44] Increasingly since then, economists have explicitly recognized the importance of the institutional structure to economic outcomes and analyzed the effects of institutions.[45] But during the period in which the study of comparative economic systems was in vogue, economic systems were viewed as systems of equations which could be solved to find an optimal allocation of resources, with virtually no attention given to the institutions of either markets or government. The system of equations depicting general economic equilibrium could be satisfied through the decentralized exchanges that take place in a market economy, although that might bring with it market failures that would fall short of perfect efficiency, or having that system of equations on hand, could be satisfied through the top-down administration of the economy by central planners.

The proponents of central planning in the socialist calculation debate represented both capitalism and socialism this way.[46] Critics of these

[43] Some libertarian anarchists argue that voluntary market institutions can do everything that government does, and do it better. See, for examples, Murray N. Rothbard, *For a New Liberty: The Libertarian Manifesto* (New York: Macmillan, 1973) and David D. Friedman, *The Machinery of Freedom: Guide to Radical Capitalism* (Chicago: Open Court Publishing Company, 1973).

[44] For a critique of this approach to economic analysis, see Paul M. Romer, "Mathiness in the Theory of Economic Growth," *American Economic Review* 105, no. 5 (May 2015), pp. 89–93. See also the insightful commentary by Donald N. McCloskey, "The Rhetoric of Economics," *Journal of Economic Literature* 21, no. 2 (June 1983), pp. 481–517, and *The Rhetoric of Economics* (Madison: University of Wisconsin Press, 1985).

[45] For a comparison of institutional versus general equilibrium approaches to economic analysis, see Meir Kohn, "Value and Exchange," *Cato Journal* 24, no. 3 (Fall 2004), pp. 303–339. Another good discussion promoting an institutional approach is Peter J. Boettke, *Living Economics: Yesterday, Today, and Tomorrow* (Oakland, CA: Independent Institute, 2012).

[46] This is true for prominent proponents of central planning like Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (Minneapolis, MN: University of Minnesota Press, 1938) and Abba Lerner, *The Economics of Control: Principles of Welfare*

proponents of socialism argued that they did not take into account the institutional setting and the process by which markets discovered equilibrium prices and quantities, A major problem that would plague central planners, the critics argued, was that the knowledge required to satisfy those equations is decentralized and difficult to convey to others.[47] Every individual has some knowledge not possessed by others, and much of that knowledge is tacit knowledge, which means that only the person who has it can use it, Often, faced with new situations that always arise in an evolving economy, people draw on their experiences to make their best judgments. This is why corporations hire experienced executives to be their CEOs rather than recently graduated MBAs who might have more current academic knowledge, but have not developed the tacit knowledge that comes with experience. Because this tacit knowledge is not transferrable among people, central economic planners could never acquire the knowledge they would need to have to solve those equations themselves.

These counterarguments did not seem persuasive to many economists, at least in part because they were viewing the economic system through the lens of a system of equations that did not have explicit institutional content, and also because they did not appreciate the concept of tacit knowledge. If the profession's view of institutions is that they are of minimal importance in determining economic outcomes, arguments based on institutions will not seem to have much applicability.

Economists appreciate the impact of institutions much more in the twenty-first century than they did in the twentieth, but because the economic systems approach has fallen out of favor, institutional analysis mostly deals with the effects of market institutions rather than being integrated into an analysis of economic systems more generally.[48] As economics has become more attuned to the importance of institutions, it has moved away from the systems approach to analyzing economies. It does not have to be this way. Institutional analysis is fully compatible with analyzing economic systems. But it did happen this way because the comparative systems approach to analyzing economies declined as the institutional approach became more

Economics (New York: Macmillan, 1946) who showed how, in theory, central planners could mimic a general economic equilibrium, but could do even better because they could adjust parameters to improve resource allocation.

47 The most articulate statements came from Hayek; for example, Friedrich A. Hayek, *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1944).

48 An exception is Peter J. Boettke, *Why Perestroika Failed: The Politics and Economics of Socialist Transition* (London: Routledge, 1993), who cites the institutional failures of the post-Soviet era in Russia which hindered economic development.

widespread. While abstract economic theory is often institution-free, the popular criticisms of cronyism and policies that favor the 1 percent over the 99 percent directly recognize that their critiques are aimed at institutions that favor the elites over the masses. The analysis of political capitalism is an analysis of the effect of institutions on economic systems.

THE INTERACTION OF ECONOMIC AND POLITICAL INSTITUTIONS

While the twentieth-century taxonomy of economic and political systems analyzed them as independent of each other, there is a long history in political economy suggesting that the two are interdependent. Up through the end of the nineteenth century, economic and political institutions were studied together under the heading of political economy, but as economics and political science evolved into separate disciplines in the twentieth century, economists lost interest in incorporating political institutions into their analysis. Part of this was an air of superiority held by economists who viewed economics as the queen of the social sciences, and who did not want to stoop down to engage in political science. The idea was that economists would derive the policy options and trade-offs, and policymakers would then choose the optimal policy.

The emergence of public choice as a subdiscipline in economics, discussed in Chapter 1, brought economic analysis to bear on political decision-making. Public choice might be defined as the use of economic methods to analyze political decision-making. But public choice only partially closes the gap in evaluating the interaction of economic and political institutions, because while it evaluates the incentives that face political decision-makers and takes account of the information they have available to them, it has only superficially evaluated how changes in political institutions can generate changes in economic institutions and how changes in economic institutions can generate changes in political institutions. If economic and political institutions are interdependent, it would make sense to return to the nineteenth-century practice of analyzing them together as political economy.

Milton Friedman and Friedrich Hayek are two economists who have argued that without market institutions that are based on voluntary exchange – economic freedom – political freedom cannot survive.[49]

[49] Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962) and Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

Friedman and Hayek were arguing for the preservation of a market economy and warning of the dangers of central economic planning, but they were not looking at the interdependence of economic and political institutions in the evolution of a capitalist economy. Mancur Olson argued that as political systems mature, interest groups become more firmly entrenched, leading to a greater political allocation of resources that leads to the decline of nations,[50] and Joseph Schumpeter pessimistically forecast the demise of capitalism because the people who were the greatest beneficiaries of capitalist institutions would not stand up to defend them.[51] Schumpeter and Olson come closer to looking at the evolutionary interaction of political and economic systems, and it is in that spirit that this volume describes the interaction of political and economic institutions in the economic system of political capitalism.

BUSINESS PARTICIPATION IN POLITICAL CAPITALISM

While Schumpeter lamented that the business interests that benefit the most from free markets nonetheless lobby for special interest benefits for themselves rather than promoting free markets, political capitalism leaves business interests little alternative. When business profitability depends on connections and cronyism, businesses have to participate in that system to remain profitable. Political capitalism not only gives business interests the incentive to use political connections for private benefits, it makes their profitability dependent on connections. The most extreme case of this was Nazi Germany, where connections guaranteed firms profitability and created barriers to entry for potential competitors to the well-connected, but even more, produced a system where government would shut down firms without those connections for the benefit of their cronies.

Microsoft provides an example of the way that political capitalism lures firms into participating. Up until the late 1990s Microsoft had almost no lobbying presence in Washington, preferring to rest its profitability on the sale of its products, driven by continual innovation. The company was blindsided by an antitrust suit against it, and responded by ramping up its lobbying presence because it had to, to protect its economic interests. Apple Computer, one of Microsoft's competitors, had already learned

50 Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

51 Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 2nd edn. (London: George Allen & Unwin, 1947).

that lesson. In Walter Isaacson's biography of Steve Jobs, Isaacson relates, "President Clinton's Justice Department was preparing a massive antitrust case against Microsoft. Jobs invited the lead prosecutor, Joel Klein, to Palo Alto. Don't worry about extracting a huge remedy against Microsoft, Jobs told him over coffee. Instead simply keep them tied up in litigation. That would allow Apple the opportunity, Jobs explained, to make an 'end run' around Microsoft and start offering competitive products."[52]

Jobs is rightly considered one of the greatest entrepreneurs of all time, and Apple one of the most entrepreneurial and innovative companies ever, yet this example shows Jobs angling to use connections to impose costs on a rival to gain a competitive advantage. Microsoft then learned the lesson that it needed to actively participate to protect its own interests. Political capitalism does not give firms the ability to opt out, because their profitability depends on their ability to make use of their political connections.

CONCLUSION

During the Cold War era there were real differences between the market-based capitalist economies of the West and the centrally planned socialist economies of the East, and an economic systems approach to analyzing those differences offered substantial insight. The core elements of economics have always been focused on understanding capitalism as an economic system, and with the twentieth-century rise of socialism as an alternative, it was natural to study socialism as an economic system and compare it to capitalism. One shortcoming of this approach is that it tended to depict economic systems on a single-dimensioned continuum. More market-based resource allocation placed economies more toward the capitalist end of the continuum while more government-directed resource allocation placed them more toward the socialist end. A more careful look shows that this was an oversimplification. The large public sector in Sweden, for example, was different in character from the central economic planning of the Soviet Union.

With the collapse of the centrally planned Eastern bloc economies, the examination of economic systems fell by the wayside as economists focused on how markets worked, the shortcomings of markets, and how public policy could address those shortcomings. But various types of interventions alter the nature of the economic system. What in theory could appear as a managed capitalism, with interventions designed to

[52] Walter Isaacson, *Steve Jobs* (New York: Simon & Schuster, 2011), p. 323.

correct for the problems of capitalism, becomes a system in which those who have the power to manage the system use that power to retain their elite status, morphing a system of free market capitalism into political capitalism.

In the twentieth-century taxonomy of comparative economic systems, different economic systems fall on a continuum somewhere between pure market economies and pure government economic planning. One thing this chapter's examination of economic systems illustrates is that the single-dimensioned continuum between pure capitalism and pure socialism is overly simple. In fact, a more complex taxonomy is needed to understand the differences that exist within economic systems. Fascism is not just a mixture of capitalism and socialism, for example, but its own separate economic system. The same is true of political capitalism.

Analyzing political capitalism as an economic system offers insight into the evolution of the economic system beyond the welfare economics approach of looking at interventions as a way of correcting problems with the market, and beyond the old economic systems taxonomy that labeled economic systems based on the level of government intervention into the economy. The twentieth-century taxonomy separated political and economic systems, representing political systems also on a single-dimensioned continuum that ranged from pure democracy to pure dictatorship. The separation of economics and political science into separate disciplines led to the separation of the analysis of economic and political systems. Economists analyzed the continuum from capitalism to socialism and political science analyzed the continuum from democracy to dictatorship. The idea that there was some interaction between those two dimensions was rarely considered.

In fact, changes in economic institutions affect political institutions and changes in political institutions affect economic institutions. The analysis of political capitalism brings them together to depict a distinct type of political economy. The theoretical foundation for understanding political capitalism as an economic system is already in place, but political capitalism has not been analyzed this way in part because the study of economic systems has fallen out of favor with academic economists, and in part because economic and political institutions have tended to be analyzed separately, rather than looking at how they interact. The next several chapters pull together several strands of economic and political theory to describe the economic system of political capitalism.

3

The Political and Economic Elite

Analyzing political capitalism as a system in which the economic and political elite cooperate for their mutual benefit raises some issues regarding the class division of elites and masses. The previous chapters have noted the widespread recognition that public policies often benefit the well-connected: the insiders, the cronies, the 1 percent. What these policies are and how they benefit the elite will be analyzed in subsequent chapters. This chapter focuses on the division between the elites and the masses. Who are the elite? How do people become members of the elite? How much mobility is there between classes? And, perhaps most fundamentally, is there really a class division in modern societies?

Recall Stiglitz's observation that the elite are rigging the system for their benefit. He said "It's one thing to win a 'fair' game. It's quite another to be able to write the rules of the game – and to write them in ways that enhance one's prospects of winning. And it's even worse if you can choose your own referees."[1] Stiglitz says, "We have a political system that gives inordinate power to those at the top, and they have used that power not only to limit the extent of redistribution but also to shape the rules of the game in their favor."[2] Economists – and Stiglitz is an economist – tend to question this division of people into discrete classes because in general they think more in terms of continuous gradations. Rather than classifying people as rich or poor (or middle class), for example, economists tend to see a continuous distribution of income with no clear division between rich and middle class, or middle class and poor. With regard to political and economic power, yes, some people have more than others, but one might question

[1] Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers the Future* (New York: W. W. Norton, 2012), p. 59.
[2] Stiglitz, *The Price of Inequality*, pp. 39–40.

whether there really is a divide between the elite and the masses, or the 1 percent and 99 percent.

Deirdre McCloskey, referring to capitalism, says, "No other system has been more free from dominance, acquisition, and calculating behavior. A dollar is a dollar, and a poor man has just as much claim to its value as a rich man. No dominance there, and less than in a society of aristocratic status or Socialist Party membership."[3] Class analysis suggests a discontinuity. Some people are in the elite and others are not, rather than a continuous gradation in wealth and political power. Thinking strictly in terms of wealth, McCloskey's observation seems right: a dollar is a dollar, and people's economic power is roughly proportional to the economic resources people have at their disposal. In terms of power, things are not so clear.

One reason for a discontinuity in the power people wield is that there is often a discontinuity in public policy outcomes. In elections, a party of a candidate either wins or loses. In public policy, an issue either passes or fails. While there may be compromises, public policy measures are often more accurately depicted as having binary outcomes.[4] One side wins; the other loses. If a group is voting on whether to have their annual meeting in New York or Las Vegas, one group gets the outcome they want; the other doesn't. In markets, when individuals are deciding where to vacation, those who want to go to New York go to New York; those who want to go to Las Vegas go to Las Vegas. In politics, there is a big advantage to being in the majority, whereas markets are more oriented toward catering to a variety of preferences.

Another factor is that the discontinuity in outcomes in politics creates a discontinuity in the payoff to exerting effort. In the market, a low-wage worker can put in a few extra hours of work and earn a few extra dollars. Someone with no political influence can put in a few extra hours and still have no political influence. Individual effort pays off in market activity, but citizens realize it does not in politics. Voters tend to be rationally ignorant

[3] Deirdre N. McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006) p. 480.

[4] One vision of the way compromise occurs is that the legislature weighs interests on both sides of an issue to determine public policy, following the ideas of Gary S. Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, 98 (1983), pp. 371–400. A more detailed argument about the way that the political marketplace produces outcomes similar to markets in which goods and services are traded is found in Donald A. Wittman, *The Myth of Democratic Failure* (Chicago: University of Chicago Press, 1995) and Wittman, "Why Democracies Produce Efficient Results," *Journal of Political Economy*, 97 (1989), pp. 1395–1424.

regarding the political choices they make, because they know that gathering more information will not affect the outcome of an election. Their one vote will not be decisive.[5] The 99 percent participates minimally in the public policy process because they realize their participation will have no effect, and having made that rational decision, it has to be true that policy decisions will be made by others: the 1 percent. Those are the insiders, the well-connected, the cronies who actually do determine public policy, and as Stiglitz observes, write their own rules and choose referees favorable to their side.

On the economic side of things, while it is true that a rich person's dollar has the same impact as a poor person's, that same observation is not true of the economic rules that govern transactions. One only has to look at the complaints of the Occupy Wall Street movement for an example. In 2008, when the economy went into a recession and the housing market collapsed, people lost their jobs and could no longer afford to make their mortgage payments. Because of the housing market collapse, their mortgage liabilities were greater than the value of their houses, so they could not sell their houses to get out from under their mortgages, and were foreclosed. Many in the 99 percent lost their houses; meanwhile, the Wall Street bankers who were holding mortgage-backed securities that lost value because the mortgages behind them were in default were bailed out. The government bailed out the 1 percent while leaving the 99 percent to fend for themselves.

Another example is the ethanol mandate for gasoline in the United States. Designed to reduce oil consumption and enhance energy security, the Energy Policy Act of 2005 mandated that ethanol be blended into gasoline. Increases in domestic oil production and substantially lower gasoline prices called this policy into question, but it persisted because corn farmers and corn processors benefitted from the increased demand for corn, the source of most ethanol. Given the choice there is a good chance that most drivers would choose to buy gasoline without ethanol, although one cannot be sure because drivers are not given the choice. It is an easy conjecture, however, that the reason they are not given the choice is that they would choose something other than the government policy. There would be no need to force people to buy ethanol in their gasoline if they would voluntarily choose to do it themselves. Most drivers accept the policy even if they do not agree with it because there is nothing they can do about it. The well-connected corn lobby dictates the policy.

[5] This observation was made by Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957).

The 1 percent decides for the 99 percent. So yes, a dollar is a dollar, but the rules that govern how those dollars can be spent, how they are taxed, and who benefits from public policy interventions are tilted toward the 1 percent.

While economists often tend not to recognize discontinuities like this, the class analysis that divides the elite from the masses has a long history in the other social sciences. Economic analysis studies individual choice, representing individuals striving to maximize the utility they get from consuming goods and services. Their choices are individual choices. Economists often do not recognize that individuals make choices as members of groups and that their decisions, especially in politics, are often based on group values and group identity rather than individual values and individual utility.[6] The division of people into elites and masses has been a component of the social sciences for well over a century, although not so much in economics. This chapter describes the elite theory that is one of the building blocks in the theory of political capitalism.

ELITE THEORY: ITS EARLY DEVELOPMENT

The observation that the elite determine public policy in democratic capitalist societies goes back to the early days of democratic capitalism. Marx and Engels, in *The Communist Manifesto*, observe that

> Each step in the development of the bourgeoisie was accompanied by a corresponding political advance of that class . . . [T]he bourgeoisie has at last, since the establishment of modern industry and the world market, conquered for itself, in the modern representative state, exclusive political sway. The executive of the modern state is but a committee for managing the common affairs of the whole bourgeoisie.[7]

This observation by Marx and Engels in 1848 is entirely consistent with the observations of Stiglitz and Stockman in the twenty-first century.

Political scientist Arthur F. Bentley, in 1908, emphasized the importance of analyzing individual political activity within the context of the group within which individuals work to further their political goals. When discussing whether an individual's political activity should be analyzed as

[6] Sociologist James S. Coleman, *Foundations of Social Theory* (Cambridge, MA: Belknap, 1990) strongly supports the rational choice economic approach to analyzing human behavior, but also is critical of economics for not recognizing the significance of group behavior.

[7] Karl Marx and Friedrich Engels, *The Communist Manifesto* (New York: International Publishers, 1948), pp. 10–11.

a member of a group, Bentley says, "The individual stated for himself, and invested with an extra-social unity of his own, is a fiction. But every bit of the activity, which is all we actually know of him, can be stated either on the one side as in individual or on the other side as a social group activity. The former statement is in the main of trifling importance in interpreting society; the latter statement is essential, first, last, and all the time."[8]

Bentley emphasizes that political interests are group interests, and that the interests of some are in direct opposition to the interests of others. "We shall always find that the political interests and activities of any given group – and there are no political phenomena except group phenomena – are directed against other activities of men, who appear in other groups, political or other."[9] The idea that politics is a contest of one interest group against another is an old one in political science. And as Bentley further notes, "It lies almost on the surface that a legislature which is a class agency will produce results in accordance with the class pressure behind it."[10]

Max Weber made the distinction between what he called open and closed relationships. "A social relationship ... will be spoken of as 'open' to outsiders if and insofar as its system of order does not deny participation to anyone who wishes to join and is actually in a position to do so. A relationship will, on the other hand, be called 'closed' against outsiders so far as, according to its subjective meaning and its binding rules, participation of certain persons is excluded, limited, or subject to conditions ... If the participants expect that the admission of others will lead to an improvement in their situation ... their interest will be in keeping the relationship open. If, on the other hand, their expectations are of improving their position by monopolistic tactics, their interest is in a closed relationship."[11]

Weber notes the tendency for relationships to shift from open to closed. "Examples are the guilds and the democratic city-states of Antiquity and the Middle Ages. At times these groups sought to increase their membership in the interest of improving the security of their position of power by adequate numbers. At other times they restricted their membership to

8 Arthur F. Bentley, *The Process of Government: A Study of Social Pressures* (Chicago: University of Chicago Press, 1908), p. 215.

9 Bentley, *The Process of Government*, p. 222.

10 Bentley, *The Process of Government*, p. 360. However, Bentley did not buy into the clear division of interests of the Marxian bourgeoisie versus proletariat. He says (p. 467), "A proletariat class, such as Marx and Engels conceived it, simply did not exist."

11 Max Weber, *Economy and Society: An Outline of Interpretive Sociology*, ed. Guenther Roth and Claus Wittich (New York: Benminster Press, 1968), p. 43.

protect the value of their monopolistic position."[12] The elite will be more willing to let others share their status if they believe a larger elite class can help secure their positions at the top, but will work to exclude others to prevent diluting the benefits that accrue to their class.

Political scientist David Truman, writing in 1951, placed heavy emphasis on overlapping memberships in interest groups as a mechanism for mitigating group conflict. Members of one group must then take account of the interests of other groups to which their members belong. "Overlapping membership among organized interest groups and among these and potential groups is, as we have seen, the principal balancing force in the politics of a multigroup society such as the United States."[13] But Truman notes "that the members of many, if not most, such groups are drawn from the same or closely similar status levels . . . The specialization of organized interest groups along class lines and the atrophy or deficiency of such groups in the less privileged classes may be a source of political instability."[14] Truman might be forecasting events like the Occupy Wall Street movement that emphasized the division between the 1 percent and the 99 percent.

Anticipating Stiglitz's claim in 2012 that the 1 percent are writing their own rules, Truman continues,

> This rather cursory examination suggests that a pathogenic politics in the United States is possible, though not necessarily imminent . . . The frustration of group claims may be dangerously prolonged and the bitterness of group conflict may be intensified through class interpretation of "the rules of the game." Similarly, the expectations of groups emerging out of the less privileged segments of the society may be poorly represented or dangerously frustrated in consequence of the concentration of, and privileged access of, organized groups among persons of higher status.[15]

Truman says, "Interests that are widely held in society may be reflected in government without their being organized in groups."[16] But, he says, "the behaviors that constitute the process of government cannot be adequately understood apart from the groups, especially the organized and potential interest groups, which are operative at any point in time."[17]

[12] Weber, *Economy and Society*, p. 44.
[13] David B. Truman, *The Governmental Process: Political Interests and Public Opinion* (New York: Alfred A. Knopf, 1951), p. 520.
[14] Truman, *The Governmental Process*, p. 522.
[15] Truman, *The Governmental Process*, p. 523.
[16] Truman, *The Governmental Process*, p. 506.
[17] Truman, *The Governmental Process*, p. 502.

The idea that an understanding of political activity requires a recognition of the importance of group behavior, and that groups tend to be organized along class lines, is well-established in political science but has been poorly recognized by economists, including those economists who study political decision-making.

C. Wright Mills, in his 1956 book, *The Power Elite*, further develops the idea of the division between elites and masses. He begins his book by saying, "The powers of ordinary men are circumscribed by the everyday worlds in which they live . . . But not all men are in this sense ordinary. As the means of information and of power are centralized, some men come to occupy positions in American society from which they can look down upon, so to speak, and by their decisions mightily affect, the everyday worlds of ordinary men and women."[18] Mills alludes to the same cronyism, and to the same system of political capitalism, as Kolko, saying, "If there is government intervention in the corporate economy, so is there corporate intervention in the governmental process."[19] The economic elite and the political elite work together for their mutual advantage.

Mills goes on to explain, "By powerful we mean, of course, those who are able to realize their will, even if others resist it. No one, accordingly, can be truly powerful unless he has access to the command of major institutions, for it is over these institutional means of power that the truly powerful are, in the first instance, powerful."[20] This again points toward the ability to write one's own rules, as described by Truman and Stiglitz.

Mills observes, "The modern corporation is the prime source of wealth, but, in latter-day capitalism, the political apparatus also opens and closes many avenues to wealth . . . If our interest in the very rich goes beyond their lavish or their miserly consumption, we must examine their relations to modern forms of corporate property, as well as to the state; for such relations now determine the chances of men to secure big property and receive high income."[21] Mills discusses members of the elite working together for their mutual benefit:

> The unity of the power elite, however, does not rest solely on psychological similarity and social intermingling, or entirely on the structural coincidences of commanding positions and interests. At times it is the unity of a more explicit coordination . . . as the institutional mechanics of our time have opened up avenues to men pursuing their several interests, many of them have come to see

[18] C. Wright Mills, *The Power Elite* (New York: Oxford University Press, 1956), p. 3.
[19] Mills, *The Power Elite*, p. 8. [20] Mills, *The Power Elite*, p. 9.
[21] Mills, *The Power Elite*, p. 10.

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that these several interests could be realized more easily of they worked together, in informal as well as in more formal ways, and accordingly, they have done so . . . As the institutional means of power and the means of communications that tie them together have become steadily more efficient, those now in command of them have come into command of instruments of rule quite unsurpassed in the history of mankind.[22]

Mills observes, "The long-time tendency of business and government to become more intricately and deeply involved with each other has, in the fifth epoch, reached a new point of explicitness. The two cannot now be seen clearly as two distinct worlds . . . During the New Deal the corporate chieftains joined the political directorate; as of World War II they have come to dominate it. Long interlocked with government, now they have moved into quite full direction of the economy of the war effort and the postwar era."[23] The concept of political capitalism is clearly embodied in Mills' concept of the power elite.

Describing the power elite, Mills says, "There is nothing hidden about it, although its activities are not publicized. As an elite, it is not organized, although its members often know one another, seem quite naturally to work together, and share many organizations in common. There is nothing conspiratorial about it, although its decisions are often publicly unknown and its mode of operation manipulative rather than explicit."[24] Mills observes that the elite recruit and train those who will join them, with recruits often coming from elite schools and privileged backgrounds. The elite is not a closed club, but new admissions must have something to offer those who are already members. As Mills sees it, some people – the elite – make public policy, while other people – the masses – must live within the constraints of the policies the elite have designed. Mills observes:

The top of modern American society is increasingly unified, and often seems willfully coordinated: at the top there has emerged an elite of power. The middle levels are a drifting set of stalemated, balancing forces: the middle does not link the bottom with the top. The bottom of this society is politically fragmented, and even as a passive fact, increasingly powerless: at the bottom there is emerging a mass society.[25]

Mills says, "The idea of a mass society suggests the idea of an elite of power."[26]

[22] Mills, *The Power Elite*, pp. 20–21, 23.
[23] Mills, *The Power Elite*, pp. 274–275. The fifth epoch Mills refers to is the post-World War II era.
[24] Mills, *The Power Elite*, p. 297.
[25] Mills, *The Power Elite*, p. 324.
[26] Mills, *The Power Elite*, p. 323.

The point of this section is not to convince readers of this elite theory by appeal to authority, but to show that its origins have a long history in the social sciences. Economists, who tend to view behavior in terms of individuals rather than groups, may be skeptical, but the chapters that follow show how integrating this well-established elite theory into ideas that are well established in the fields of economics and public choice enhances the understanding of the economic system.

ELITE THEORY IN THE TWENTY-FIRST CENTURY

The idea that the economic and political system is controlled by the elite for their benefit has only recently been challenged by the ideals of democracy. Who would question, in a monarchy, that the system is run for the benefit of the crown? Even after 1776, the previous section demonstrated that the view that the economic and political system was controlled by the elite did not disappear, and it remains current in the twenty-first century. The views of economists Joseph Stiglitz and David Stockman have already been noted. Political scientists Jacob Hacker and Paul Pierson convey the same message, emphasizing the role of the political elite. Looking at the increasing divide between elites and masses, they say, "Where the conventional wisdom confidently declares, 'it's the economy,' we find, again and again, It's the politics.'"[27] They say, "Step by step and debate by debate, America's public officials have rewritten the rules of American politics and the American economy in ways that have benefited the few at the expense of the many."[28] Hacker and Pierson perceive a major shift in the political landscape since 1980. They ask, "How, in a political system built on the ideal of political equality and in which middle-class voters are thought to have tremendous sway, has democratic politics contributed so mightily to the shift toward winner-take-all?"[29] In a study of political capitalism, Hacker and Pierson's view is that American capitalism as an economic system has increasingly evolved into political capitalism since the election of Ronald Reagan.

Building on the elite theory that has been a part of the social sciences for well over a century, Hacker and Pierson observe that "Powerful groups defending the winner-take-all economy – business coalitions, Wall Street

27 Jacob S. Hacker and Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer – And Turned Its Back on the Middle Class* (New York: Simon and Schuster, 2010), p. 290.

28 Hacker and Pierson, *Winner-Take-All Politics*, p. 6.

29 Hacker and Pierson, *Winner-Take-All Politics*, p. 12.

lobbyists, medical industry players – are fully cognizant of the massive stakes involved, and they are battle-ready after years of training. Vigilant and highly skilled at blocking or diverting challenges, these organized forces possess big advantages over the disorganized."[30] Reflecting on the aftermath of the 2008 financial crisis, Hacker and Pierson note, "Yet while public furor at Wall Street boils over, organized activity to channel that justifiable fury into policy reform barely simmers . . . Banks are organized; their customers are not."[31]

Martin Gilens echoes the conclusion of Hacker and Pierson that the elite have an increasingly powerful influence on public policy. Undertaking an empirical analysis of public opinion data on public policy, Gilens concludes, "The analyses of change over time in this chapter do reveal an important general trend: the strengthening of policy responsiveness for affluent Americans."[32] Gilens notes that "*all* members of Congress, by dint of their congressional salaries alone, are solidly in the top decile of the American income distribution. Perhaps one reason public policy tends to reflect the preferences of the affluent, then, is simply that policymakers who are themselves affluent pursue policies that reflect their personal values and interests."[33] While Gilens does not use the term "elite" to describe members of Congress, he does offer a reason why the interests of the political and economic elite coincide.

Larry Bartels, in his book *The New Gilded Age*, observes, "It probably should not be surprising, in light of their scholarly expertise and interests, that economists have tended to focus much less attention on potential *political* explanations for escalating economic inequality than on potential *economic* explanations."[34] Bartels offers a partisan political explanation, which is that increasing inequality is due to Republican party policies. He says, "Some readers are likely to see the product of my efforts as a rather partisan book, at least by academic standards. For what it is worth, I can report that it did not start out that way . . . I was quite surprised to discover how often and how profoundly partisan differences in ideologies and values have shaped key policy decisions and economic outcomes."[35] For

[30] Hacker and Pierson, *Winner-Take-All Politics*, p. 291.
[31] Hacker and Pierson, *Winner-Take-All Politics*, p. 292.
[32] Martin Gilens, *Affluence and Influence: Economic Inequality and Political Power in America* (Princeton, NJ: Princeton University Press, 2012), p. 193.
[33] Gilens, *Affluence and Influence*, p. 235 (italics in original).
[34] Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* (Princeton, NJ: Princeton University Press, 2008), p. 26 (italics in original).
[35] Bartels, *Unequal Democracy*, p. ix.

present purposes, Bartels' partisan conclusions are of secondary importance to his emphasis on the importance of politics, and his conclusions that public policy has tilted toward favoring the elites over the masses.

Noting the differences between surveys of popular opinion and political outcomes, Bartels says, "I explore these glaring disjunctions between the predictions of simple majoritarian models and actual patterns of policymaking in the United States over the past half-century . . . The gap between the predictions of conventional political-economic models and the actual workings of American democracy also reflects the profound difficulties faced by ordinary citizens in connecting specific policy proposals to their own values and interests."[36] Those political-economic models are discussed later in this chapter. Meanwhile, note the emphasis on public policy that is at odds with majority opinion. Bartels continues, "Any serious attempt to understand the political economy of the New Gilded Age requires grappling with the political psychology of American voters and with the real limitations of public opinion as a basis for democratic policymaking."[37]

Why are public policies slanted to favor the elite? Bartels concludes, "Wealthier and better-educated citizens are more likely than the poor and less-educated to have clearly formulated and well-informed preferences, and significantly more likely to turn out to vote, to have direct contact with public officials, and to contribute money and energy to political campaigns."[38] In an empirical analysis of Senate roll call voting, Bartels finds "that senators' roll call votes were quite responsive to the ideological views of their middle- and high-income constituents. In contrast, the views of low-income constituents had *no* discernable impact on the voting behavior of their senators."[39] Bartels undertakes a further empirical analysis to try to identify why senators appear more responsive to the views of wealthy rather than poor constituents, and concludes, "These results provide surprisingly strong and consistent evidence that the biases I have identified in senators' responsiveness to rich and poor constituents are *not* primarily due to differences between rich and poor constituents in turnout, political knowledge, or contacting."[40]

Elite theory has a long history in political science and sociology, supported by empirical studies that demonstrate the disproportionate influence of the elite in politics.

[36] Bartels, *Unequal Democracy*, p. 27. [37] Bartels, *Unequal Democracy*, pp. 27–28.
[38] Bartels, *Unequal Democracy*, p. 252.
[39] Bartels, *Unequal Democracy*, p. 260 (italics in original).
[40] Bartels, *Unequal Democracy*, pp. 279–280 (italics in original).

THE POLITICS OF POLITICAL CAPITALISM

Political scientists have done a better job of describing the nature of political capitalism than have economists, at least partly because economics depicts individuals voluntarily interacting, which limits the power that one individual has over others. Even when the individual actor is a giant firm, within the framework of the market that firm can only buy its inputs, hire its labor, and sell its products if the other parties to those transactions voluntarily agree. They must reach agreement within government-designed constraints that sometimes facilitate agreement and sometimes inhibit or prevent potential transactions from taking place. Nevertheless, market transactions take place only when all parties agree. This is not true in politics, where political winners can use government to impose policies by force.

Political science more readily recognizes (along with many economists, to be fair) that the government-enforced constraints within which market transactions take place are often designed through a cooperation of the economic and political elite for their mutual benefit. When those who command economic power can use it to slant political decision-making in their favor, market transactions do not appear to be as unbiased as when they are depicted as voluntary transactions made under an objective set of rules.

Political scientists, and even more, sociologists, have recognized that people often act as members of groups rather than simply as atomistic individuals. Economists might respond that they do so because they value group membership, or that the collective action of the group benefits them as individuals. While it is undoubtedly true in a tautological sense that individuals act as members of groups because they view it as in their own interest to do so, group solidarity can have a substantial influence on political outcomes. This is widely recognized for the population in general when commentators talk about the interests of ethnic groups. There is at least as much solidarity among industry groups and formal business associations, and the idea that connections are important in both business and politics again reinforces the general recognition of the importance of groups.

Racial and ethnic tensions point toward group behavior, and people often are inclined to identify with others who attended the same school, for no reason other than that connection. Blacks were more likely to vote for Barack Obama for President, and women to vote for Hillary Clinton, solely because of a shared race or gender.[41] Identity voting is strong enough to sway the way people vote, and view political outcomes.[42] Indeed, group identity is even strong among sports fans, if the many riots after soccer games is any indication. Nominally, people watch sports contests for entertainment, but these riots indicate the degree of group identity people have with their favorite sports teams.[43] People do act as members of groups, not just as autonomous individuals.

Political scientists would be more likely to be attuned to group behavior because in politics some groups do have the ability to use the force of government against others. In market transactions, individuals can refuse to participate unless it is in their interest to do so; in politics everyone is forced to abide by the government's rules regardless of whether they agree. Majorities can coerce minorities. That is clear. But if they are able to grab the reins of political power, minorities can also coerce the majority. Political capitalism is based on the recognition that the elite as a group has the ability to set at least some of the rules within which the government compels everyone to interact.

ACADEMIC VIEWS ON DEMOCRACY

Political scientists Martin Gilens and Benjamin Page present a taxonomy that divides academic views on the American political system into four broad traditions, and undertake an empirical study to see which of these traditions is most consistent with actual political outcomes. They identify the four traditions as majoritarian electoral democracy, majoritarian pluralism, biased pluralism, and economic elite domination. They conclude that public policy has a strong

[41] Emily's List (see www.emilyslist.org) states as its mission "driving progressive change throughout our country by winning elections that put pro-choice Democratic women into office." While there is a clear party orientation here (parties are groups), this particular group also aims to elect people based on their gender, which supports the idea that women might favor other women as a part of group identity.

[42] Academic support for identity voting and identity politics can be found in Stephen Ansolabehere and M. Socorro Puy, "Identity Voting," *Public Choice* 169, nos. 1/2 (October 2016), pp. 77–95, Moses Shayo, "A Model of Social Identity with an Application to Political Economy: Nation, Class, and Redistribution," *American Political Science Review* 103, no. 2 (May 2009), pp. 147–174, and Pamela Johnston Conover, "The Influence of Group Identifications on Political Perception and Evaluation," *Journal of Politics* 46, no. 3 (August 1984), pp. 760–785.

[43] Googling "riots after soccer games" produced 525,000 hits (search done on June 9, 2016), which included riots in Britain, France, Greece, Egypt, Morocco, Serbia, Brazil, and China.

tendency to favor the elite, although in many cases the preferences of the elite are shared by the masses.[44]

The majoritarian electoral democracy tradition depicts policy outcomes as reflecting the preferences of average citizens. This view corresponds with many economic models of the political decision-making process. Early works in public choice by Anthony Downs and Duncan Black conclude that under many circumstances, democratic decision-making produces outcomes that are most preferred by the median voter – the voter in the middle of the preference distribution.[45] In the context of elite theory, the majoritarian electoral democracy tradition views democratic outcomes as reflecting the preferences of the masses.

Majoritarian pluralism depicts the political process as a balancing of various interest groups through the political process. The interest group theories of Arthur Bentley and David Truman, discussed earlier in the chapter, fit within this category. Economists also have worked within this tradition. The Chicago school approach to public choice more explicitly depicts a political marketplace that balances the demands of various interests to work much like the markets for goods and services, leading not only to the preferences of the general public being met but also producing an efficient balance in the allocation of resources among different interest groups.[46]

The effect of interest groups on democratic outcomes has been recognized since the American founding, and James Madison's *Federalist No. 10* expressed concerns about the impact of factions and the design of government to control them. The majoritarian pluralism tradition concludes that public policies are determined by the balancing forces within democratic government. This includes checks and balances in the formal design of government and the balancing of one interest group against another in the political marketplace.

[44] Martin Gilens and Benjamin I. Page, "Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens," *Perspectives on Politics* 12, no. 3 (September 2014), pp. 564–581.

[45] Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957) and Duncan Black, *The Theory of Committees and Elections* (Cambridge: Cambridge University Press, 1958).

[46] See Gary S. Becker, "A Theory of Competition Among Pressure Groups for Political Influence." *Quarterly Journal of Economics*, 98 (1983), pp. 371–400, and Donald Wittman, *The Myth of Democratic Failure* (Chicago: University of Chicago Press, 1995) and "Why Democracies Produce Efficient Results," *Journal of Political Economy*, 97 (1989), pp. 1395–1424 for work in this tradition.

Biased pluralism recognizes that some interests will be able to tilt the public policy process to favor them over the general public interest. Mancur Olson's influential book, *The Logic of Collective Action*, noted that more concentrated interests are better able to organize and thus be more effective, whereas the members of broader groups will have a tendency to be free riders, and perhaps to pay little attention to smaller costs that are imposed on them.[47] Common examples that illustrate Olson's point are agricultural programs that boost farmers' incomes substantially, but at a smaller cost to every consumer. In the twenty-first century, corn farmers benefit from sugar programs that restrict the importation of sugar, making the US price roughly twice the world price, which pushes food processors to use corn syrup as a substitute. Also, the requirement that motor fuels contain ethanol, made from corn, boosts the demand for corn and its price, while costing motorists a small amount every time they fill their tanks. Concentrated interests like the corn lobby receive substantial benefits and the general public, who pays the price, does not organize to fight the corn lobby because, first, they are a large group so it is difficult for them to organize, and second, each member of the general public pays a relatively small cost so has little motivation to organize. Meanwhile, the small cost imposed on everybody produces large benefits to the concentrated interest, giving them an incentive to organize and to use the political process for their benefit.

Biased pluralism more closely fits the model of political capitalism because it recognizes that all interests are not equally represented through the democratic process. The elite are able to cooperate with each other to secure benefits for themselves at the expense of the masses.

Even closer to the concept of political capitalism is the economic-elite domination tradition. As Gilens and Page describe it, the economic-elite domination tradition "argues that US policymaking is dominated by individuals who have substantial economic resources, i.e., high levels of income or wealth – including, but not limited to, ownership of business firms." Mills' *The Power Elite* is an example of this tradition. As Mills described it, elite status can come from factors other than wealth or income, although other sources of elite status often generate income. Entertainers and sports stars are examples.

[47] Mancur Olson, Jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1965).

This tradition goes back at least to Charles Beard's *An Economic Interpretation of the Constitution of the United States*,[48] Gilen and Page note. Beard argued that the provisions of the Constitution were designed to protect the interests of the elite class of individuals who wrote it. The Constitutional Convention took place over an entire summer, meaning that those who attended had to have an independent source of income to allow them to attend, especially in a mostly agrarian society in which the Convention took place over an entire growing season. So, landed interests, financial interests, and business interests were represented. As Beard notes, the new nation did not have a long-standing aristocracy, meaning that most wealth came from economically productive activities, so the provisions that favored wealth creation ultimately were beneficial for the nation. Still, Beard's thesis was very controversial when it was published in 1913, and remains the subject of study and debate into the twenty-first century.[49]

The economic-elite domination tradition provides a solid foundation for understanding the role of interests in political capitalism. While its origins go back at least to Marx and Engels, it is also readily apparent in the twenty-first-century literature describing a new gilded age, and a political economy in which the 1 percent are able to write the rules of the game for their own benefit.

Gilens and Page collected a substantial data set of public opinions on public policy changes which included the incomes of survey respondents, allowing them to test which of the above four theoretical traditions more accurately reflect the process of policy-making. Their empirical analysis indicates that the traditions of biased pluralism and economic-elite domination best fit their data. They conclude, "When the preferences of economic elites and the stands of organized interest groups are controlled for, the preferences of the average American appear to have only a minuscule, near-zero, statistically non-significant impact upon public policy."[50] They go on to say, "To be sure, this does not mean that ordinary citizens always lose out; they fairly often get the policies they favor, but only because those policies happen also to be preferred by the economically-elite citizens who wield the actual influence."[51] They further say that their

[48] Charles A. Beard, *An Economic Interpretation of the Constitution of the United States* (New York: Macmillan, 1913).

[49] Beard's thesis and the Constitutional Convention are discussed more thoroughly in Randall G. Holcombe, *From Liberty to Democracy: The Transformation of American Government* (Ann Arbor: University of Michigan Press, 2002), ch. 4.

[50] Gilens and Page, "Testing Theories of American Politics," p. 575.

[51] Gilens and Page, "Testing Theories of American Politics," p. 576.

findings "certainly constitute troubling news for advocates of 'populist' democracy, who want government to respond primarily or exclusively to the policy preferences of their citizens. In the United States, our findings indicate, the majority do *not* rule – at least not in the causal sense of actually determining policy outcomes. When a majority of citizens disagrees with economic elites or with organized interests, they generally lose."[52]

Some traditions in political science depict political power as more evenly distributed than others. The democratic ideal of one person, one vote, suggests that all citizens ultimately have equal political power. Casual observation indicates that some people are able to exert more political influence than others, and elite theory offers a less egalitarian alternative in which an elite group is able to design public policy for their benefit, often at the expense of the masses. This idea lays the foundation for looking at models in subsequent chapters to build a theory of political capitalism. The pieces are all there, and what remains is to put them together. Elite theory is one of the pieces.

DOES CAPITALISM BREED INEQUALITY?

Not surprisingly, the political scientists whose ideas were discussed above tend to put a heavy emphasis on politics as a driving force in the division between elites and masses. Another viewpoint is that the capitalist system itself is responsible for growing inequality. Thomas Robert Malthus argued that population tends to grow exponentially while resources available to support that population tend to grow linearly, so population growth will always press upon resources available to support the population and most people will be condemned to live at a subsistence level of income – barely enough to allow them to survive.[53] Malthus did not have much data upon which to build his argument, so it is based on the assumption of exponential population growth pressing against a linear growth in resources to support the population. Malthus says:

> Taking the population of the world at any number, a thousand millions, for instance, the human species would increase in the ratio of – 1, 2, 4, 8, 16, 32, 64,

52 Gilens and Page, "Testing Theories of American Politics," p. 576 (emphasis in original).

53 A subsistence level of income meant to classical economists like Malthus, Ricardo, and Mill, an income just sufficient to allow the population to reproduce its number. Population growth is possible only if income rises above subsistence, and income below subsistence means the population will shrink.

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128, 256, 512, &c. and subsistence as – 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, &c. In two centuries and a quarter, the population would be to the means of subsistence as 512 to 10: in three centuries as 4096 to 13; and in two thousand years the difference would be almost incalculable, though the produce in that time would have increased to an immense extent.[54]

This is the basis for Malthus's argument. Although it is short on empirical evidence, the logic is apparently strong enough that the Malthusian lament that the Earth is running short on resources to support its growing population remains a popular one despite more than two centuries of population growth since Malthus wrote. Malthus concludes, "But though the rich by unfair combinations, contribute frequently to prolong a season of distress among the poor; yet no possible form of society could prevent the almost constant action of misery upon a great part of mankind, if in a state of inequality, and upon all, if all were equal."[55]

David Ricardo built on the ideas of his friend Malthus, noting that land is a scarce resource, which gives rise to land rent. If land were as abundant as air, Ricardo notes, no charge could be collected for using it. "If all land had the same properties, if it were unlimited in quantity, and uniform in quality, no charge could be made for its use . . . It is only, then, because land is not unlimited in quantity and uniform in quality, and because in the progress of population, land of an inferior quality, or less advantageously situated, is called into cultivation, that rent is ever paid for it."[56] Ricardo follows the same logical path as Malthus, while noting that the increased scarcity of land due to population growth increases land rent, squeezing both wages and profit. Ultimately, Ricardo concludes, "Long indeed before this period, the very low rate of profits will have arrested all accumulation, and almost the whole produce of the country, after paying the labourers, will be the property of the owners of land and the receivers of tithes and taxes."[57]

As Ricardo sees it, growing income inequality is an outcome of capitalism because the market price for land continually rises, favoring owners of land (and the receivers of tithes and taxes) while pushing others down to a subsistence level of income. Ricardo argued that rent does not need to be paid to land to get it to be productive. Land will produce just as much

[54] Thomas Robert Malthus, *An Essay on the Principle of Population* (London: J. Johnson, 1798), Chapter II, paragraph 17.
[55] Malthus, *An Essay on Population*, Chapter II, paragraph 32.
[56] David Ricardo, *Principles of Political Economy and Taxation*, 3rd edn. (London: John Murray, 1821), p. 41.
[57] Ricardo, *Principles of Political Economy*, p. 79.

whether or not it receives a payment,[58] although wages do have to be paid to laborers to get them to work, and profit does have to accrue to the owners of capital to get them to invest. The capitalist system, which makes land private property that rents for a market price, by itself leads to growing income inequality.

Land rent is a small part of the national income of advanced nations in the twenty-first century – about 2 percent – but this argument might be applied to capital in the twenty-first century, as Thomas Piketty has, as discussed below. Capital's share of income continues to grow, producing growing income inequality as a natural outcome of the capitalist system. The point is that Ricardo thought that capitalism creates growing inequality independent of any political interference with the market.

John Stuart Mill observed the inequality that Malthus and Ricardo saw, and came up with a slightly different diagnosis. Flirting with the possibility of communism as an alternative economic system in his *Principles of Political Economy*, Mill makes the following observation about the distribution of income in the mid-nineteenth century:

> If, therefore, the choice were to be made between Communism with all its chances, and the present state of society with all its sufferings and injustices; if the institution of private property necessarily carried with it as a consequence, that the produce of labour should be apportioned as we now see it, almost in inverse ratio to the labour – the largest portions to those who have never worked at all, the next largest to those whose work is almost nominal, and so in a descending scale, the remuneration dwindling as the work grows harder and more disagreeable, until the most fatiguing and exhausting bodily labour cannot count with certainty on being able to earn even the necessaries of life; if this or Communism were the alternative, all the difficulties, great or small, of Communism would be but as dust in the balance.[59]

Ultimately, Mill does not side with communism, however, but with a reform of capitalism. "The principle of private property has never yet had a fair trial in any country . . . The laws of property have never yet conformed to the principles on which the justification of private property

[58] Ricardo was thinking about growing crops on agricultural land and observing that the land will be equally fertile whether or not it is paid. His argument is not generally correct, because land rent allocates land to its highest-valued use. There is no farmland in downtown Manhattan, New York, despite the fact that more than 10 million people live (and eat) in the area, because land rent sends a market signal that it is more economical to use the land for high-rise buildings and ship food in from locations where the land rent is lower, for example.

[59] John Stuart Mill, *Principles of Political Economy With Some of Their Applications to Social Philosophy* (London: Longmans, Green, and Co., 1920 [orig. 1848]), p. 208.

rests . . . but have heaped impediments on some, given advantage to others; they have purposely fostered inequalities, and prevented all from starting in a fair race."[60] Mill, unlike Ricardo, does not view capitalism as inevitably leading to inequality, but did see the institutional structure in the mid-1800s as generating inequality. Mill favored limiting the amount that people could inherit, and progressive income taxation, as two methods that could tilt the balance more toward a fair race.

Thomas Piketty, in a book that was a *New York Times* bestseller (how often does that happen with an academic economics book?) in 2014, makes a straightforward argument that capitalism inherently increases income inequality.[61] He divides income into two different types: labor income and capital income (which also includes rental income from land). Labor income comes from people working, whereas capital income comes from people owning income-generating assets. He notes that capital ownership is skewed so that most capital is owned by those at the upper end of the income distribution. Capital income grows over time at the rate of interest (the rate of return on capital), which he denotes as r, whereas labor income grows as the rate of overall GDP growth, which he denotes as g. Because the rate of return on capital is greater than overall income growth, $r > g$, which means that income inequality grows over time as a result of the nature of the capitalist system. The income of the elite grows at rate r while the income of the masses grows at the slower rate g.

Unlike the political theories dividing elites and masses discussed above, Piketty's argument, like Ricardo's, concludes that without any political favoritism at all, there will be a growing divide between the incomes of the elites and masses. Whether Piketty's claim is true is subject to debate,[62] but shows that not every critic of inequality in capitalist economies sees it as a result of cronyism, favoritism, or corruption. At least some see it as an inevitable outcome of the capitalist system itself. As Piketty sees it, the capitalist system reinforces the class division independent of politics. Both Larry Bartels and Martin Gilens, two political scientists whose work was discussed above, reference Piketty's data as evidence of the inequality they

[60] John Stuart Mill, *Principles of Political Economy*, pp. 208–209.

[61] Thomas Piketty, *Capitalism in the Twenty-First Century* (Cambridge, MA: Harvard University Press, 2014).

[62] For an excellent critique of the data Piketty uses to make his claims, see Phillip W. Magness and Robert P. Murphy, "Challenging the Empirical Contribution of Thomas Piketty's *Capital in the Twenty-First Century*," *The Journal of Private Enterprise* 30, no. 1 (Spring 2015), pp. 1–34. An extended critique of Piketty's book can be found in Jean-Philippe Delsol, Nicolas Lecaussin, and Emmanuel Martin, eds. *Anti-Piketty: Capital for the 21st Century* (Washington, DC: Cato Institute, 2017).

perceive, but they both attribute that inequality to politics, not to capitalism.

PUBLIC CHOICE: AN ECONOMIC ANALYSIS OF POLITICS

Chapter 2 explained how economics and politics, studied together as political economy in the nineteenth century, divided into the separate disciplines of economics and political science in the twentieth. For the most part, economists avoided analyzing the political decision-making process, claiming that it was outside their discipline. In the public policy arena, the role of economists was to derive and explain how to allocate resources efficiently, and the political process by which those policies were implemented was the subject matter of political science.

One problem with this division is that policies that are, in theory, optimal may not be achievable in practice, perhaps because the information required to implement them is not available to policymakers and perhaps because, even if they have the information, policymakers have the incentive to implement policies that are not optimal. Public choice theory emerged in the 1960s as a subdiscipline that uses economic methods to analyze political decision-making. The idea is to use the same assumptions about incentives and individual behavior that economists use to analyze market activity to analyze political decision-making. Public choice assumes that people make decisions the same way whether they are making economic decisions or political decisions.

Nobel Laureate James Buchanan and coauthor Gordon Tullock, in *The Calculus of Consent*, one of the seminal books in the subdiscipline of public choice, take a "purely individualistic"[63] approach to the analysis of political decision-making. They say, "Collective action is viewed as the action of individuals when they choose to accomplish purposes collectively rather than individually, and the government is seen as nothing more than the set of processes, the machine, which allows such collective action to take place."[64] Taking this individualistic approach, Buchanan and Tullock "also reject any theory or conception of the collectivity which embodies the exploitation of a ruled by a ruling class. This includes the Marxist vision, which incorporates the polity as one means through which the economically dominant group imposes its

[63] James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962), p. 13.
[64] Buchanan and Tullock, *The Calculus of Consent*, p. 13.

will on the downtrodden."[65] The public choice approach to analyzing political decision-making, as Buchanan and Tullock see it, leaves no room for the group behavior and elite theories that are the subject of this chapter. Their conception is one of politics as exchange. They conclude,

> The market and the State are both devices through which cooperation is organized and made possible. Men cooperate through exchange of goods and services in organized markets, and such cooperation implies mutual gain . . . At base, political or collective action under the individualistic view of the state is much the same. Two or more individuals find it mutually advantageous to join forces to accomplish certain common purposes. In a very real sense, they 'exchange' inputs in the securing of the commonly shared output.[66]

Buchanan and Tullock discuss logrolling as a process of political exchange in which the participants trade votes or other political favors for their mutual advantage to improve everyone's welfare relative to the status quo. They examine constitutional constraints on the powers of government as a method of controlling government power to channel it toward the interests of all its citizens. They explicitly contrast their approach to the way political scientists have analyzed the political process, saying, "Political theorists seem rarely to have used this essentially economic approach to collective activity."[67] So, the elite theory that is the subject of this chapter requires some justification if it is to be combined with insights of public choice to describe political capitalism.

In another of the seminal books that laid the foundation for public choice, Anthony Dows, in *An Economic Theory of Democracy*, develops the median voter model, in which voter preferences are arrayed on a single-dimensioned continuum from the political left to the political right, and political competition pushes public policy to be that favored by the median voter – the voter whose preferences are in the center of the left–right distribution of political preferences.[68] Following the methodology described by Buchanan and Tullock, Downs treats everyone as individuals, acting on their own preferences. Downs introduces the idea of rational ignorance in politics, saying that because the chance that one individual vote will determine the outcome of an election is vanishingly small, voters have little incentive to become informed about their political decisions. Regardless of how any one individual votes, the election outcome will be

65 Buchanan and Tullock, *The Calculus of Consent*, p. 12.
66 Buchanan and Tullock, *The Calculus of Consent*, p. 19.
67 Buchanan and Tullock, *The Calculus of Consent*, p. 20.
68 Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957).

the same, so there is no payoff to being an informed voter, in contrast to the payoff of being an informed consumer. Consumers always get what they choose; voters often do not, and whether they do is not determined by their individual votes anyway. Rational ignorance is yet another reason why voters have little incentive to engage in group activities.

The public choice approach – the economic analysis of politics – tends to take an individualist approach to political decision-making because economic analysis in general focuses on individual behavior. Individuals make decisions; groups do not. A group choice, such as an election outcome, is merely the result of aggregating the individual choices of all the members of the group. This approach discounts the possibility that when individuals make their individual choices, they may do so by considering group interests. Voting according to group interests rather than individual interests fits more easily within the individualistic framework when one realizes that in fact individual votes and preferences typically do not determine group choices. It is easy to vote for a collective preference when one realizes that one vote will not be decisive.

The Chicago school approach to political decision-making, typified by Nobel Laureate Gary Becker, is based on this same individualistic framework of politics as exchange, as previously noted.[69] This approach depicts a political marketplace which weighs various political interests against each other and balances the costs and benefits on a public policy continuum to choose the most efficient policy to achieve the desired political outcome. Group pressures are the aggregation of individual pressures, following the methodology Buchanan and Tullock advocated in *The Calculus of Consent*.

This individualistic approach to collective decision-making is not true of all economists. Mancur Olson, in his *The Logic of Collective Action*, explicitly looks at how group dynamics affect individual choices. But economists take a strongly individualistic approach to collective decision-making often enough that it is worth taking an in-depth look at how the political theories of group dynamics and elite domination relate to this individualistic approach.

Individualistic assumptions are more reasonable when discussing market behavior rather than political behavior, because market choices are almost always individual choices. People decide for themselves what they will buy, where they work, how much they will save versus consume, and other economic decisions. In markets, people get what they, individually,

[69] Becker, "A Theory of Competition Among Pressure Groups, and Wittman, "Why Democracies Produce Efficient Results," both cited previously.

choose. In politics, collective decisions apply to everybody, so collective choices inevitably give people some outcomes they do not prefer. This gives them an incentive to organize with others and to make decisions based on a group identity rather than an individual identity. This is even more true when by organizing they can use the force of government to provide advantages to those in their group.

Consider the quip, "democracy is two wolves and a sheep voting on what to have for dinner." This stylized example shows the advantage of working as a group to use the force of government for the group's advantage. In a market setting based on voluntary exchange, one can conjecture that there is not a voluntary transaction that would lead to the sheep's selling out to become the wolves' dinner. When a majority can use the force of government to its advantage, that provides the incentive to join forces and act for the interest of the group. And if a few – the elite – can control the reins of government, they have an incentive to cooperate to do so, and to exclude others from their elite group. Group divisions make more sense when analyzing political activity, which is based on force, than when analyzing market activity, which is based on mutually agreed-upon transactions.

ECONOMIC ANALYSIS OF GROUP BEHAVIOR

The emphasis in this chapter has been on the academic literature in political science and sociology, where elite theory has been the most developed and accepted. Some economists have, however, accepted these ideas, even though economic analysis remains primarily individualistic. In a symposium on identity economics published in the *American Economic Review*, economist Robert Ackerlof says, "Traditionally, economists have modeled agents as individualistic, uninfluenced by their social context, and motivated only by personal gain. However, increasingly, they have been drawing on concepts outside of economics, such as 'norms,' 'esteem,' and 'identity,' to model agents' social natures."[70] The ideas of political scientists and sociologists discussed in this chapter have been creeping into the fringes of economics, and the following chapters suggest their relevance to the understanding of political capitalism.

The basic logic behind elite theory can be understood in three steps, all of which have had some recognition in economics. First, individuals sometimes act as members of groups rather than as individuals. Ackerlof notes,

[70] Robert Ackerlof, "'We Thinking' and Its Consequences," *American Economic Review* 106, no. 5 (May 2016), p. 415.

"There are countless real-world examples of situations in which individuals apparently act selflessly; in the best interest of their families, firms teams, political parties, and countries."[71] Second, individuals sort into groups in which they have common interests. Economist Jean-Paul Carvalho observes, "By excluding non-members ... an organization confines its members to like-minded individuals. This is a form of intolerance, which is critical to identity formation."[72] Ackerlof says, "Groups with a sense of common identity find it easier to engage in collective action."[73] Third, groups use any power at their disposal to provide institutional advantages to their group over others. Economist Rachel Kranton says, "People create social differences to serve their purposes, such as political or economic domination ... Similarly, politicians and others promote division and hatred as a rational competitive strategy."[74]

Economists Dennis Snower and Steven Bosworth develop a model in which some groups have higher status than others. "All individuals seek to join the highest-ranking group that will accept them."[75] "We tend to be more prosocially cooperative with our in-groups and more positionally competitive with our out-groups."[76] In the context of political capitalism, one can see the elites as members of a high-status group that excludes those they do not view as peers, and that cooperate with others in their group to compete with other groups for the benefit of their own.

Looking at these three steps, the first one is likely the most difficult one for economists to take: to accept that individuals act as members of groups rather than as individuals. Economic methodology is based on individual behavior, not group behavior, and economists are quick to explain why behaving as a member of a group is in the individual's self-interest. From a sociological point of view, the problem with this economic approach to group behavior is that it implies that individuals will abandon their groups if it is in their self-interest to do so, whereas simple observation shows many cases in which individuals make great individual sacrifices for their groups, including sacrificing their lives. Both casual observation and academic research show that

[71] Ackerlof, "We Thinking," p. 415.
[72] Jean-Paul Carvalho, "Identity-Based Organizations," *American Economic Review* 106, no. 5 (May 2016), p. 410.
[73] Ackerlof, "We Thinking," p. 418.
[74] Rachel E. Kranton, "Identity Economics 2016: Where Do Social Norms Come From?" *American Economic Review* 106, no. 5 (May 2016), p. 406.
[75] Dennis J. Snower and Steven J. Bosworth, "Identity-Driven Cooperation Versus Competition," *American Economic Review* 106, no. 5 (May 2016), p. 422.
[76] Snower and Bosworth, "Identity-Driven Cooperation," p. 420.

opportunistic behavior such as free riding on the efforts of others is much rarer than the purely individualistic model of human behavior would suggest. Nevertheless, the economist's individualistic approach to human behavior fits uncomfortably with an analysis based on group behavior.

If the idea that individuals sometimes act as members of groups can be accepted, the next two steps toward elite theory seem consistent with economic analysis. The second step, that group formation is based on common interests, is natural. Why else would one become a member of a group? The third step, that groups use their collective power to bring benefits to those in the group, that they cooperate with in-group members and compete with those outside the group, is similarly consistent with economic analysis. If that first step can be taken, elite theory, in which the elite cooperate for their mutual advantage at the expense of the masses, seems straightforward for economists. As the discussion in this section indicates, some economists have taken that step, even though the mainstream in economics remains firmly individualistic in its approach.

ELITE THEORY AND POLITICAL CAPITALISM

The idea that public policy is designed by elites for their benefit applies to most governments throughout the history of the world. Most governments have been explicitly designed that way. Monarchies explicitly put the interests of the monarch and others in the royal class ahead of commoners and view citizens as subjects of the state. Dictatorships have a hierarchical design such that the role of those at the bottom is to serve the interests of those at the top. The state is often viewed as having interests of its own, which ultimately means interests the political leadership defines, and citizens have the obligation of carrying out those interests. President Kennedy, in his inaugural address in 1961, famously said, "Ask not what your country can do for you, ask what you can do for your country." While Kennedy's request might be interpreted in various ways, a direct interpretation of his words makes it appear he is saying people should look for ways to place their interests below the interests of their country rather than thinking of their country as existing to serve them.[77]

[77] Note that Kennedy did not say that people should serve their government, but their country, which might mean considering the interests of their fellow citizens. While it might be charitable for them to do so, the role of the state, according to the American Founders, was to serve the interests of its citizens; it was not a duty of its citizens to serve the interests of the state.

Douglass North divided theories of the state into two groups. In one, the state is an organization that maximizes the well-being of its citizens, and in the other – the predatory theory of the state – the state is designed to maximize the well-being of those in power, regardless of its impact on the well-being of the majority of its citizens.[78] While much of political history can be analyzed as a struggle by citizens to attempt to control the power of the state and direct it toward improving their well-being, the concept of a state designed to serve its citizens had not been developed until the American Revolution.[79] In democratic capitalism, government was designed to further the interests of its citizens rather than the political leadership.

In keeping with the framework of twentieth-century political and economic systems, capitalist democracies followed the model of a state in which government served the interests of the people, and in which economic activity took place only with the voluntary consent of buyers and sellers. The ideology of capitalism, at least in its ideal form, was one of voluntary transactions that served the interests of both the buyers and sellers; otherwise they would not voluntarily engage in the transactions. Political capitalism is not simply a reversion to the idea that in reality the political system works for the benefit of the elite, but rather an application of elite theory to the economic system of capitalism. Of course, monarchies and dictatorships place the interests of the elite above the interests of the masses. Democratic capitalism in its ideal form was envisioned as embracing both political and economic systems that furthered the interests of the masses. Political capitalism is more than just a reversion to a predatory model of the state that draws a parallel between capitalism and predatory governments like monarchies and dictatorships. It extends elite theory to the democratic process that governs capitalist economies that nominally are designed for the benefit of the masses.

78 Douglass C. North, *Structure and Change in Economic History* (New York: W. W. Norton, 1981). Mehrdad Vahabi, "A Positive Theory of the Predatory State," *Public Choice* 168, nos. 3/4 (September 2016), pp. 153–175, develops a framework for analyzing North's predatory state.

79 Ayn Rand makes the case that this idea was novel at the time the United States was established in "The Nature of Government," Chapter 14 in *The Virtue of Selfishness* (New York: Signet Books, 1961). An interesting examination of the struggle between citizens and the state to establish more citizen control over government is found in Roger D. Congleton, *Perfecting Parliament: Constitutional Reform, Liberalism, and the Rise of Western Democracy* (Cambridge: Cambridge University Press, 2011).

CONCLUSION

The bulk of the analysis in the following chapters is based on economic models of political decision-making. Those models offer a substantial amount of insight into the way that the political-economic system works, but they often rest on an individualistic behavioral model that discounts group behavior and that does not recognize the division between elites and masses that elite theory develops. One result is that the theories in the following chapters have been viewed atomistically, as descriptive of political phenomena, but not combined into a comprehensive theory of political economy. By integrating the insights of elite theory with those public choice theories, areas of commonality among them become more clear, and out of that more unified theory emerges a clear description of political capitalism.

Elite theory describes the division of society into elites and masses but offers limited insight into the institutional mechanisms that the elite use to further their interests. This is understandable, because elite theory was developed by political scientists and sociologists to describe the distribution of political power. The economic and public choice theories in the following chapters fill out the institutional detail to explain how the elite are able to use the system to promote their interests. The theory of political capitalism combines these well-established theories, using them as building blocks that, when integrated, offer more insight into political and economic systems than the individual theories do on their own.

4

Interest Groups and Political Exchange

The theory of political capitalism rests on a solid foundation of academic work in the social sciences that has been developed throughout the twentieth century and into the twenty-first. The elite theory described in the previous chapter provides an essential component by establishing that there is a limited group of people – the elite – who are in a position to use the political process to their advantage, while the masses are essentially disenfranchised from the process. While citizens in modern democracies do get to vote for their political leaders, and taken together, all their votes determine the outcome of democratic elections, no one vote is decisive, so most individuals have no political power by themselves. Furthermore, their electoral choices are limited by the alternatives offered to them by the political elite. This chapter lays out an economic foundation to support the elite theory that was developed in political science and sociology, but remains peripheral (at best) in the economic analysis of politics.

The economic approach to politics explains how individuals interact through political institutions to further their own interests. In most cases, the optimal strategy for individuals is to remain rationally ignorant of political activity, because their one vote – or their one voice if they choose to become more active – will have a negligible influence on any political outcomes.[1] The masses have little incentive to participate because their participation makes no difference to their quality of life. For most people, knowing the difference between restaurants can affect the quality of their lunch, but knowing the difference between two candidates for the United States Senate will have no effect on them, because the same person will be elected regardless of how they cast their one vote.

[1] This idea of rational ignorance was one of the many contributions of Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957).

Sometimes individuals will pool their influence by joining a special interest group, such as the National Education Association, the American Association of Retired Persons, or the National Rifle Association. The people who run those organizations are among the elite who are able to negotiate with legislators and they do have an effect on public policy, so the masses can participate in that way, by supporting organizations run by the elite. Even here, the masses have minimal incentives to participate. They can volunteer, or make financial contributions, but for members of the masses, their individual contributions will make an imperceptible difference to the overall effectiveness of the organization. Mancur Olson, in his highly regarded *Logic of Collective Action*, notes that people in large diffuse groups will tend to free ride on organizations even when they are sympathetic with the organizations' goals, so smaller groups with more concentrated benefits will have an organizational advantage and will be able to enter the political process to create policies that benefit themselves at the expense of the larger but more poorly organized masses.

The ethanol policies discussed in the previous chapter provide a good example. A few dollars each from consumers of motor fuels adds up to millions of dollars for corn farmers and processors. Because it costs each consumer a few dollars, no individual has much of an incentive to object to those policies, but a few dollars from each consumer provides concentrated benefits to the corn industry, which has a substantial incentive to engage in political activities that perpetuate those policies that benefit them. In this example, the ethanol producers are members of the elite and the motor fuel consumers are members of the masses.

Chapter 3 discussed the discontinuity that exists among individuals in political power, as opposed to the more continuous nature of economic power. This chapter develops that idea in more detail to analyze that discontinuity. Economic power is roughly proportional to income and wealth, so \$200 commands roughly twice the economic power of \$100; \$2 million commands roughly twice the economic power of \$1 million. This is not so true in politics, partly because one side wins while the other side loses. If one person likes Coca-Cola and another likes Pepsi, in the market they can each have what they want. If the person who prefers Coca-Cola has more money, that person would be in a position to buy more (of everything) than the person with less money, but in economic transactions they both win. If a political decision determines whether the group will buy Coca-Cola or Pepsi, the one with the most political power will win. Everybody gets what the side with the most political power prefers.

Elite theory separates the population into elites and masses, and describes a discontinuity in political power. This discontinuity can be given a more solid economic foundation by viewing it through the lens of the Coase theorem, a well-established idea within economics. This chapter begins by explaining the Coase theorem and showing how it provides an economic foundation for the elite theory described in the previous chapter.

TRANSACTION COSTS AND THE COASE THEOREM

The Coase theorem is a product of one of the best-known and most frequently cited articles in economics: Ronald Coase's "The Problem of Social Cost."[2] There are no theorems stated in Coase's article, but shortly after its publication George Stigler discussed the article's implications under the name of the Coase theorem.[3] A common statement of the Coase theorem is: in the absence of transaction costs, the allocation of resources is independent of the assignment of property rights. A more intuitive version of the theorem would read: in the absence of transaction costs, resources are allocated to their highest-valued uses. Transaction costs are anything that stands in the way of people making mutually advantageous exchanges. The simple logic of the Coase theorem is that if there is nothing standing in the way of people making a mutually advantageous exchange, whoever values something the most will be in a position to strike a bargain to obtain it.

Coase's article is an analysis of the academic literature on externalities at the time he was writing. Externalities are costs (and sometimes benefits, but this section focuses on costs) some people's actions impose on others when resources are allocated externally to the market system. Air pollution is a common example. Some people engage in economic activity that pollutes the air, and because there is no market for clean air, others bear the cost of that pollution that they had no part in creating. If there were no transaction costs, which means everyone can costlessly bargain with each other to maximize the value of resources they control, polluters and those bearing the cost of pollution would be able to negotiate with each other to secure the optimal amount of pollution.

The optimal amount is probably not zero. Consider for yourself whether you would be willing to give up your refrigerator, television, and electric

[2] Ronald H. Coase, "The Problem of Social Cost." *Journal of Law & Economics*, 3 (1960), pp. 1–44.

[3] George J. Stigler, *The Theory of Price*, 3rd edn. (New York: Macmillan, 1966), p. 113.

lights in exchange for shutting down the electric power plant that generates that electricity. If transaction costs are high, polluters have no incentive to take account of the costs they impose on others, so one would expect larger-than-optimal levels of pollution. If there were no transaction costs, polluters would have to pay those who are affected for the right to pollute, or perhaps those who are affected would pay polluters to reduce their pollution. Either way, if there are no transaction costs, people will be able to costlessly bargain to allocate resources optimally.

Consider a hypothetical example of a group of people holding an outdoor barbeque when a neighbor begins burning leaves next door, with the smoke from the burning leaves migrating to interfere with the people holding the barbeque. If the value of holding a smoke-free barbeque is greater to the barbequers than the value of burning the leaves is to the leaf burner, the barbequers should be able to offer the leaf burner something in exchange for dousing the leaves, which makes both the barbequers and the leaf burner better off. The exchange may be as simple as asking the leaf burner to put off burning the leaves and join them in their festivities, it could be a monetary payment, or could be something else. In the absence of transaction costs, they can find a mutually advantageous exchange to make to the leaf burner to put out the fire. If the leaf burner places a higher value on burning the leaves immediately than the barbequers place on having a smoke-free barbeque, no mutually advantageous exchange can be made, but in either case, resources will be allocated to their highest-valued uses.

Now make a small change in the previous example to consider an industrial town where a dozen steel mills are generating air pollution that is spread among tens of thousands of residents who live nearby. The example is similar to the one above, in that the air pollution caused by one party has a negative effect on another party, but in this case, for those who are breathing the air pollution to strike a bargain with those who are creating it would require not just two people to agree, but tens of thousands. In this case, the large number of people who would have to reach an agreement would likely constitute a high transaction cost that would preclude an agreement from being made. Recall Mancur Olson's idea that it is easier to get small groups to organize than large groups. While the barbequers could offer payment to the leaf burner easily (transaction costs are low), it is more difficult to organize tens of thousands of residents so they can offer payment to dozens of steel mills to cut back on their pollution, even if the residents valued cleaner air more than those who ran the steel mills valued the ability to create more air pollution. Transaction costs are an impediment to being able to bargain to allocate resources to their highest valued uses, and one source of high transaction costs is a large number of people who would have to be involved in a potential transaction.

The point that Coase was making was not that resources will tend to be allocated to their highest-valued uses, but that when they are not, the reason is that transaction costs stand in the way. When transaction costs are low, people can bargain to allocate resources in the way that is most valuable to them. When transaction costs are high, people are unable to make such bargains, and resources may not be allocated to their highest-valued uses. Transaction costs are a fact of economic life, and the reason that resources often are not allocated to their highest-valued uses because transaction costs stand in the way.

POLITICS AND THE COASE THEOREM

The Coase theorem applies to politics the same way it applies to markets. When transaction costs are low, people can bargain to allocate resources in a way that maximizes the value to the members of the low-transaction cost group – the people who are able to bargain. When transaction costs are high, people will not be able to bargain to allocate resources to maximize the value to them. In politics, some people find themselves in the low-transaction cost group while others find themselves in the high-transaction cost group.[4] The people in the low-transaction cost group bargain with each other to make public policy. The people in the high-transaction cost group are unable to participate in the negotiations that determine public policy, and find themselves subject to the policies designed by those in the low-transaction cost group. Those in the low-transaction cost group are the elite; those in the high-transaction cost group are the masses. The Coase theorem provides an economic foundation for elite theory.

Consider political bargaining among members of the legislature. In the United States Congress, there are 435 people in the House of Representatives, and 100 in the Senate. The group is small enough that they all know each other, so transaction costs will be low and they will be able to bargain to produce policies that maximize their value to themselves.

[4] Daron Acemoglu asks, "Why Not a Political Coase Theorem? Social Conflict, Commitment, and Politics," *Journal of Comparative Economics* 31, no. 4 (December 2003), pp. 620–652, and Francesco Parisi, "Political Coase Theorem," *Public Choice* 115, nos. 1/2 (April 2003), pp. 1–36, also writes of a political Coase theorem. In both cases, they refer to the Coase theorem as the situation in which low transaction costs allow all parties to costlessly bargain with one another. More generally, Coase's point was that in most cases transaction costs prevent all parties from entering bargains like this.

This type of bargaining, often called *logrolling*, is transparent enough that citizens know it takes place and the press regularly reports on it. Provisions will be added to bills specifically to buy enough votes to get it to pass, and legislators will agree to support each other's bills for their mutual benefit. This political exchange occurs among legislators because transaction costs are low so legislators are able to bargain to produce legislation that maximizes its value to those who participate in the political exchange.[5]

This does not mean that those policies will be the ones that maximize value for everyone in the nation. Rather, the bargaining process allows those in the bargaining group to maximize the value to themselves: those who are in the low-transaction cost group who are able to participate in the political exchange. Those who face high transaction costs and are unable to participate in the bargaining process – the masses – will not have their preferences taken into account by those who are in the bargaining group – the elite. Indeed, because government policies are created by a few people in the low-transaction cost group but apply to everyone, those in the low-transaction cost group are in a position to use the force of government to impose costs on others. Just as with externalities in markets, the political transactions of some can impose costs on others who do not participate in the transactions.

In general, people look out for their own interests, so there is good reason to think that those who hold the power of government and who are able to bargain to determine what policies are passed and implemented will design polices that benefit themselves. The policies that are best for the members of the low-transaction cost group may impose costs on those who are in the high transaction cost group – those who are unable to participate in the political bargaining process.

Legislators are in the low-transaction cost group that can bargain among themselves to produce policies that maximize their value to that group. Most citizens are in the high-transaction cost group and cannot participate in the political bargaining process, so find themselves in a position to bear costs as those in the low transaction cost group use the force of government to place tax and regulatory burdens on them. Incorporating the ideas of Chapter 3, people in the low-transaction cost group are the elite, and those

[5] A substantial amount of literature in economics and public choice provides academic support for this type of political exchange. See, for example, Barry R. Weingast, Kenneth A. Shepsle, and Christopher Johnsen, "The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics," *Journal of Political Economy* 89, no. 4 (August 1981), pp. 642–664, and Kenneth J. Koford, "Centralized Vote Trading," *Public Choice* 39, no. 2 (1982), pp. 245–268.

in the high-transaction cost group are the masses. The Coase theorem provides the well-established economic foundation for making this connection.

People can buy their way into the low-transaction cost group – the elite – if they are able to offer others in that group benefits that make it worth their while to bargain with them. Lobbyists are able to negotiate with legislators because they are in a position to offer benefits to legislators in the form of campaign contributions, political support from their clients, and perhaps other more personal benefits. A corporate lobbyist might be discussing upcoming legislation with a legislator who happens to mention that he has a family member who is looking for a job in the lobbyist's industry. A job offer to the family member could aid in the passage of legislation favorable to the lobbyist's client. Even if the lobbyist provides campaign contributions, a significant number of legislators hire family members to be a part of their campaign staffs, providing a mechanism by which political contributions can provide a direct financial benefit to policymakers.[6] These are obvious and legal ways in which lobbyists can buy their way into the low-transaction cost group to be able to bargain with legislators.

Connections count. A frequent occupation of former legislators is lobbyist. Those former legislators know current legislators, giving them a personal connection with those in the low-transaction cost group. Legislative staffers and government agency bureaucrats also can make use of connections to bargain with those they worked with in the past. But connections will only get someone so far. Connections can provide an introduction, but to be in the low-transaction cost group requires that members have something to offer others in the group; otherwise, they will be unable to bargain for what they are seeking. Someone without connections will not even be able to get in the door. Someone with connections can make a request, but the policymaker will only be in a position to say, "I'll see what I can do," without some tangible benefit being offered in exchange for the requested benefit.

The Coase theorem lies at the heart of transaction cost economics, and transaction cost economics provides a solid economic foundation

6 Peter Schweizer, *Extortion: How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets* (Boston: Houghton Mifflin, 2013), p. 75, notes that in the 2008 and 2010 election cycles, 82 members of Congress had family members on their payrolls or hired them as consultants. Ken Buck, *Drain the Swamp: How Washington Corruption Is Worse Than You Think* (Washington, DC: Regnery, 2017) tells a similar story about the interaction between money and policy outcomes in the US Congress, noteworthy partly because Buck wrote the book when he was a member of the House of Representatives.

on which the elite theory described in Chapter 3, developed by sociologists and political scientists, can be understood. In the transaction cost framework, elites are those who are in the low-transaction cost group who can bargain with each other to produce public policies. The masses face high transaction costs so cannot participate in the bargaining process. Because elites control the power of government, this opens the possibility that elites can use the force of government to impose costs on the masses.

THE COASE THEOREM IN MARKETS AND IN GOVERNMENT

In markets, transactions are voluntary, so the Coase theorem says that if transaction costs are greater than the gain from an exchange, no exchange will take place. Transaction costs may stand in the way of some exchanges that otherwise would be mutually advantageous, but they do not enable exchanges that lower welfare. Market exchanges are always value-enhancing, unless, as in the air pollution example discussed earlier, market exchanges produce externalities and individuals are unable to negotiate to mitigate the effect of the externality because transaction costs stand in the way. One of the roles of government, in theory, is to design policies that mitigate the effects of externalities so they do not cause inefficiencies. But government does not tend to act like this theoretical ideal because real-world governments are not omniscient benevolent dictators. Because government policies are created by some – the elite – but apply to everybody, government action creates externalities. That is, government provides a mechanism whereby some are able to impose costs on others.

In the abstract, people can hope that the government always acts in the public interest, but even casual observation indicates that the elite who make public policy do so with their own interests in mind. Externalities exist when the activities of some impose costs on third parties. Because government can force some to bear the costs of policies that benefit others, government policies create externalities. Those who design policies can benefit by producing policies that impose costs on others. That is, the elite in the low transaction cost group can design policies that benefit themselves by imposing costs on the masses who are in the high transaction cost group. This is the standard way that externalities are viewed, and applies as much to political action as to market activity. The next three chapters consider in more detail how this happens, but for now the ethanol example serves as an illustration.

BUCHANAN AND TULLOCK ON EXTERNAL POLITICAL COSTS[7]

Because James M. Buchanan, one of the original developers of public choice theory, discussed external political costs in an article he authored and in a book coauthored with Gordon Tullock, it is worth digressing to see how they used that term. In both cases it referred to something slightly different from the external costs that are generated in markets. Buchanan, in his article "Policy, Politics, and the Pigouvian Margins," noted that majorities can impose costs on minorities, and called them external costs because they were imposed on some (the minority) by others (the majority).[8] In their book, *The Calculus of Consent*, Buchanan and Tullock referred to the costs people bear because political decisions impose costs on them greater than the benefits they receive as external costs, but in their framework people willingly accept those external costs in exchange for lower decision-making costs.[9] In both cases they are correct to observe that some bear costs as a result of the political decisions of others, but in neither case does the way they use the term directly parallel the way external costs are generated in markets.

The low-transaction cost group is not a majority, as Buchanan describes it in his article. Mancur Olson explained that well-organized minorities are often able to use the political process to benefit themselves at the expense of the poorly organized general public, for exactly the reason implied in the Coase theorem.[10] Well-organized minorities face low transaction costs and can bargain to create policies that impose costs on the poorly organized majority that faces high transaction costs. The majority Buchanan describes is not the same as the Coasean low-transaction cost group.

In *The Calculus of Consent*, Buchanan and Tullock describe the case where people agree to bear external costs because on net they benefit from a combination of lower external plus decision-making costs. Everyone is in the low-transaction cost group in the model Buchanan and Tullock present, because in their model everybody unanimously agrees to constitutional rules that make them all better off. In the Coasean framework, the

[7] Many readers will be familiar with the ideas of Buchanan and Tullock regarding external political costs, and this section is directed at those readers. For those who are not familiar with their ideas, this section can be skipped and is not required to understand the ideas in this chapter.

[8] James M. Buchanan, "Politics, Policy, and the Pigouvian Margins," *Economics* n.s. 29, no. 113 (February 1962), pp. 17–28.

[9] James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962).

[10] Olson, *The Logic of Collective Action*.

high-transaction cost group is not agreeing to accept external costs as compensation for lower decision-making costs, as in *The Calculus of Consent*. They have no choice, because transaction costs prevent them from participating in the decisions that impose costs on them. Unlike Buchanan and Tullock's model, those in the high-transaction cost group often are not better off bearing those external costs. Everyone agrees to bear external costs in *The Calculus of Consent*, whereas in the Coasean framework high transaction costs prevent some people from being a part of the political bargaining process.

INSTITUTIONS THAT LOWER TRANSACTION COSTS

Consider again the air pollution example discussed earlier. While the individual residents may not be able to strike a bargain with the many steel mills, because transaction costs are too high, the government might be able to intercede to limit the air pollution. What this does is create small numbers – one government – out of large numbers – tens of thousands of citizens. Members of the large numbers high transaction cost group can transform themselves into a small numbers group that can bargain with lower transaction costs. The government also has the advantage of being able to use force to impose its policies, so there does not have to be an agreement between the government and the steel mills.

This concept of government presumes that the government acts in the interest of the general public. However, the government is controlled by elites, so when the masses petition government to step in and represent their interests, the resulting public policies are more likely to be slanted toward the steel mill owners who have economic power rather than the large group of individual citizens living around the steel mills. People perceive problems and say they want the government to do something, but because public policy is determined by elites, what the government actually does is often at odds with what many citizens think should be done. The 99 percent clamor for government action, but that action is undertaken by the 1 percent. This is political capitalism.

For citizens to have an impact, they must find a way to organize to speak with a unified voice, and with the political clout that comes with their collective ability to vote in democratic elections. This happens frequently in politics when people with similar interests join together to form an interest group to promote their common interests. The National Education Association (NEA), National Rifle Association (NRA), and American Association of Retired Persons (AARP) are examples. While a single individual has little influence over public policy, these organizations represent many individuals, so have sufficient power to enter the low-transaction cost group and bargain for policies that benefit them.

Extending this line of reasoning, if individuals are always in a position to join with others of similar interests to influence public policy, everyone can enter the political bargaining process and the Coase theorem applies to everyone. Everyone can be in the low-transaction cost group.[11] The problem with this argument is that people do face high transaction costs when engaging in the political process, so voters are often apathetic, uninvolved, and rationally ignorant. People are rationally ignorant about many markets also, because it is not worth their while to become informed enough to transact in those markets. The major difference is that people are not forced to trade in markets in which they have no interest, whereas the public policies created by the elite apply to everyone.

PROBLEMS WITH COALITION FORMATION

Mancur Olson's book, *The Logic of Collective Action*, focused on the problems that like-minded people have in organizing to engage in collective action. Consider groups like the NRA or AARP, for example. Their members have common interests, but when those groups act to further those interests they benefit everyone with the same interests, regardless of whether they are members of the group. This gives individuals an incentive to free ride on the organization's efforts. One person's contribution to the NRA or AARP will make little difference to the overall effectiveness of the group, so the individual who has essentially no political influence outside the group will also have an imperceptibly small influence on the group. What difference does it make if the NRA or AARP has one more member? People who share the agenda of such groups can hope for them to succeed, but have little personal incentive to contribute to their efforts.

This led Olson to conclude that smaller, more concentrated groups will be more effective in the political arena than larger groups. If a group is

[11] Donald Wittman, "Why Democracies Produce Efficient Results," *Journal of Political Economy*, 97 (1989), pp. 1395–1424, and *The Myth of Democratic Failure* (Chicago: University of Chicago Press, 1995), offers a very complete articulation of the idea that political institutions allow everyone to be in the low-transaction cost group. Gary Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics* 98 (1983), pp. 371–400, offers a similar but different argument that whatever the policy objective, policymakers have an incentive to accomplish that objective at the lowest possible cost.

small enough that members know each other, members will feel peer pressure to contribute and participate, but as groups get larger, members become increasingly anonymous, allowing them to free ride unnoticed by others. Also, as groups get larger, each individual's effort is a smaller share of the total effort. In a group with 30 members, each individual's contribution share is larger than a group with 1,000 or 10,000 members. Shirking and free riding grow along with group size.

Many interest groups are organized to engage in activities that transfer benefits from the general public to members of the group. The smaller the group's membership, the greater each individual's proportionate share. For a group that generates, say, $10,000,000 in benefits from a government policy, if that group has 100 members, each member's share is $100,000. If the group has one million members, each member's share is $10. The smaller group creates more concentrated benefits, providing a greater incentive to participate. In this example, assume that the $10,000,000 in benefits is generated by imposing a cost of $5 on 2 million people. In the large group with 1 million members, each member has only slightly more incentive to seek the benefit ($10) than those who bear the cost have to resist it ($5). In the small group, each individual has a much greater incentive to seek the benefit ($100,000) than those who bear the cost have to resist it. The political forces will be much stronger for the small group of rent-seekers than for the large group.

For large groups to acquire and maintain members, they must be in a position to offer their members some exclusive benefits that only come with membership. The NRA offers their members magazines that appeal to firearm enthusiasts, training classes, and competitive shooting events. The AARP offers its members discounts at restaurants, hotels, and other places. For individuals who share the goals of the organization anyway, those member benefits are a way to entice people to contribute.

While it is difficult for citizens to organize into interest groups that can become a part of the low-transaction cost group, it is easier for businesses to do so, just because there are fewer of them. Trade associations and industry groups can easily organize to benefit members of the group, and bring with them the clout of the economic elite. Government regulations often facilitate group formation, because it is easy for those in a regulated industry to see that they have a common interest in avoiding the costs imposed by regulation, and by enjoying any benefits that might be produced by it.

Recall Adam Smith's observation 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 contrivancy to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less make them necessary."[12] In medieval times people in certain professions were required to be guild members, essentially forcing them to organize into a group that could further the best interests of their profession. Those guilds were government-enforced cartels, a mechanism useful to the elite in political capitalism.

Luigi Zingales quotes James Randall, former president of Archer Daniels Midland, who says, "We have a saying here in this company that permeates the whole company. It's a saying that our competitors are our friends. Our customers are the enemy."[13] Both Smith and Randall recognize the sometimes opposing interests of the elites versus the masses. Describing the characteristics of political capitalism, Zingales goes on to say, "The problem is not the temporary advantage that companies secure through innovation but, rather, the longer-lasting political power they can secure through their size and lobbying influence."[14]

THE DISCONTINUITY IN POLITICAL POWER

The fact that some people have more political power than others is evident enough that it needs no defense. Quite clearly, a member of the US Senate has more political power than most of the citizens who are eligible to vote for that Senator. The idea that political institutions facilitate low transaction costs, so everyone is in the low-transaction cost group cannot plausibly mean that everyone has the same amount of political power, but it does suggest that the amount of political power people have is a continuous function from those with the least amount of political power to those with the most. This is represented in Figure 4.1, which shows a continuous rise in political power from the least to the most powerful.

[12] Adam Smith, *The Wealth of Nations* (New York: Random House, Modern Library, 1937 [orig. 1776]), p. 128.

[13] Luigi Zingales, *A Capitalism for the People: Recapturing the Lost Genius of American Prosperity* (New York: Basic Books, 2012), p. 28.

[14] Zingales, *A Capitalism for the People*, p. 29. See also Luigi Zingales, "Towards a Political Theory of the Firm," *Journal of Economic Perspectives* 31, no. 3 (September 2017), pp. 113–130.

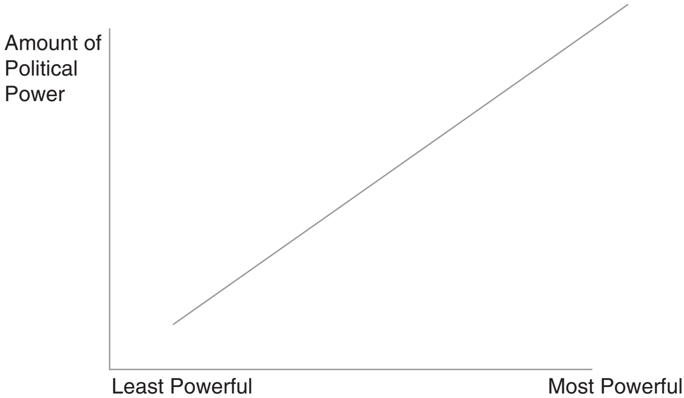

Figure 4.1 Is Political Power a Continuous Function?

This corresponds with the way economic power is perceived. Someone with an income of $100,000 has twice the economic power as someone with $50,000 in income, and someone with $2 million in wealth has twice the economic power as someone with $1 million in wealth.[15] If political power were really equally distributed among the citizenry, the line in Figure 4.1 would be horizontal. A more unequal distribution of political power would make that line steeper. Accepting the reality that some people have more political power than others, this seems like a good way to represent graphically the distribution of political power under the hypothesis idea that political institutions allow everyone to be a part of the political bargaining process – the idea that political institutions keep transaction costs in political decision-making low for everyone.

Elite theory, which hypothesizes that some people are in the low-transaction cost group and are able to bargain to design public policy to maximize its value to those in that low-transaction cost group, whereas others are in a high-transaction cost group that cannot participate in the bargaining process, depicts a discontinuity in the distribution of political power, as represented in Figure 4.2. The masses, who face high transaction costs, have almost no political power, and the elites, who are in the low-transaction cost group, have substantial political power. That discontinuity in political power divides the elites from the masses.

[15] As I write this, with the hope that people might be reading it decades later, I realize that the continual march of inflation will make these dollar figures seem implausibly low to future readers.

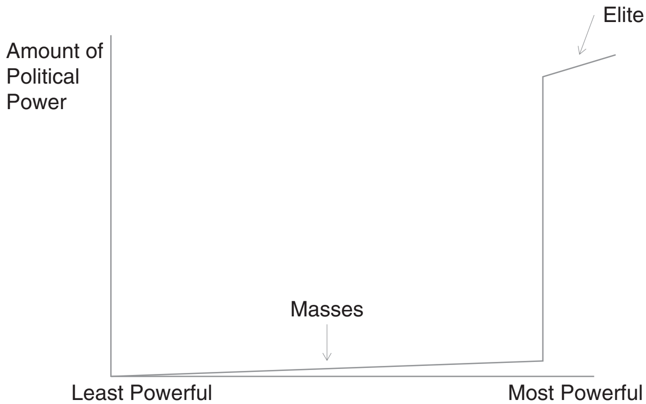

Figure 4.2 The Discontinuity in Political Power

A distribution of political power like that depicted in Figure 4.2 represents the power distribution described by elite theory. Transaction cost economics provides the economic foundation for understanding why political power is distributed that way. Economic power is distributed as represented in Figure 4.1, where twice the purchasing power is twice the economic power. Political power exhibits a discontinuity, as represented in Figure 4.2, which divides the elites from the masses. People at the low end of the income distribution can work some overtime or take a second job and make a little more money. People at the low end of the political power spectrum – the masses – can contribute a little more to political causes and volunteer a little more of their time and still have no perceptible influence over political outcomes and public policies. The theory of political capitalism rests on this discontinuity, which is why it is important to emphasize it has a solid economic basis in the theory of transaction costs.

INSTITUTIONS THAT FACILITATE LEGISLATIVE EXCHANGE

This chapter looked earlier at ways citizens can participate in political activity through interest groups that facilitate cooperation among like-minded individuals. The discontinuity in political power creates an incentive to free ride off the political activities of others, which is why the masses tend to be politically inactive and rationally ignorant in politics, The elite, who are able to bargain to affect public policy decisions, have an incentive to become involved because they are the ones who make public policy. Because they design political institutions in addition to public policy, political institutions evolve to facilitate exchange and lower transaction costs among members of the elite. As Stiglitz observes, the elite write the rules.

The nucleus of the low transaction cost group is the legislature, because public policymaking starts there. There are small numbers of people in legislatures so they all know each other and can bargain with each other to produce outcomes that are highest valued to the group. Legislatures have also created institutions for themselves which lower transaction costs to facilitate their being able to bargain.

The currency with which legislative bargains are made ultimately is votes. To get legislation passed requires a majority vote, so political entrepreneurs can never go it alone to design and implement public policy. The key to effective political bargaining is reciprocity. A legislator will agree to support legislation favored by other legislators in exchange for those others supporting what that legislator hopes to pass.[16] The agreement is sometimes explicit, but often implied. If a legislator approaches a colleague to ask for the colleague's support on a piece of legislation, both parties understand that support brings with it an IOU, and that the legislator who agrees to support the legislation can later come back to the colleague and call in the IOU to ask for support at a later time. Because there is a small number of legislators and they all know each other, they must honor those IOUs, or otherwise be frozen out of the political bargaining process in the future. They cannot afford to be frozen out, because it ultimately requires a majority to get anything done. Legislators must retain their reputations as people who repay their legislative debts.

Over time, legislators can accumulate IOUs, which gives them additional clout. Those with accumulated IOUs can act as middlemen to facilitate political exchange. Junior legislators can approach senior legislators to ask for help to get bills passed and the senior legislators can go to those who owe the legislator votes to get their support, acting as a middleman and taking a cut from each transaction to build political power.[17] Sometimes the exchanges are simple trades of votes for votes, but

[16] Barry R. Weingast, Kenneth A. Shepsle, and Christopher Johnsen, "The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics," *Journal of Political Economy* 89, no. 4 (August 1981), pp. 642–664, explain the way the political marketplace works by implementing the principles of universalism and reciprocity. You vote for my legislation and I'll vote for yours, and everyone in the legislature – the low-transaction cost group – gets legislation they want passed.

[17] This idea is developed in Kenneth J. Koford, "Centralized Vote Trading," *Public Choice* 39, no. 2 (1982), pp. 245–268.

sometimes they are more complex deals in which a legislator will agree to vote for legislation, provided the legislation is modified to provide some additional benefit to the legislator. Funding for projects in the legislator's district, or a benefit for one of the legislator's financial supporters, are examples. In their seminal treatise in public choice, *The Calculus of Consent*, James Buchanan and Gordon Tullock explained how this legislative exchange, also called logrolling, can work to provide benefits to all parties to the exchange.[18] In relation to political capitalism, note that the people who benefit are those who are able to participate in political exchange – those in the low-transaction cost group. High transaction costs prevent the masses from engaging in logrolling.

Regardless of the nature of the political exchange, transaction costs will be lower when legislators can monitor each other's behavior to confirm that they lived up to their end of the bargain. Whether it is simply trading a vote for a vote, or a more complex deal in which a legislator agrees to vote for legislation if it is amended to include a provision for the specific benefit of that legislator, parties to the exchange will want to know that those they deal with have lived up to their end of the bargain. That assurance is provided in legislative voting because votes are a matter of public record. Contrast this with citizen voting in general elections, where citizens vote by secret ballot. Secret ballots raise transaction costs and make it more difficult for voters to sell their votes.

With a secret ballot, voters could agree to sell their votes, but the vote buyers would have no way to verify that the voters actually voted the way they agreed. The secret ballot adds a transaction cost to popular voting that, in addition to the large number of voters, makes it difficult to sell votes in general elections. Legislative voting, in contrast, makes votes a matter of public record, lowering transaction costs and making it easier for legislators to sell their votes. The voting arena that has high transaction costs already (because of large numbers of voters) has the additional transaction cost of a secret ballot to further discourage political exchange, whereas the voting arena that has low transaction costs (because of small numbers) has transaction costs lowered further by the institution of making votes a matter of public record.

In the United States, voting by absentee ballot and voting over the internet are becoming more common. Decades ago, voters had to provide a justification for wanting an absentee ballot, but increasingly, they are granted for any reason. Both of those institutional changes make it easier

[18] James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962).

for people to sell their votes and provide verification to those who bought them. Meanwhile, selling one's vote in a general election has the appearance of doing something unethical, while logrolling and vote trading in legislatures is public knowledge and just considered the way legislatures carry on their business.

The legislature has designed other institutions to facilitate political exchange. The committee system divides up the legislative agenda and gives each committee a property right in a subcomponent of the legislative agenda. One can think of the legislative agenda as a common pool resource in which all legislators have an incentive to introduce legislation, regardless of its prospects of passing, overusing the legislative agenda.[19] There would be little cost, if a constituent requested some legislation, to a legislator introducing it even while knowing it could not pass. This problem of legislative congestion is mitigated by the committee system, which gives each committee the incentive to maximize the value of the bills they forward for vote by the entire legislature. Forwarding bills that stand little chance of passing squanders the value of their property right in committee membership, giving committee members the incentive to produce legislation that will create value for them, which will be the case when their legislation passes.[20]

Another institution that facilitates political exchange is the seniority system, which makes political assignments based on a legislator's seniority. Committee assignments and chairmanships are allocated this way, which gives legislators a property right in those assignments. This facilitates political exchange because legislators do not need to devote time and energy into protecting their assignments, so are able to devote their efforts toward passing legislation. By analogy, consider a rancher who has a property right in his herd, but must devote time to sitting by the property line with a rifle to try to prevent cattle rustlers from taking his cattle. The time the rancher spends doing this takes away from time that could be spent in other productive activity. Similarly, the more secure property right that seniority gives to legislative assignments enables legislators to devote more time toward designing legislation rather than protecting their committee assignments, which facilitates legislative exchange.[21]

[19] This is an application of the well-known idea from Garrett Hardin, "The Tragedy of the Commons," *Science* 162, Issue 3859 (December 13, 1968), pp. 1243–1248.

[20] This idea is developed further in Randall G. Holcombe and Glenn R. Parker, "Committees in Legislatures: A Property Rights Perspective," *Public Choice* 70, no. 1 (April 1991), pp. 11–20.

[21] See Randall G. Holcombe, "A Note on Seniority and Political Competition," *Public Choice* 61, no. 3 (June 1989), pp. 285–288, for a further development of this idea.

These examples apply mostly to the legislative structure in the United States, but parliamentary systems that are more commonly used in Europe (and around the world) also have institutions that facilitate political exchange, perhaps even more effectively than American institutions. Proportional voting allocates parties seats in the parliament in proportion to the percentage of votes the parties receive, and unlike in the United States, parties choose their candidates. The result is that candidates must support the party, or not be included on the party ticket in the future, so votes take place along party lines. This means that rather than bargaining taking place among a hundred or more legislators, the number involved in bargaining falls to just a few parties. Lower numbers reduce transaction costs.

Legislative exchange involves low transaction costs because the number of legislators is small, but on top of that, other legislative institutions have been designed by the legislatures themselves to facilitate exchange. Legislators have every incentive to design institutions to maximize the value they can produce for themselves from those institutions. As legislative institutions have evolved to facilitate political exchange, the elite have been more able to engage in bargains that benefit them. Within the framework of transaction cost economics, parties look for ways to modify institutions to lower transaction costs so they can more effectively engage in mutually beneficial exchange, and the evolution of legislative institutions has allowed the elite to do just that.

DEMOCRATIC POLITICS AND THE PUBLIC INTEREST

Politicians often encourage citizens to participate in the political process, mainly by voting, attending city commission meetings, and being politically engaged. They have an incentive to do so, because the greater the amount of participation, particularly as measured by voter turnout, the more those who win elections can claim to have the support of the people, or even a mandate. This idea goes back at least to Rousseau's concept of a social contract. Rousseau says, "The citizen gives his consent to all the laws, including those which are passed in spite of his opposition, and even those which punish him when he dares break any of them . . . When in the popular assembly a law is proposed, what the people is asked is not exactly whether it approves or rejects the proposal, but whether it is in conformity with the general will, which is their will. When therefore the opinion that is contrary to my own prevails, this proves neither more nor less than that I was mistaken, and that what I thought to be the general will was not so."[22]

A public choice approach to political decision-making would take issue with Rousseau's notion of a general will. Buchanan and Tullock, in *The Calculus of Consent*, say, "Collective action is viewed as the action of individuals when they choose to accomplish their purposes collectively rather than individually, and the government is seen as nothing more than the set of processes, the machine, which allows such collective action to take place . . . we have explicitly rejected the idea of an independent 'public interest' as meaningful."[23] The material in the preceding chapters offers much support for Buchanan and Tullock's view of democratic government over Rousseau's. The special interest influence over public policy decisions that are designed by the elite and forced on the masses is not an expression of the general will, but rather of the will of the well-connected who are able to use the democratic processes of the popular assembly for their own benefit.

While the quotation from Rousseau is a translation from the original French, one interesting feature of it is that it refers to people in the singular, consistent with Rousseau's vision of a general will. Buchanan and Tullock, in contrast, view the collective action of people as the attempt of individuals to further their own individual goals through collective action, not an embodiment of the general will.

Buchanan and Tullock's observation is that groups do not have interests beyond the interests of the members of their group. There are only individual interests, and the interest of a group of people can mean nothing more than the individual interests of the group's members. Nevertheless, the idea of a general will or the public interest, expressed through a democratic decision-making process, is a popular one. Rousseau's idea that democratic governments reveal the general will gives those who hold the reins of government power an appearance of legitimacy as they exercise that power. They are not arbitrarily using the force of government, but rather have a mandate to exercise it to further the public interest, as revealed via democracy.

For this idea that democratic decision-making reveals the public interest to hold, the masses must participate in democratic elections. If voter

[22] Jean Jacques Rousseau, *The Social Contract, Or Principles of Political Right* (Translated by G. D. H. Cole. www.constitution.org/jjr/socon.htm. 1762), Book IV, Ch. 1, no. 2.

[23] James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962), p. 13.

turnout is low, it is difficult for those who are elected to claim that their policies represent the views of the citizens. So, politicians encourage people to vote, which gives them some claim that their exercise of government power is legitimate. Consider politically divisive policy decisions like George W. Bush's 2003 invasion of Iraq, or Barack Obama's health care reform that greatly increased federal government involvement in the health care industry. Citizens perceived that those Presidents had the legitimate power to make those decisions because they were elected President. People buying into the ideology of democracy who disagreed with those policies nevertheless agreed with the idea of democratically electing leaders into positions in which they have the power to make those decisions. The ideology of democracy legitimizes those decisions because even people who disagree with the specific decisions agree that the decision-makers had the legitimate right to make them.

Democracy has a symbolic value for those who command government power, because it conveys the image that those who exercise the power of government are carrying out the will of the people.[24] That image can only be maintained if people actively participate in the democratic decision-making process. Voting is the best way, from the elite's standpoint, for the masses to participate, because each individual vote has essentially no impact on the outcome of an election, so voters are provided with the illusion that their participation determines the election outcome, which reinforces the perceived legitimacy of government. The argument that all the votes taken together determine the outcome of an election is weak from the standpoint of viewing elections as an expression of the general will, because the options offered to voters are chosen by the elites. There is the illusion of voter choice, which hides the reality that the elites determine the limited options from which voters can choose.

MONEY AND POLITICS

The political class encourages citizens to get involved in government by voting, by attending local commission meetings, by supporting their political campaigns, and more generally by becoming informed about the policy options that are under consideration. Voters have little incentive to become informed because their one vote has a negligible impact on any political outcome. Voters are, to use Anthony Downs's term, rationally

[24] This idea is developed by Murray Edelman, *The Symbolic Uses of Politics* (Urbana: University of Illinois Press, 1964).

ignorant because it does not benefit them to acquire more information or cast a more informative vote.[25] Further, the political class stands in the way of voters casting informed votes because the "information" it conveys to voters comes in the form of vague generalities and policy promises that they often do not have the power to keep. They want voters to participate, because it enhances their image of legitimacy, but they would rather voters be less informed as they cast their votes, because it better enables them to hide from public view what they are actually doing.

When citizens who actually have the ability to make an impact on the public policy debate become involved, the political class objects to their involvement. One example is the political backlash against Charles and David Koch. US Senator Harry Reid, on his website, said that the Koch brothers have as much influence as 2,000 union members because of the money they spend supporting political issues.[26] In reaction to their political participation, Reid called the Koch brothers "un-American," saying, "It's too bad that they're trying to buy America, and it's time that the American people spoke out against this terrible dishonesty of these two brothers who are about as un-American as anyone I can imagine."[27] Why are the Koch brothers un-American for getting involved in the political process even as politicians criticize political apathy and encourage the masses to get involved? It is because the Koch brothers have the resources behind them to actually have some influence over public policy. They are members of the elite. Politicians want the masses, who have no influence, to participate, but they object when people who actually have the ability to influence politics and challenge the political elite participate.

Even as the political elite encourage people to become involved in politics, they want to "take the money out of politics" so that anyone who can actually have some influence is silenced. This is ironic because individual politicians seem to have no qualms about accepting "donations" to their own political campaigns and Political Action Committees. Because incumbents have an overwhelming advantage in political contests, "taking the money out of politics" is code for reducing the influence of big donors who might threaten their status within the political elite. It is just another way for the elite to maintain their dominance over the masses.

25 Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957).
26 www.reid-senate.gov/koch-facts#.V_gOI_TPj_E, accessed October 7, 2016.
27 *Washington Post*, February 27, 2014, found at www.washingtonpost.com/news/post-politics/wp/2014/02/27/reid-koch-brothers-are-un-american/.

INTEREST GROUP INFLUENCE INCREASES OVER TIME

Special interests are able to influence public policy because they are a part of the low transaction cost group that has connections with those who make public policy. In his book, *The Rise and Decline of Nations*, Mancur Olson explains how special interests become more firmly entrenched in the political process over time, describing a mechanism by which laissez faire capitalism can evolve into political capitalism.[28] When a nation's political system is realigned to disrupt the network of existing political connections, government policy will not be as responsive to special interests, because special interests will not have the connections to be able to exert political influence. Olson uses as examples post-World War II Japan and Germany. Defeated in war, the old network of political connections was destroyed and new governments were established in their place. People wanting to get ahead were not in a position to do so via government favors, because the old political connections were broken, so turned their efforts toward productive activity. Economic growth in post-World War II Japan and Germany provides some evidence to support this.

As the new group of political elites became more established, connections developed between the political and economic elite which opened opportunities for the economic elite to exploit those connections for their own benefit. Their entrepreneurial efforts began shifting from productive economic activity toward seeking special interest benefits using their political connections.[29] Businesses found that they could profit not only from producing goods and services for consumers, but also by lobbying the political elite to create government policies that provided them with special favors. As entrepreneurial activity moves more from creating value for firms' customers toward generating special interest benefits through politics, this leads to what Olson described as the decline of nations.

Olson's framework lays out a clear path within which laissez-faire capitalism evolves into political capitalism. Olson's decline of nations describes a shift in entrepreneurial activity toward using political connections to obtain special interest benefits as those political connections are

[28] Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

[29] William J. Baumol, "Entrepreneurship: Productive, Unproductive, and Destructive," *Journal of Political Economy* 98, no. 5, Part 1 (October 1990), pp. 893–921, and *Entrepreneurship, Management, and the Structure of Payoffs* (Cambridge, MA: MIT Press, 1993) discusses the influence of institutions on entrepreneurship, noting that poor institutions can lead entrepreneurial actions toward nonproductive and destructive ends.

solidified over time. This leads to a growth of government and an evolution of the rules governing economic activity toward favoritism, away from objective rules that place everyone on a level playing field. As this evolution in public policy takes place, business profitability increasingly turns on public policy decisions and away from producing value for consumers. If Olson's decline of nations eventually leads to political capitalism, firms end up dependent on connections and cronyism for their profitability.

The emphasis often is placed on the role of special interests who use their influence to tilt the public policy process in their favor, but to do so, those interests must provide benefits to the government insiders – elected officials and members of the bureaucracy – who design those policies. Ultimately, it is the political insiders who wield the power of government and who make policy decisions, and they tend to do so in ways that benefit themselves. The political and economic elite conspire for their mutual benefit.[30]

Whether the outcome of full-blown political capitalism is inevitable will be discussed later. Meanwhile, one can see that the increased reliance on political connections and favoritism described by Olson provides a clear connection between theories of interest group politics and political capitalism. This is yet another building block in a well-established academic literature that provides a foundation for the theory of political capitalism. Over time, forces inherent in the political system lead to an erosion of institutional quality, and push capitalist economies toward political capitalism.

CONCLUSION

The influence of special interests in politics is common knowledge, and has been extensively studied by academics throughout the social sciences. Elite theory has drawn the connection between the interests of the elite and public policy outcomes, but without providing a theoretical foundation through which elites are able to use the system for their benefit. A key building block for the theory of political capitalism, which provides an economic foundation for elite theory, is transaction cost economics. Applying the insights of the Coase theorem, some people are in a low-transaction cost group that can engage in political bargaining. They are the elite. Most people face high transaction costs and are unable to participate

[30] Mark A. Zupan, *Inside Job: How Government Insiders Subvert the Public Interest* (Cambridge: Cambridge University Press, 2017).

in the political bargaining process. They are the masses. The Coase theorem and transaction cost economics provide the bridge between the economic and political theories that are the foundation for the theory of political capitalism.

There is a discontinuity in political power that does not exist with economic power. Economic power increases proportionately with income and wealth, whereas most people have no political power and a few people determine public policy. The difference is transaction costs. The elite are in the low-transaction cost group and can bargain with each other to produce the political policies that they value the most, whereas the masses face high transaction costs and are unable to bargain to further their interests through public policy. The masses must abide by the policies that are designed by the elite.

The key difference between economic and political power is that government uses force to impose its policies on everyone. This enables the elite to implement policies that impose costs on the masses. In the market, even those with great economic power can only get what they want from the masses if the masses voluntarily agree to cooperate. Those with political power get everyone to follow the policies they prefer by using the force of government. Those with economic power get people to further their interests only when cooperation benefits all parties to an exchange. The most powerful corporations can only get the money of the masses if the masses agree to spend it. The most powerful politicians command the masses to pay their taxes and abide by their regulations whether or not the masses agree.

5

Political Creation of Economic Rents

Rent-seeking as a political phenomenon is well established in the academic literature, and the terminology has spread into popular usage, so much so that newspaper and magazine articles refer to it by that name. The theory of rent-seeking provides one of the building blocks for understanding political capitalism. At the same time, just as an understanding of rent-seeking provides a better understanding of political capitalism, an understanding of political capitalism also adds insight into understanding the nature of rent-seeking. The twin objectives of this chapter are to provide both a better understanding of political capitalism and a better understanding of rent-seeking.

Rent-seeking refers to an attempt to use the political process to provide a transfer of economic resources to the rent-seeker. Rent, in this context, refers to the economic benefit the transfer confers to the rent-seeker. The name is misleading, because the rent in this context is not closely related to payments that are commonly referred to as rent. Calling the transfer a rent makes it appear similar to the payment a tenant makes to a landlord, but the two uses of the term are largely unrelated. The mistaken similarity comes from David Ricardo's claim, in 1817, that rent did not need to be paid to land to make it productive. Wages must be paid to laborers to get them to work, and investors must expect profits to entice them to invest, but land will be just as productive regardless of whether it is paid a rent. So, rent appears to be a transfer to landowners that adds no value to the aggregate economy. Regardless of whether Ricardo was right (he was not),[1] rent in Ricardo's context is voluntarily tendered to the

[1] The term has a convoluted history in its use by economists. David Ricardo, *Principles of Political Economy and Taxation*, 3rd edn. (London: John Murray, 1821) begins Chapter 2 by defining rent: "Rent is that portion of the produce of the earth, which is paid to the

property owner by the tenant, whereas the rent transferred through rent-seeking is taken from some through the force of government and given to others. Because the term is now in common use, this volume continues to refer to these forced transfers as rents, even while recognizing that rent in this context is a forced transfer of resources that differs from rent in other contexts.

Rent-seeking is unproductive activity for the economy as a whole because the rent is a transfer in which the rent recipient gains at the expense of those from whom resources are transferred. The transfer is unproductive, and process of rent-seeking results in a net loss to society because, as discussed in more detail below, while the rent itself is just a transfer, a welfare loss arises partly as a result of a misallocation of resources due to people's response to the transfer and partly because the rent-seeker uses up real resources to try to obtain the rent.

In the simplest case, the transfer could be a straightforward transfer of money, such as a subsidy. A company could lobby for a subsidy, which would transfer money from taxpayers to that company. But the transfer could also come in the form of a tax break, or in the form of a regulation that results in a transfer to the rent-seeker. The transfer is just as real, although not as obvious. The regulation that requires ethanol, primarily made from corn, to be added to gasoline is an example. The demand for corn increases as a result, increasing corn prices and increasing gasoline prices, resulting in a transfer from consumers to corn producers. This example shows that the transfer need not come directly from government, although it is the result of government regulation.

The regulation creates a mechanism to transfer resources directly from those who bear the cost to those who receive the rent. Some who bear the

landlord for the use of the original and indestructible powers of the soil." He goes on to note that the soil would be just as productive regardless of the rent it received, even if it received no rent at all. This has led economists to refer to a rent as any payment to a factor of production beyond what is necessary to get it to be productive. This definition of rent has issues too (which this digression will not discuss), but note that this way of looking at rent does not describe the transfer that takes place with rent-seeking. As to Ricardo's original claim, it is not correct because rent allocates land to its highest-valued use. Consider, for example, why with well over 10 million people living in the greater New York City area, most eating several meals a day, there is no agriculture nearby to provide the food to those people. The reason is that land rent is so high in NYC that it is more economical to produce food where land is cheaper and ship it in. This example demonstrates the value of rent. Of course, any particular piece of farmland will grow just as much food regardless of the rent it is paid, which is what Ricardo was thinking, but land rent is what determines whether that land will be farmed, or used to build skyscrapers, or some other use.

cost do so through voluntary transactions, with government-mandated strings attached. In the above example, corn becomes more expensive, so anyone buying corn transfers resources to corn producers as a result of the regulation, even though the purchase of corn or the purchase of motor fuel is a voluntary transaction. There is still an element of coercion imposed on those who make the voluntary transactions. Many people buying gasoline would prefer not to also purchase ethanol to be mixed with their gasoline, but the regulation forces them to buy ethanol if they want to buy gasoline, creating a transfer from the purchasers of gasoline to the producers of ethanol.

Tariffs are another common example of the result of rent-seeking. A tariff could be placed on imported steel, resulting in a higher price of steel, transferring income from consumers of products made from steel to steel producers. In this case, the government takes a share of the transfer in the form of the tariff revenue. Why is there a tariff? Domestic steel producers lobby for it – steel producers are the rent-seekers – because it shelters them from foreign competition and allows them to raise their prices. The transfer goes directly from the buyers of steel to the domestic producers, without the government directly transferring the rent, and the government even profits from the tariff revenue it collects.

Rent-seeking takes place because the rent recipients are able to use the force of government to gain the rents. Market activities take place only when all parties to transactions agree to them, which encourages productive and mutually advantageous activities. Corn farmers can only gain income from consumers in the market if consumers voluntarily agree to buy corn or corn products, but through government, corn farmers can use the force of government to gain a transfer from consumers and taxpayers, leaving those who finance the transfers no alternative but to bear the costs. The relevance to political capitalism is readily apparent: rents will be transferred to those in the low-transaction cost group who have the ability to design public policy to their advantage: the elite. Most of the costs of rent-seeking will be borne by those in the high-transaction cost group who are unable to participate in the negotiations that shape public policy: the masses.

Rent-seeking is worse than just taking money from some people and giving it to others, however, because it results in an inefficient use of resources. One source of inefficiency, long-recognized by economists, is that the institutions that generate the rents – monopolies, tariffs, regulatory restrictions – interfere with the efficiency of the market, misallocating resources. A second inefficiency, which is the main subject of the academic literature on rent-seeking, is that rent-seekers use real resources to try to capture the rents. Those resources could have been used productively in the economy, but instead are squandered in an attempt by the rent-seekers to gain a transfer at the expense of others. The problem is not just that the elite benefit at the expense of the masses, but that the entire economy operates less efficiently and is poorer as a result.

THE CONCEPT OF RENT-SEEKING

The concept of rent-seeking was first described by Gordon Tullock in his 1967 article, "The Welfare Costs of Tariffs, Monopolies, and Theft."[2] Many readers will be familiar with the concept. Despite the familiarity of the idea, it is worth outlining the theory of rent-seeking in order to clearly explain why elements of rent-seeking theory provide a foundation for political capitalism, and equally significantly, to show how the theory of political capitalism modifies the way that economists and political scientists should view the institutional foundations of rent-seeking. The theory of rent-seeking has developed largely as a description of a competition for rents without much regard for the institutions within which those rents are created, and the theory of political capitalism provides some insight into those institutions.[3]

One area in which Tullock applied the concept of rent-seeking was the case of monopoly, which standard economic analysis shows creates a welfare loss because monopolists restrict their output so they can raise their prices. Tullock notes that nearly every case of monopoly results from either an outright grant of monopoly privilege by government, has been created by government regulation that produces a barrier to entry, or is the government itself. To gain a monopoly privilege or regulatory barrier to entry, firms use real resources to hire lobbyists and attorneys, among other expenditures, to persuade policymakers to restrict competition and award them a monopoly, which enables them to make monopoly profits. Those resources that rent-seekers use to gain monopoly profits are an additional welfare loss of monopoly, sometimes referred to as Tullock costs, giving credit to the person who developed the idea. Not only is the rent a transfer

[2] Gordon Tullock, "The Welfare Cost of Tariffs, Monopolies, and Theft," *Western Economic Journal* 5 (June 1967), pp. 224–232.

[3] Note that in this regard, rent-seeking theory parallels the development of neoclassical economics, which also largely ignores the role of institutions. An excellent discussion along these lines is found in Meir Kohn, "Value and Exchange," *Cato Journal* 24, no. 3 (Fall 2004), pp. 303–339.

that produces nothing, it imposes a welfare loss on the economy that lowers overall economic well-being, because of the resources rent-seekers use to persuade policymakers to enact policies that give them rents.

Tullock's analysis of the welfare costs of tariffs is the same. Tariffs create a trade barrier that raises the cost of imports and therefore allows domestic sellers to charge more – a transfer from buyers to the sellers of domestic goods who are protected by the tariff that raises the price of competing imports. Tariffs interfere with voluntary market exchanges, reducing productivity and lowering incomes. Standard economic analysis recognizes this welfare loss,[4] but Tullock goes on to note that tariffs are a product of government, and that those protected by the tariffs use real resources to lobby to put them in place. Those resources used to engage in the political process to establish the tariffs – the Tullock costs – are also welfare losses.

Consider the earlier example of the regulation requiring ethanol in gasoline, which benefits corn producers. Congress did not think this up on its own. The idea was heavily promoted with strong lobbying pressure from the corn producers. Not only is there a welfare loss from the inefficient regulation, which standard economics has recognized, there is an additional welfare loss in the form of Tullock costs, because those who receive the rents expend real resources to engage in political activity to obtain and maintain the rents.

While Tullock introduced the concept, the rent-seeking name came from Anne Krueger's article, "The Political Economy of the Rent-Seeking Society."[5] Krueger, a development economist, was writing about import restrictions in developing economies, particularly India and Turkey. She noted a number of mechanisms in the import restrictions of many countries that result in wasteful rent-seeking expenditures. She cited the granting licenses for the importation of raw materials in proportion to firms'

[4] While economists almost always agree that tariffs result in a welfare loss, this tends not to be true of the general public. Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton: Princeton University Press, 2007) explains that voters often hold irrational beliefs and have little incentive to change them, because their one vote has no effect on an election outcome. One of those irrational beliefs Caplan cites is an anti-trade bias. He notes the difference of opinion of economists, who he considers the experts, and the general public on this and other issues.

[5] Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974), pp. 291–303. When I was a graduate student at Virginia Tech, Krueger presented this paper in a departmental seminar, probably in the Spring of 1974, although I am not sure exactly when it was presented. In a question and answer period after the seminar one of the attendees remarked on the similarity between Krueger's analysis and Tullock's 1967 paper, and Krueger answered that she was unaware of Tullock's paper.

production capacities, which pushes firms to make wasteful investments in excess capacity, licenses for the importation of consumer goods given in proportion to the applications, creating the incentive for an inefficiently large number of inefficiently small importers, and perhaps most inefficient of all, licenses granted at the discretion of government officials, which gives rise to costly lobbying, establishing offices in the capital city, giving jobs to relatives of officials – the Tullock costs – and outright bribery.

Prior to Tullock's article, the inefficiencies due to monopolies, tariffs and other trade restrictions, government regulations, and other transfers were well-recognized. Tullock's insight was to identify the additional welfare loss resulting from the real resources rent-seekers used up to obtain these rents. Krueger lamented that some of the best and brightest people in India were engaged in rent-seeking activities, trying to negotiate a maze of government regulations to capture a rent that was privately profitable but that resulted in a net welfare cost for the Indian economy as a whole.

THE REAL RESOURCE COST OF RENT-SEEKING

How large is the Tullock cost of rent-seeking – the amount of resources consumed to capture the rents? Much of the rent-seeking literature concludes that it approximates the total value of the rents. Discussing tariffs, Tullock says,

> Generally governments do not impose protective tariffs on their own. They have to be lobbied or pressured into doing so by the expenditure of resources in political activity. One would anticipate that the domestic producers would invest resources in lobbying for the tariff until the marginal return on the last dollar so spent was equal to its likely return producing the transfer. There might also be other interests trying to prevent the transfer and putting resources into influencing the government in the other direction. These expenditures, which may simply offset each other to some extent, are purely wasteful from the standpoint of society as a whole; they are spent not in increasing wealth, but in attempts to transfer or resist transfer of wealth.[6]

Krueger develops a mathematical model to estimate the cost of the resources devoted to rent-seeking and concludes, "That cost, in fact, is equal to the value of the rents."[7]

A straightforward example can illustrate the logic behind the conclusion that the total value of the rent is dissipated in the costs to

[6] Tullock, "The Welfare Cost of Tariffs, Monopolies, and Theft," p. 228.
[7] Krueger, "The Political Economy of the Rent-Seeking Society," p. 300.

obtain it. Assume that a prize (the rent) of $100 is offered to the highest bidder out of a group of ten rent-seekers. Each bidder is instructed to place an amount of money in a sealed envelope and submit it as a bid. How much would each rent-seeker be willing to put in the envelope to obtain the rent? With ten contestants, one line of reasoning is that if each bid the same amount they would have a one in ten chance of winning, placing their expected value at $10, so they would be willing to bid that amount to win the rent. Ten contestants each spending $10 would place the rent-seeking expenditure at $100 to win the $100 rent.

If each of the contestants reasoned through the paragraph above, they might realize that others would be bidding the same amount, so to ensure a win, a rent-seeker would want to bid more – say, $15. But another contestant might want to make sure of a victory and bid $25. Is there any limit to this escalation? At the limit, one should be willing to pay as much as $99 to win $100. The total amount spent on rent-seeking could well-exceed the rent, resulting in over-dissipation of the rent and a resource loss greater than the total amount of rent.

The logic behind complete dissipation – the conclusion arrived at by Krueger – is that over time, rent-seekers will be able to see the return they get from their lobbying and rent-seeking activities. If, on average, rent-seeking is profitable and they get more back in rents than they spend seeking them, then following Tullock's logic in the above-quoted passage, they will spend more on rent-seeking, until the marginal dollar they spend just returns them a dollar of benefits in the form of rents. If, on the other hand, rent-seeking costs more than the rents returned, rent-seekers should cut back on their rent-seeking expenditures until at the margin a dollar spent on rent-seeking returns a dollar in rents. If rent-seeking is profitable, it encourages entry into rent-seeking; if rent-seeking is unprofitable, it encourages exit. So, the equilibrium amount of rent-seeking is that amount that results in what economists call a normal profit. The amount spent seeking rents will just equal the amount of rent that is generated. All the rent ends up being dissipated in rent-seeking expenditures, which is a waste of resources from a social standpoint.

The academic literature on rent-seeking views it as a contest in which rent-seekers devote resources toward winning a rent, with the rent going to the highest bidder, as illustrated in the above example. An edited volume on rent-seeking provides insight into the way economists view rent-seeking. It devotes eight chapters to the theory of rent-seeking, and all eight of those chapters refer to rent-seeking as a contest.[8] Arye Hillman, one of the editors, notes in an introductory chapter that it is common to assume that the value of the resources dissipated as a welfare loss in rent-seeking equals the total amount of rents generated, based on the theory of rent-seeking, but says, "The possibility of under- or over-dissipation compromises the assumption that observed rents indicate social losses. Nonetheless, against the background of the murky processes of rent-seeking, at best all we usually have to go on for evaluating losses from rent-seeking are observed rents."[9] In an academic article, economist Toke Aidt says that the two core ideas in the rent-seeking literature are that rent-seeking activities "involve unproductive use of real resources and cause a social loss" and that "Rent-seeking costs are, by and large, unobserved but by applying contest theory and assumptions about the behavior of rent-seekers, the size of the social cost can be inferred from the value of the contestable rent."[10]

The possibility that rents might not be dissipated completely has been considered by a number of scholars in the literature.[11] One reason is that inframarginal rent-seekers might face lower costs of competing. Another reason is that there may be certain qualifications for receiving the rent, creating a barrier to entry, although this pushes the problem back one stage, because rent-seekers will compete to have rents available for the qualifications they have. For example, only tobacco farmers can receive tobacco subsidies, but this may encourage corn farmers to seek rents that go only to corn farmers. Most of the literature, regardless of whether it concludes that rents are completely dissipated, under-dissipated, or over-dissipated, depicts rent-seeking as a contest where the rent-seekers are

[8] Roger D. Congleton and Arye L. Hillman, eds., *Companion to the Political Economy of Rent-Seeking* (Cheltenham: Edward Elgar, 2015). Five of the eight chapters refer to rent-seeking as a contest in their titles, and the other three clearly depict rent-seeking as a contest in their models.

[9] Congleton and Hillman, *Companion to the Political Economy of Rent-Seeking*, pp. 10–11.

[10] Toke S. Aidt, "Rent Seeking and the Economics of Corruption," *Constitutional Political Economy* 27, no. 2 (June 2016), p. 143

[11] Some examples include Gordon Tullock, "Efficient Rent-Seeking," pp. 97–112 in James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Towards a Theory of the Rent-Seeking Society* (College Station: Texas A&M University Press, 1980), Richard S. Higgins, William F. Shughart II, and Robert D. Tollison, "Free Entry and Efficient Rent-Seeking." *Public Choice* 46, no. 3 (1985), pp. 247–258, William J. Corcoran, and Gordon V. Karels, "Rent-Seeking Behavior in the Long Run," *Public Choice* 46, no. 3 (1985), pp. 227–246. and William R. Dugan and James M. Snyder. "Are Rents Fully Dissipated?" *Public Choice* 77, no. 4 (December 1993): 793–813.

competing for rents, and focuses on the incentives and behavior of the rent-seekers.[12]

RENT CREATION AND RENT DISSIPATION

The depiction of rent-seeking as a contest in which rents are dissipated as welfare losses places both rent-seekers and the policymakers who provide those rents in an unrealistic setting that does not account for the institutional structure within which rent-seeking takes place, and that unrealistically depicts the incentives of the rent-granting policymakers. A more realistic depiction of rent-seeking should consider the incentives of those involved and the institutional framework within which rent-seeking occurs. In the traditional model in which rents may be completely dissipated or even over-dissipated!, there would appear to be little incentive for rent-seekers to enter a rent-seeking contest, and even less of an incentive for the policymakers to create those rents. However, if institutions can limit the dissipation of rents, a surplus will be created which can then be shared between the rent-seekers and the rent-granters.[13]

When considering the motivation of those who create the rents, it is apparent that they only have the incentive to create rents when they have something to gain, and the clearest way for rent-creators to gain is for them to limit competition for the rents so that there is a surplus that can be divided between the rent recipient and the rent-creator. Rent-creators have the incentive to design a system that has as little dissipation as possible – ideally, no dissipation. This is consistent with the ideas of Nobel laureate Gary Becker, who in an influential article noted that whatever the ultimate policy goals are for policymakers, they have an incentive to implement policies that achieve those goals at lowest cost.[14] Minimizing the dissipation of rents maximizes the joint gain to both the rent recipient and the rent-creator.

The monopolies granted by Queen Elizabeth I (1533–1603) and King James I (1566–1625) of England are early examples of rent creation.

[12] An exception is Elie Applebaum and Eliakim Katz, "Seeking Rents by Setting Rents: The Political Economy of Rent Seeking," *Economic Journal* 97, Issue 387 (September 1987), pp. 685–699, who examine a regulator that is able to provide rents to a regulated industry, and examines the incentives of the regulator to secure some benefits as a result of granting the rent.

[13] This idea is further developed in Randall G. Holcombe, "Political Incentives for Rent Creation," *Constitutional Political Economy* 28, no. 1 (March 2017), pp. 62–78.

[14] Gary S. Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, 98 (1983), pp. 371–400.

The crown granted patents for common goods like salt, starch, and playing cards, nominally to promote domestic industry and create a more self-sufficient economy. The patent system became a revenue-generating mechanism for the crown because the government could tax the patent holders to recover some of the monopoly rents for its own use.[15] The same process of rent creation occurred in France. Geoffrey Hodgson relates, "In prerevolutionary France under Louis XIV there were numerous corporations, closely tied up with royal power and bureaucracy, that spanned the world of business and politics. The sale of corporate offices provided an important source of royal revenues. In return, numerous corporations and guilds received privileges from the king."[16]

These examples illustrate the motivation for the rent-creator – the crown – to grant the patents and monopolies that generated the monopoly rents. The crown creates the rents and benefits by taxing away some of the rents for its own use. The theoretical framework within which complete dissipation of the rents occurs does not fit these examples, because if the rents were completely dissipated, there would be no surplus going to the rent recipients out of which the granter of the rents could be paid. Even partial dissipation takes away from the potential benefits that can accrue to both the rent recipient and the rent-creator.[17] The rent-seekers would have little incentive to pursue the rents if there were no net gain to them, and the rent granters would have no incentive to grant them if they gained nothing from creating the rent.

Looking at the incentives of both the rent-seekers and the rent granters, the rent-seeking process provides them with the maximum benefit if they are able to create a barrier to entry into rent-seeking to prevent it from becoming a competition. That way, the entire amount of the rent is available for division between the rent-seeker and the rent granter. Rent-seeking losses – the Tullock costs – are due to competition for rents, so if

[15] G. A. Bloxam, "Letters Patent for Inventions: Their Use and Misuse," *The Journal of Industrial Economics* 5, no. 3 (July 1957), pp. 157–179, and Chris Dent, "Generally Inconvenient: The 1624 Statute of Monopolies as Political Compromise," *Melbourne University Law Review* 33, no. 2 (2009), pp. 415–453. Perceived abuses of the patent system led Parliament to pass the Statute of Monopolies in 1624 which repealed all existing patents and monopolies and limited future patents to novel inventions.

[16] Geoffrey M. Hodgson, *Conceptualizing Capitalism: Institutions, Evolution, Future* (Chicago: University of Chicago Press, 2015), pp. 302–303. References omitted from quotation.

[17] Roger D. Congleton and Sanghack Lee, "Efficient Mercantilism? Revenue-Maximizing Monopoly Policies as Ramsey Taxation," *European Journal of Political Economy* 25, no. 1 (December 2007), pp. 102–114 provide a good analysis of the incentives for government to create monopolies that generate rents in this way.

a barrier to entry into competition for a rent can be erected such that there is only one rent-seeker, those losses will be completely eliminated. The optimal strategy for the rent-creator is to limit competition for rents as much as possible.

In a monarchy or a dictatorship, this could be accomplished by limiting the grant of rents only to people who are close associates of the autocrat – friends and family – or to those who offer an explicit payment to the autocrat in exchange for the opportunity to capture a rent. One function of designating some people as members of a royal class could be to restrict competition for rents to so they are limited to that elite group, which creates a barrier to entry for others. An autocrat would have little to gain from responding to rent-seeking expenditures like lobbying. Indeed, the autocrat should want the rent to go to the party that generates the greatest surplus, which would be someone who undertakes no socially wasteful rent-seeking expenditures.[18]

The creator of the rent has every incentive to prevent rent-seeking from becoming a contest by creating a barrier to entry into rent-seeking and granting rent-generating opportunities to those who can generate the greatest surplus, to maximize the amount of the surplus going to the rent-creator. Conversely, the creator of the rent has no incentive to create it if all of the rent is dissipated so there is no surplus left to share with the creator. One question the rent-seeking as a contest model leaves open is what incentive anyone would have to create a contest that generates net social costs, and no net gains to either the creator of the contest or the contestants. The academic literature on rent-seeking contests focuses on the behavior of the contestants, given that there is a contest, and does not look at the incentives of those who create the contests.

RENT-SEEKERS

Look at the rent-seeking contest from the standpoint of the rent-seekers. If rents are fully dissipated, as much of the literature suggests, there appears to be little incentive to engage in rent-seeking. The expected value of entering the contest is zero, but some win while others lose. If entrants

[18] Kofi O. Nti, "Rent-Seeking With Asymmetric Valuations," *Public Choice* 98, nos. 3/4 (March 1999), pp. 415–430, develops a model in which different contestants place different values on the rent and looks at the incentives facing the contestants. In this case, the rent-creator should grant the rent to the individual who values it the most, because that maximizes the amount that the rent recipient and the rent-creator can divide. Still, the joint benefit is maximized when the rent-seeking costs are minimized.

were risk-averse, nobody would enter a contest with complete dissipation, so thinking about the hypothetical contest in an earlier example, a risk-averse contestant would not be willing to pay $10 for a one-in-ten change of winning $100. This means that if all entrants were risk-averse, they would bid less than the expected value of the winnings, so dissipation would not be complete. There would still be rent dissipation as entrants use real resources to compete for a transfer, even if the dissipation is not as large as the rents created.

The discussion above regarding complete dissipation suggested that risk-neutral contestants might enter a contest with an expected payoff equal to the cost of entry, just as firms enter a competitive industry, expecting a normal rate of return. This conjecture is based on an analogy with the long-standing model of competitive equilibrium in neoclassical economics. This framework, more than a century old, assumes that firms enter industries that are profitable and exit industries that are unprofitable, so that in equilibrium, all firms in the industry just make a normal rate of return.[19] But the rent-seeking model is different from the neoclassical competitive model in that regard. All firms earn a normal return in a neoclassical competitive equilibrium, whereas in the model of complete rent dissipation the winners earn an above-normal return while other contestants lose. Risk-loving rent-seekers could generate over-dissipation, but even if over-dissipation does not occur, rent-seeking appears to be a gamble rather than a good business decision.[20] Even when Tullock costs equal the rents, rent-seekers are gambling on a chance to win, rather than engaging in a business venture with the hope of earning a normal profit as in the neoclassical competitive model of competition.

In the real world, competitive firms often take short-run losses because of investment projects that do not pan out, or as a result of research and development expenditures that arrive at a dead end. In the neoclassical competitive model, however, the equilibrium outcome in that model is that all firms earn a normal rate of return. The paragraph above comparing rent-seeking contests with competitive firms makes a comparison between theoretical models, not real-world institutions. In the real world there is

[19] This argument goes back to Alfred Marshall, *Principles of Economics*, 8th edn. (New York: Macmillan, 1920), who depicted entry and exit into competitive industries as the mechanism of adjustment to equilibrium. The first edition of Marshall's very influential text was published in 1890.

[20] Paan Jindapon and Christopher A. Whaley, "Risk Lovers and the Rent-Overinvestment Puzzle," *Public Choice* 164, nos. 1/2 (July 2015), pp. 87–101, develop a model in which rents are over-dissipated.

more risk in a competitive market than the model lets on. But models of rent-seeking competitions draw their inspiration from the neoclassical theory of competition, so it is appropriate to compare that theory with rent-seeking theory and to emphasize their differences. In the model, competitive firms all receive a normal rate of return; in the model, rent-seeking competitors do not. Some win the contest and gain rents; others lose.

Just as the model of competition in neoclassical economics does not represent a complete picture of economic competition, the model of competitive rent-seeking also does not. In markets, however, firms enter because they expect to be profitable, even though that expectation sometimes is not realized. They take a chance because they are anticipating a profit. As the rent-seeking model in which rent-seeking is a contest has developed, however, rent-seekers realize as they enter that they are entering a game in which many contestants come out losers.

Over a long period of time with the ability to enter many rent-seeking contests, some contestants might enter the contests if the rents were not over-dissipated, figuring their winnings would just offset their losses in the long run. This still leaves open the question of why they would enter a rent-seeking contest in which all rents are dissipated, with no positive expected payoff. The distinction between the expected competitive returns in the neoclassical model of perfect competition and rent-seeking is worth emphasizing, because the parallel has been so often drawn. Firms in the model of competitive equilibrium are not gambling as are those who enter rent-seeking contests. The two models – competitive markets and competitive rent-seeking – are not equivalent.

If some contestants are more likely to win than others,[21] the consistent losers should drop out of the contest, leaving only those who are consistent winners. If this causes each contestant to spend more, it may create a new set of consistent losers among those who remain, reducing the number of rent-seekers. This points toward the case, illustrated by the examples of the monopolies granted by the British crown, in which rent-seeking is limited to net winners, who are able to share their surplus rents with the political parties who granted them. Rent-seekers have an incentive to seek rents when institutions assure them of a positive payoff. The idea that they would

[21] Guiseppe Dari-Mattiacci and Francesco Parisi, "Returns to Effort in Rent-Seeking Games," *Public Choice* 159, nos. 1/2 (April 2014), pp. 99–104, examine the case where there is an increasing return to rent-seeking effort, so contestants that spend more on rent-seeking have an advantage disproportionate to the amount they spend.

enter a rent-seeking contest in which the expected payoff is zero but some win while others lose is questionable. This turns rent-seeking into a gamble, and the common assumption of risk aversion points toward potential entrants avoiding such contests.

It is easy to understand why rent-seekers would enter a contest in which entrants are, on average, net winners. It is more difficult to develop assumptions about rent-seeking behavior that would give people an incentive to enter a rent-seeking contest with complete dissipation, which is a gamble, or a contest with over-dissipation in which entrants would expect to come out losers. But a big omission in the discussion in this section – and in the rent-seeking literature more generally – is that it looks only at the incentives of the rent-seekers, under the assumption that they are participating in a contest to win some exogenously determined rent. The academic literature on rent-seeking is oriented this way, but it provides a very incomplete look at the actual institutional structure of rent-seeking.

RENT-CREATORS

Models of rent-seeking contests focus on the competitors for the rents, rather than looking at the incentives facing those who create them. Rent-creators have no incentive to create a contest in which the rents are dissipated. Why design a contest that has net social costs, and that reduces or eliminates any benefit to the contest's designers? The theory of rent-seeking should begin by looking at the incentives facing those who create the rents, with the assumption that the creators of rents design rent-seeking institutions so that they – the creators – benefit. Net benefits are maximized when rent dissipation is minimized.

Nobel laureate Gary Becker depicts the legislature as a political marketplace in which competition among pressure groups leads to public policies that maximize the political support going to members of the legislature.[22] In considering a tariff, for example, legislators weigh the marginal political benefit from supporters of the tariff against the marginal political cost from opponents and choose the tariff level at which the value of the political support gained by the proponents just equals the cost of the political support lost from the opponents at the margin. The payoff to the legislature is the political support they maximize. Rents could be dissipated in a rent-seeking competition among pressure groups, but all parties have an

[22] Becker, "A Theory of Competition Among Pressure Groups for Political Influence."

incentive to prevent dissipation, so they have a larger surplus available to split among themselves. Becker emphasizes that regardless of the specific policy goals of political decision-makers, they always have an incentive to achieve them in the least-cost manner, to maximize the benefits that are produced. This would mean awarding rents in a way that minimizes rent dissipation.

One classroom rent-seeking game goes something like this. The instructor invites all students to bid to win $20. The instructor passes out envelopes and tells students to place any amount of money they want in their envelopes, write their names on the envelopes, and pass them up to the instructor. The instructor awards the $20 to the highest bidder – the student who put the most in her envelope – and keeps the rest of the money. The total amount collected will often exceed the $20 rent that is awarded to the winner. This game can be profitable for the instructor, but note that as described, there is no rent dissipation. The game is designed so that all of the profit from the creation of the rent goes to the instructor. In a complete dissipation game, the instructor would send all the bids into a shredder, and then off to a dumpster to make sure any loose change is unrecoverable. Is it more likely that the designer of a rent-seeking game would design the first type of game, in which all the bids went to the game's creator, or the second, in which all the rent-seeking expenditures were dissipated?

Focusing on the incentives facing those who create rents, rather than just assuming there is a rent-seeking contest open to everyone, suggests that rent-seeking institutions will be designed to minimize rent dissipation, so that the rent-creator will be in a position to capture back some of the rents. This can be done by creating a barrier to entry into rent-seeking. Looking at the incentives of those who create the rents, it becomes apparent why complete dissipation of the rents is an unlikely outcome. It has little to do with the incentives or behavior of the contestants, which is the focus of most of the rent-seeking literature, and everything to do with the incentives of those who create the rents.

BARRIERS TO ENTRY INTO RENT-SEEKING

Interest group theories of politics conclude that concentrated special interests are able to gain benefits for themselves at the expense of the general public. Mancur Olson's influential work on interest group politics explains why concentrated special interests are able to effectively organize, creating a group of insiders who are able to impose costs on outsiders.[23] Concentrated interests have more of an incentive to organize than large disbursed interests. If a concentrated interest group, like corn farmers, can extract rents worth just a few dollars from each citizen, that adds up to millions of dollars for the members of the interest group. Concentrated interests have fewer members, so members have less of an incentive to free ride on the efforts of the group, and are more likely to be noticed if they do. Concentrated interests will have the ability to exclude outsiders, creating a barrier to entry that will prevent others from competing for the rents they seek. The interest group theories in the previous chapter help explain how barriers to entry are created to limit competition for rents.

When looking at legislative activity, logrolling takes place to negotiate deals among legislators, and between the legislature and lobbyists, but this type of political exchange can only occur among those who can enter these exchanges. In this setting, the division between the elite and the masses becomes relevant to understanding the institutional structure that generates rents. This division of the population into elites and masses creates a barrier to entry into rent-seeking. The barrier to entry limits competition for rents, which then limits rent dissipation. It also explains who gets the rents. Rents go to the economic elite, who then share some of the gains with the political elite to ensure the continued flow of rents. This idea is already embodied in the interest group theories which are a well-recognized component of public choice, but the insight has not been applied to rent-seeking.

Rent-seeking that works to the advantage of those who create the rents must limit competition for those rents so that all the rents are not dissipated. Elite theory suggests that there are cronies – the 1 percent – who have access to rents unavailable to others. The creation of such a barrier to entry is easy to envision in an autocracy, because it is to the autocrat's advantage to do so. In democratic societies, some individuals have more access to the political process than others, and that creates a barrier to entry keeping the masses from entering rent-seeking competitions. Individuals in the low-transaction cost group can bargain for rents, but those in the high-transaction cost group are prevented from doing so by high transaction costs. Voters tend to be rationally ignorant, and the reasoning behind this rational ignorance is significant. Citizens are rationally ignorant because they believe they have no political influence. An incentive to free

23 Mancur Olson, Jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1965).

ride keeps the masses from effectively organizing, giving undue influence to concentrated special interests. This limits entry into rent-seeking, which creates a surplus that can be divided between the creators of the rents and the initial recipients of the rents.

The elite theory discussed in the previous two chapters lends substantial insight to the channel through which rent-creators can design barriers to entry, so that rents are not dissipated and the rent-creators can claim a share. Rents are created by members of the low-transaction cost group – the elite – for their benefit, with members of the high-transaction cost group – the masses – bearing the cost. With regard to rent-seeking, the key point is that independent of this particular theoretical mechanism for creating a barrier to entry, those who create rents have every incentive to limit entry by whatever means are available to them, so they can profit. Otherwise, there is no incentive for those with the power to do so to design policies that generate rents.

One mechanism for limiting entry is for the elite to restrict the availability of rents only to other members of the elite. They have an incentive to do this because the elite are in a better position to reciprocate by providing benefits to the rent-creators than the masses. This is a large part of what grants them entry into the elite. Rents are largely unavailable to the masses because high transaction costs prevent them from bargaining to obtain rents. Applying the insights from elite theory to the process of rent-seeking adds insight into the institutional structure of rent-seeking. Rents are created by the elite to be transferred to members of the elite, with the costs borne by the masses. High transaction costs prevent the masses from entering bargains to obtain rents for themselves, and from negotiating to mitigate costs that are imposed on them from rent-seeking. Placing rent-seeking within a broader context of political capitalism lends insight into the rent-seeking process.

INSTITUTIONS THAT PREVENT RENT DISSIPATION

A solid theoretical foundation supports the idea that some people have access to the political process not available to others. The evidence shows that connections count, and that the politically connected will have access to rents that are unavailable to most people. The rent-seeking literature assumes there is a rent-seeking competition and focuses on the behavior of the competitors, typically with no limits placed on who can enter the competition, but the analysis of rent-seeking should start by looking at the incentives facing those who create the rents, not those who compete for them.

The rent-creators are the ones who determine the parameters of any rent-seeking contests. The public choice assumption that people act to further their own interests means that rents would not be created unless the creators received a benefit from doing so. There is no good alternative to this assumption. Even a public interest theory of government is inconsistent with the inefficiencies associated with rent-seeking and rent creation. Rents will be created only if the creators gain. They can do this by limiting entry and preventing rent-seeking competitions.

The very concept of rent-seeking depicts a process in which some people are able to use the force of government to transfer benefits – the rents – to themselves at the expense of others. The rent-seeking literature stops at the point where it depicts one group who receive the rents and the others who are forced to pay them, without identifying any regularities that separate the rent recipients from others. Observing that the well-connected are the ones who are able to harness the power of government for their benefit while the disorganized masses are those who are targeted to pay the costs is a very small step, yet an important one for purposes of understanding both rent-seeking and political capitalism.

The insiders who are well-connected receive rents and outsiders who do not. The ability to procure rents requires the connections that come with membership in the elite, and the costs imposed by the rents are placed on outsiders. A tariff that raises the price of an import, which is a prime example of a rent that goes to the insiders who are protected by the tariff paid for by the purchasers of the protected goods. The question is: how does the institutional structure determine who are the elite insiders who collect the rents? The rent-creators have the incentive to draw a clear line between rent recipients and those who bear the costs to limit competition and maximize the surplus which can be shared with the rent-creators. Those in the low-transaction cost group are able to craft policies for their own benefit, and those in the high-transaction cost group are prevented from bargaining to avoid having costs placed on them.

Rent-seeking theory already recognizes that there are rent recipients who are net gainers, and net losers who pay the cost, having resources transferred from them to the rent recipients. If it is not obvious that some people are in a better position to capture rents than others, the elite theory from the previous chapters provides the theoretical foundation to see it. The rents go to the elite, out of the pockets of the masses. While seemingly a small observation, this adds considerable insight to the rent-seeking process. It is not that rents go from some to others, it is that rents go from the masses to the elite. Incorporating elite theory into the rent-seeking framework explains why elites create barriers to entry into rent-seeking, which limits rent dissipation. The standard rent-seeking model substantially overstates the Tullock costs of rent-seeking.

EROSION OF BARRIERS TO ENTRY IN RENT PRODUCTION

Those who grant the rents have the incentive to erect barriers to entry into rent-seeking for their own benefit, but this system of generating political profits can break down is if barriers to entry into rent production are eroded. A centralized system of rent production can limit who can produce rents, whereas a decentralized system opens the door for many rent producers. For example, if the central administration has complete control over who can get an import license, the producer of that rent can limit the competition by only giving licenses to close associates. If import licenses can be granted by dozens of customs houses in multiple ports of entry, rent-seekers can approach a second (or third) customs house if they are turned down by the first. The multiple customs houses will be competing with each other in the granting of rents to rent-seekers, which will reduce the payoff they can demand for granting the rent.

Thus, the most important barrier to entry to limit the dissipation of rents may be the barrier to entry that limits who is in a position to create rents. The rent-creator must establish a barrier to entry in the ability to create rents, or competition to receive rents can occur, which would result in rent dissipation. Such barriers are rarely included in rent-seeking models.[24] Economists Richard Higgins, William Shughart, and Robert Tollison say, "It is unsatisfactory to imagine, for example, that the franchisor sets the number of contestants,"[25] but if the franchisor is creating the rents, it has every incentive to do so. Not only does this appear to be a satisfactory assumption, it appears to be descriptive of reality.

COMPETITIVE RENT-SEEKING: THE TULLOCK–KRUEGER MODEL

Some evidence that there is not always a barrier to entry into rent-seeking is presented by Krueger in her original article on rent-seeking,

[24] For example, James Lake, James and Maia K. Linask, "Costly Distribution and the Non-Equivalence of Tariffs and Quotas," *Public Choice* 165, nos. 3/4 (December 2015), pp. 211–238, present a model in which there are no barriers to entry into rent-seeking.

[25] Higgins, Shughart, and Tollison, "Free Entry and Efficient Rent-Seeking." P. 255.

which described the Turkish and Indian economies at the time she was writing. In the economies she described, the institutional barriers to entry broke down, turning rent-seeking into a competition that completely dissipated rents. Thus, based on her first-hand observations she assumed that rent-seeking costs were equal to the amount of the rents generated. This is the case that the literature depicting rent-seeking as a contest describes.

The possibility of complete dissipation is supported by Krueger's examples, so one could not conclude that institutional barriers to rent-seeking always prevent rent dissipation. However, Krueger, writing in the 1970s, singled out those poor economies with low-quality institutions that encourage rent-seeking, in contrast to developed economies that do not appear to have the same degree of rent-seeking welfare losses. Rent-seeking as a competition that completely dissipates the rents – the case that Krueger described – is the extreme case in which policymakers have been unable to maintain the barriers to entry into the creation of rents that would prevent free entry into rent-seeking.

While Krueger's description appears to fit those particular cases, the rent-seeking literature may have latched on to those extreme cases and portrayed them as typical rent-seeking institutions when, in fact, they are extreme examples. There is a good reason why Krueger, an American economist, used Turkey and India as her examples rather than the United States. Indeed, when she was discussing rent-seeking societies, she was deliberately focusing on poor societies with minimal economic growth. She was explicitly not including developed economies in the category of rent-seeking societies.

The value in studying competitive rent-seeking lies in trying to understand what institutional features allow it to occur. What institutions facilitate this complete rent dissipation in in some countries when it does not occur in others? The theory of rent-seeking competitions in which all rents are dissipated does not describe the institutional features that allow this dissipation to occur. It describes the competition among the rent-seekers, but not the behavior of the rent-creators. Complete dissipation can occur, as Krueger describes, but there are good arguments, backed by persuasive case studies, to show that often it does not. The creators of rents have an incentive to design an institutional framework that erects a barrier to entry to limit rent dissipation and provide a positive return to rent-seekers and to themselves.

RENT-SEEKING AND CORRUPTION

The degree to which rent-seeking is related to corruption depends on how the two terms are defined. Those writing on the subject admit that it is difficult to come up with a precise definition of corruption. In a survey of the corruption literature, Arvind Jain says corruption constitutes of "acts in which the power of public office is used for personal gain in a manner that contravenes the rules of the game."[26] The reference to the rules of the game fits well within the political capitalism framework in which the elite design the rules of the game. If rents are distributed according to the rules laid down by the elite, that would seem to imply that the process is not corrupt, in the sense that the elite write the rules and then follow them. Jain goes on to note, "A corrupt dictator who can centralize rent extraction may be more desirable than a fragmented system."[27] But if the dictator designs the rules for his benefit, one might question whether this is corrupt according to Jain's earlier definition. This may be a matter of semantics. Many people would call a system in which the elite write the rules for their own benefit corrupt, and this may be what Jain has in mind, despite his earlier definition of corruption. Jain's "corrupt dictator" is following the rules of the game – the rules designed by the dictator – which suggests the vague line that separates rent-seeking from corruption.

Jain does point out that the ability to centralize the granting of rents creates a barrier to entry that limits rent-seeking costs. When the system by which rents can be granted is decentralized and individuals can grant rents at their discretion, this encourages rent-seeking competitions that dissipate rents. Think about the incentives for rent creation. In a multi-level governing structure, those at the top have every incentive to limit the ability to create rents, but if lower-level governments or if individuals within the power structure have a substantial ability to act autonomously, those at the top may have limited control and rent-seeking competitions can emerge. As Aidt notes, "Corrupt officials create rents which they extract for themselves via bribery."[28]

If a government is corrupt, which means that government officials can use their authority to demand personal benefits for the performance of government services, corruption leads to rent creation. Rent creation is a way for corrupt officials to personally profit from the power government

[26] Arvind K. Jain "Corruption: A Review," *Journal of Economic Surveys* 15, no. 1 (2001), p. 73

[27] Jain, "Corruption: A Review," p. 100.

[28] Aidt, "Rent Seeking and the Economics of Corruption," p. 151.

gives them. But the ability to create rents should not lead to corruption, because corruption creates rent-seeking costs that dissipate the benefits from the rent. Rather, the ability to create rents should push the rent-creators to write the rules in such a way that competition for rents is limited, so the rent-creators can maximize the benefits they receive from the rent creation.

Is this corruption? Perhaps it should be called that, although the definition of corruption is murky. The larger point is that governments with the power to write the rules to create rents have every incentive to write them to minimize corruption, if corruption means working outside the rules, whereas corrupt governments have an incentive to create rents, because they can benefit from charging for them. Seen this way, rent-seeking does not cause corruption, but corruption leads to rent-seeking. In the context of political capitalism, the elite want to create rents according to strict rules that limit competition to maximize their ability to profit from the rents they create. Rent-creators want everybody to follow the rules – the rules they have created to maximize the benefits that accrue to themselves.

Critics of cronyism, corporatism, and favoritism often see these problems as the result of corrupt government, and see the solution as cleaning up the corruption by getting rid of corrupt and unethical individuals. The fuzzy line between rent-seeking and corruption points toward the deeper institutional problems of political capitalism. The elite have every incentive to design the rules such that their transactions are legal, partly to free them from being accused of criminal activity and partly because they can design institutions to create barriers to entry into rent-seeking.

CONCLUSION

In the article that gave rent-seeking its name, Anne Krueger took an institutional approach, describing an institutional structure in which all of the rents generated were dissipated in rent-seeking costs. She provided details and descriptions of institutions that led to rent dissipation. The academic literature on rent-seeking since then has focused heavily on theoretical models of rent-seeking competitions with little in the way of the institutional foundations that led Krueger to her insights. Krueger observed and described actual institutions that led to rent dissipation, but those institutions were observed in poor countries rather than her home country of the United States. Her examples show how rent dissipation can occur, but the literature that has followed has not taken the institutional approach that Krueger used when developing her insights on the process.

Krueger's assumption of complete dissipation, based on her observations in less-developed economies, has dominated the development of rent-seeking theory. Models in which all rents, or even most rents, are dissipated do not square well with the incentives facing participants in the rent-seeking process. One problem with many of those models is that they set up a competition and focus on the behavior of the competitors, but do not look at the incentives of those who design the public policies that generate the rents. Policymakers have an incentive to create rents only if those policymakers have something to gain from doing so.

Policymakers benefit most from creating rents when they limit the competition for them, which minimizes the rent-seeking costs and leaves the largest surplus available to be divided between the rent recipients and the rent-creators. The case of complete dissipation, described by Krueger, is best viewed as the extreme and pathological case in which the institutional structure has broken down and allows no way for those who create the rents to capture any benefit from them. That institutional breakdown might be an unintended consequence of the initial rent creation. For example, a quota could be established to protect a domestic industry, with institutions for obtaining import licenses that are too weak to be an effective barrier to entry. Over time, the system degenerates into one that contains an increasing amount of inefficiencies, until rent-seeking competitions erode all rents. The key question then becomes what institutional features can slow or stop the process.

The analysis in this chapter shows that those who create the rents have an incentive to create a barrier to entry into rent-seeking, limiting who can compete for them, at the same time that they create the rents. This provides a surplus that can then be divided between the rent-creators and the rent recipients. The barrier to entry limits the inefficiencies of rent dissipation in a manner consistent with the way microeconomic theory describes the role of barriers to entry in monopoly markets. Competition dissipates profits, and in both cases barriers to entry work to preserve them. The difference is that barriers to entry that create monopoly markets cause resources to be used inefficiently, whereas barriers to entry into rent-seeking reduce an inefficient use of resources. Looking at the incentives of those who create the rents, there are good reasons to think that a substantial dissipation of the rents would be the exception rather than the rule, a conclusion that is supported with a strong theoretical foundation and a variety of case studies.

What can create a barrier to entry into rent-seeking? The previous two chapters provide the answer. Rents are available to the elite, who control the system and write the rules. High transaction costs exclude the masses from competing for rents, and the masses have no incentive to seek them because they are unlikely to obtain them. The academic literature on rent-seeking, written mostly by economists, naturally takes an individualistic approach, because this is consistent with most economic methodology, and as such, does not differentiate people into those able to pursue and obtain rents and those who are not. But the framework of rent-seeking depicts some who receive the rents and others who pay the cost, and it is worth considering what would put people in one group or the other. Why is it that some people are rent recipients while rents are transferred from others? It is a small step to conclude that those in the privileged position of being able to obtain the rents are the elite – those who are able to design public policies – and the costs are borne by the masses.

One factor that may have been an impediment to the economic theory of rent-seeking getting to this point is the strong emphasis in the literature on rent dissipation. If the value of the rents received is dissipated in the costs of rent-seeking, this diminishes the net value of the rents and makes rent-seeking look less like a profitable avenue for the elite and well-connected, and more like a competitive return to political activity. But rent-creators have no incentive to create a rent-seeking contest in which all rents are dissipated. For their benefit, they will create rents only when there is something for them – the rent-creators – to gain. The idea that rents go to the elite makes more sense if there is a net benefit to receiving them.

The literature's heavy emphasis on rent dissipation – will rents be completely dissipated, or only partially dissipated, or perhaps over-dissipated? – come from looking at rent-seeking as a contest with free entry, and focusing on the incentives and behavior of the rent-seekers. By looking at the incentives of the rent-creators, it should be apparent that they will design the creation of rents to minimize dissipation, so the analysis of rent-seeking as a competition among rent-seekers mischaracterizes its nature. Institutions will be designed to minimize that competition, and therefore maximize the opportunity for those who create the rents to benefit.

The theory of rent-seeking, well-established in the academic literature, is one of the building blocks for a theory of political capitalism. The elite are able to gain rents because of their elite status. The masses are not in a position to compete for rents. This chapter shows that the theory of political capitalism also provides insight into the nature of rent-seeking institutions. A frequent question in the academic literature on rent-seeking is why rent-seeking costs appear to be smaller than would be predicted by rent-seeking theory. By incorporating the insights from the previous chapters into the analysis of rent-seeking institutions, it becomes apparent why, in most cases, the Tullock costs of rent-seeking are kept in check by the incentives facing those who create the rents, and also becomes apparent that rents tend to go to the elite at the expense of the masses.

In the real world, unlike theoretical models of rent-seeking competitions, rent-seeking is not a contest in which everyone can compete and in which everyone has a chance to win. It is a description of institutional arrangements that systematically benefit some at the expense of others. Just as elite theory adds to the understanding of rent-seeking, the theory of rent-seeking adds to the understanding of elite theory by describing one of the mechanisms by which political and economic institutions systematically advantage the elite. The ideas are stronger and more coherent when they are combined and viewed as two components of political capitalism.

6

Transitional Gains and Rent Extraction

The previous chapters have built on the extensive and well-established academic literatures on elite theory, interest group politics, and rent-seeking to describe how political capitalism operates to design the rules of government so they facilitate a transfer resources from the masses to the elite. This chapter looks into that process in more detail, building on another insight of Gordon Tullock's, the political creation of transitional gains, and Fred McChesney's explanation of rent extraction.[1] Tullock describes a transitional gains trap in which rents are created through the political process for the benefit of the owners of specific assets. The rents accrue to the owners of those assets, so recipients must own the assets to receive the rents. The requirement that rent recipients own specific assets is one way to create a barrier to entry. After the rents are created, the present value of the future rents becomes capitalized in the value of the assets associated with them, and the owners of those assets no longer receive an above-normal return on their assets. They receive only a normal rate of return because the assets appreciate in value to capitalize the present value of the future flow of rents. The policies that create the rents are inefficient, offering a good argument for reversing them, especially in light of the fact that after the transitional gain, the rent recipients earn only a normal rate of return on their assets.

The trap is that if the policy that created the rent is reversed, the value of the assets associated with the rent will fall, creating a transitional loss. The recipients of the rents apply political pressure to maintain those rents

[1] Gordon Tullock, "The Transitional Gains Trap," *Bell Journal of Economics* 6 (Autumn 1975), pp. 671–678, and Fred S. McChesney, "Rent Extraction and Rent Creation in the Economic Theory of Regulation." *Journal of Legal Studies* 16(1) (January 1987), pp. 101–118, and McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion* (Cambridge, MA: Harvard University Press, 1997).

and avoid the transitional loss. Despite the inefficiency of the policy that creates the rents and despite the fact that after the transitional gain the recipients do not receive an above-normal return on their assets, the policy is difficult to reverse because it would impose short-run costs on the rent recipients.

Tullock views this trap as an unfortunate mistake on the part of those who create transitional gains. He says, "The moral of this, on the whole, depressing tale is that we should try to avoid getting into this kind of trap in the future." His view is that policymakers have erred in creating those transitional gains and are now trapped into maintaining the policies that created them. He goes on to say, "Our predecessors have made bad mistakes and we are stuck with them, but we can at least make efforts to prevent our descendants from having even more such dead-weight losses inflicted on them."[2] The problem becomes both more complex and more understandable when Tullock's transitional gains trap is augmented with McChesney's rent extraction.

McChesney notes that while policymakers can create rents and share in the benefits, as the previous chapter described, another way policymakers can use the power of government to their advantage is to threaten to impose costs on individuals. Legislators could, for example, threaten to impose a costly regulation, or create a tax on a specific firm or industry. Those who are threatened with these costs then have an incentive to engage in negotiations to prevent those costly policies from being enacted. Rents – meaning, the transfers that go to rent recipients – remain unchanged with rent extraction. The rent extractors simply threaten to implement policies that impose costs on individuals, which those individuals try to resist by lobbying government and offering payments in various forms. No new rents are created and no old rents are destroyed, but payment is extracted from those who are threatened with unfavorable policies. They pay off the rent extractors in exchange for maintaining the status quo. While there are no new rents created with rent extraction, the Tullock costs of rent-seeking – the welfare losses that result from resources being allocated to avoid the rent extraction – remain.

These two ideas, developed separately, are more powerful when seen as two components of the same process, one of the mechanisms of political capitalism the elite can use to their advantage. Policymakers create rents in the present so that they can extract future payments from the recipients by threatening to take them away. The fact that

[2] Quotations from Tullock, "The Transitional Gains Trap," p. 678.

transitional losses will occur if the policy is reversed provides the targets of rent extraction with the incentive to pay off to avoid the transitional loss. The transitional gains trap is more of a trap than at first it appears for the rent recipients, but is a rational use of political power by the rent-creators.

Political capitalism is a system in which business profitability is dependent on political connections, and because some businesses face the prospect of transitional losses should the policies that created transitional gains be reversed, the creation of transitional gains clearly fits within the framework of political capitalism. The creation of transitional gains makes the recipients dependent on the political elite for their continued profitability.

TRANSITIONAL GAINS

Successful rent-seekers are able to receive above-normal returns for a period of time because of government policies that transfer benefits to them at the expense of others. In many cases the transfer is associated with the ownership of specific assets. One example in Tullock's article on transitional gains is the issuance of a limited number of taxicab medallions in New York City. All taxis in the City are required to display a City-issued medallion on their hoods and the City issues new medallions only infrequently. The requirement that taxis must have a medallion coupled with their limited numbers creates a barrier to entry, raising the incomes that flow to the owners of the medallions. The medallions are marketable, so existing owners can sell them, and anyone who wants to put a new taxi into service in the City must buy one. The value of the future rents accruing to medallion ownership becomes capitalized into the value of the medallion. Prices for medallions peaked in 2014, when medallions sold for well over $1 million each.

The initial owners of the medallions reaped a transitional gain because the medallions created a barrier to entry into the New York taxi business, generating rents for taxi drivers who were shielded from competition from new entrants by the medallion requirement. After the requirement went into effect, the present value of the future rents created by the barrier to entry was capitalized into the value of the medallion. Anyone who wanted to enter the New York taxi business had to buy a medallion, and the cost of the medallion was equal to the expected present value of those future rents. Medallion owners could expect only a normal rate of return on their medallions. The rents that accrued to those who paid $1 million or more for a medallion only went to repay the price of the medallion, which is why the gain from the policy was only transitional.

To be clear, the transitional gain does not disappear; it becomes capitalized into the value of the medallion. The rent still flows to the owner of the medallion, and the medallion is valued as it is because it represents the future flow of rents. The owner can sell the medallion to realize that value, so the gain is transitional only in the sense that the flow of rents represents just a normal rate of return on the now-higher value of the medallion.

The policy is inefficient, because it artificially restricts the number of taxis in the City, but despite its inefficiency and the fact that it no longer provides an above-normal return to medallion owners, it is difficult to eliminate, because to do so would create a transitional loss to the medallion owners. Politically, it would be difficult for the City to announce that it was going to eliminate this inefficient program and instead issue licenses for taxis to all applicants for some nominal registration fee. To do so would eliminate the value of the medallion. Someone who paid $1 million for a medallion would now find that medallion almost worthless.

The New York taxi medallion example is interesting for another reason: as of 2017 the value of medallions had fallen precipitously and some were sold for under $300,000. One big factor was the growth of Uber and other ride-sharing services that compete with taxis. Medallion owners suffered a transitional loss, not because of a change in government policy but because of an innovation in the market the government policy did not anticipate. This in turn has given rise to a demand by taxi operators to regulate ride-sharing services like Uber in a manner similar to the way taxis are regulated. That policy conflict between the taxi operators and the ride-sharing services is ongoing and unresolved at the time of writing, but one can see that it opens the opportunity for policymakers to extract rents from both groups. Both groups would be willing to devote real resources to try to influence government policy their way.

Another example of a transitional gain is farm price supports which increase the price of agricultural crops. The price supports generate a rent that goes to the sellers of the supported farm products.[3] Because farmland is required to receive the rent, over time the rent is capitalized into the

[3] One interesting note is that Tullock does not refer to these transitional gains as rents. The term rents was initially used by Krueger in her paper published in 1974, a year prior to Tullock's "Transitional Gains Trap" paper. Also, Tullock never refers to his earlier paper, "The Welfare Cost of Tariffs, Monopolies, and Theft," *Western Economic Journal* 5 (June 1967), pp. 224–232, in his transitional gains trap paper. He does refer to his book, *Toward a Mathematics of Politics* (Ann Arbor: University of Michigan Press, 1967) published in the same year as his "Welfare Cost" article. It may be that he did not recognize the close relationship between the two articles as he was writing the second one.

value of farmland, increasing the price of farmland. The initial regulation creates a transitional gain to the rent-seekers, which eventually is capitalized into an asset, dissipating the gain from rent-seeking. The owners of farmland when the policy is first put into place can sell their land to realize the value of that transitional gain, but once the value of farmland has risen, recipients of the now-higher prices of their products only receive a normal rate of return on their assets. As with the taxi medallions, if the regulation that initially created the rent were to be reversed, there would be a transitional loss because the value of farmland would fall.

After recounting a number of additional examples, Tullock ultimately concludes that creating these transitional gains is a policy error, and one that is difficult to reverse. Because reversing the policy would create a transitional loss, the interests who are receiving the rents would lobby to oppose the reversal, and while Tullock tries to consider policies that could compensate them for that loss out of the efficiency gain from eliminating an inefficient policy, he has no clear suggestions beyond his suggestion that policymakers avoid creating transitional gains in the future.[4] Tullock sees the creation of transitional gains as a mistake that, presumably, policymakers would avoid if they understood the long-run impacts of their actions. Incorporating McChesney's idea of rent extraction into Tullock's analysis suggests that policymakers have good reasons for creating transitional gains. They create transitional gains now so that they can extract payments from the recipients in the future.

RENT EXTRACTION

Fred McChesney describes what he labels rent extraction, which occurs when policymakers threaten to alter the status quo to impose costs on groups, unless they pay up to keep those policy changes from occurring. Peter Schweizer describes the same process, offering many examples, which he accurately describes as extortion, a term that may be more descriptive than rent extraction.[5] Rent extraction creates no new rents, and what policymakers extract is not necessarily a rent, so extortion does seem more descriptive of the activity McChesney describes. One similarity with rent-seeking is that when people are threatened with public policies that will alter the status quo to their disadvantage, they do have the

[4] Tullock, "The Transitional Gains Trap," p. 678.

[5] Peter Schweizer, *Extortion. How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets* (Boston: Houghton Mifflin Harcourt, 2013).

incentive to expend real resources to prevent that from happening, so the Tullock costs described in the previous chapter are a likely by-product of rent extraction.

Examples are easy to find. Many cities have imposed an excise tax on soft drinks, and more have threatened to do so, prompting a rash of lobbying from the producers and sellers of soft drinks to prevent that cost from being placed on them. Regulations like this are often proposed that would lower the profitability of businesses in an industry, prompting those businesses (and more likely, industry associations) to lobby against the regulations. Policies are often proposed to take away subsidies or tax credits from firms that are receiving them, again prompting a reaction from those who would bear the costs of these policy changes. While out-and-out bribery from those who are being extorted is illegal, rent extraction is little different from requesting a bribe when policymakers inform people that they are considering implementing policies that will impose costs on their businesses, but also imply that if those who would bear the costs would pay up in some way – the ways will be considered in more detail below – the damaging policy will not be enacted. Following up on the previous chapter, the fuzzy line between rent extraction and corruption is apparent.

Rent-seeking and rent extraction differ in several significant ways. First, people are not competing for the rents in rent extraction. Policymakers are using threats to extract payments from their victims, who pay up even though no new rents are created. Second, payments go to those who have the power to impose those costs, so there is a clear incentive for policymakers to engage in rent extraction, which is not the case if rent-seeking is depicted as a contest in which the rents are dissipated. Third, rent extraction does not impose any new inefficiencies on the economy, although it may perpetuate existing inefficiencies. Rent extraction simply demands a payment to retain the status quo.

It may be worth remarking again on the potentially confusing terminology, because rent means something different in all of these cases. In rent-seeking, what actually is being sought is not a rent, as the term is typically used, but a transfer. In rent extraction, what is being extracted is not a rent – and also not a transfer – but a payment in exchange for implementing policies favorable to the payer or for not implementing policies that are harmful to the payer. Not only is rent not particularly descriptive (and potentially misleading) in both of these cases, the rents that are sought in rent-seeking are not the same things as the rents that are extracted in rent extraction, but in keeping with the academic literature, this volume uses the term rent to describe the transfers in rent-seeking as well as the payments in rent extraction.

RENT EXTRACTION AND TRANSITIONAL GAINS

New taxes and regulations are proposed all the time that would impose costs on individuals. In the abstract, policymakers could threaten to impose all kinds of costs on anyone, and in fact often do. Federal, state, and local governments have imposed a large range of excise taxes and regulatory burdens targeted to specific firms and industries. Policymakers could choose any industry and threaten to place an excise tax on their products, or impose a costly regulation on them, prompting those in the industry to engage in lobbying to pay off the policymakers to not implement the policy. Despite this being a common occurrence, singling out one particular group to bear costs not imposed on others could meet with political resistance if those costs would violate a sense of fairness perceived by a majority of legislators' constituents, if the proposed policy appeared arbitrary or unwarranted. However, it may be politically less costly to threaten to remove a policy benefit that had been granted previously by the legislature. If citizens recognize the inefficiency of policies that restrict entry into businesses (such as taxi medallions) or that subsidize some by taxing others (like farm subsidies), there may be public support for reversing those policies even though that would result in transitional losses.

The political costs of threatening to remove a subsidy that generates rents for one particular group may be lower than the political costs of threatening to impose a tax on one group that other groups do not have to pay. Why should one group be singled out to bear the burden of a costly tax or regulation? Removing a government-granted benefit seems fairer, and may also gain political support from those who are paying the cost of providing that benefit. A legislature could plausibly tell farmers they are contemplating reducing or eliminating farm subsidies, or could tell oil producers they are considering eliminating accelerated depletion allowances, prompting those groups to pay up to have those changes taken off the table. The ability to extract rents offers an incentive to create them.

There is another advantage to engaging in rent extraction by threatening to remove a policy that generates a rent for an identifiable interest group. That interest group has already demonstrated its ability to organize and act together to obtain the rent. The interest group will already have a contact for the rent extractors in the form of their lobbyists who have secured past benefits for the group. By going after current rent recipients, rent extractors already have a well-organized and clearly identifiable group with whom they can negotiate to extract rents. In contrast, were they to try to impose a regulatory or tax cost on some group not organized to engage in rent-seeking, it is possible that high transaction costs will prevent the group from being able to organize to pay off the rent extractors. The problem of organizing interest groups, discussed in Chapter 4, can be overcome by dealing with groups that are already organized.

Tullock concluded his article on transitional gains by saying that the policies that created those transitional gains were mistakes that, he hoped, future policymakers would not make. Combining the insights of Tullock's transitional gains trap with the insights of McChesney's rent extraction shows that policymakers have more of an incentive to create those transitional gains than at first meets the eye. Once the transitional gains are created, policymakers can benefit from them by threatening to reverse the polices that created the gains. The creation of transitional gains also creates the opportunity to engage in rent extraction. Because the incomes of those groups receiving rents are now dependent on the policy that creates them, policymakers are in a position to continue to extort payments from them to maintain the policies on which they depend.

Those in government have an incentive to extract payment in exchange for legislative action, or inaction, and those who are paying have an incentive to continue paying to avoid having costs imposed on them. The gain that Tullock described is transitional because it becomes capitalized into the assets associated with it. But the gain to policymakers endures because year after year they can threaten to reverse the policies and inflict transitional losses. The creation of transitional gains is not a short-sighted mistake of policymakers; it creates an ongoing flow of benefits to those who have the power to reverse the policies.

Rents are created initially to allow the rent-creators to engage in continual rent extraction to maintain them. Rent-seeking competitions, as the academic literature on rent-seeking describes them, do not share these qualities. If all the rents are dissipated in the form of Tullock costs, there is nothing left to extract. Interest groups do seek benefits from legislatures, but interest group politics does not necessarily lead to rent-seeking contests. The benefit to the rent-creator within this framework is that, once created, the rent-creators can extract payments from the recipients by threatening to reverse the policies that generate the rents. The ability to extract payment from the recipients provides the incentive to create transitional gains.

While rents could in theory be extracted from many sources, rent-creators have an incentive to minimize the political costs of rent extraction, and political costs can be minimized by creating rents that obviously provide differential benefits to a well-organized group. The group is already organized, so rent extractors know who to approach to extract the rents, and because the group receives benefits from favorable policies to begin with, a proposal to reverse obvious favoritism will garner more popular support than a proposal that appears to unfairly impose costs on some group.

THE INSTITUTIONS OF RENT EXTRACTION

Peter Schweizer's book, *Extortion*, provides real-world examples of rent extraction and a good discussion of the institutions that are used to extract rents. Schweizer notes that when lobbyists provide benefits to legislators, many people equate that with bribery: the lobbyist is bribing the legislator in exchange for the legislator promoting policies helpful to the lobbyist. But, he says, "What we often see as bribery is often a form of extortion."[6] While in most cases the lobbyist approaches the legislator for a favor, in many cases the lobbyist does so because the legislator has threatened the lobbyist's client with costs, either in the form of holding up legislation that can benefit the lobbyist's client or proposing legislation that can harm the lobbyist's client. The legislator is then in a position to pursue some compensation in exchange for preventing some unfavorable treatment. The distinction between bribery and extortion in politics often is not clear.

A typical example would involve a meeting between legislator and a lobbyist who wants to prevent the passage of some potentially harmful legislation. The legislator tells the lobbyist that his committee will be deciding next week whether to bring the bill on this subject up for a vote, and no decision has been made yet. Also, by the way, the legislator mentions that he is fundraising for his reelection, or for the general support of his party, and needless to say, any donations would be welcome. Of course, the legislator does not directly ask for a payment in exchange for tabling the legislation, and the lobbyist might even bring up the issue. "Thanks for taking the time to talk with me, and if there is anything I can do for you, please don't hesitate to ask." And of course, both of them know that if the lobbyist does make a payment to the legislator's campaign, the unfavorable legislation is more likely to be tabled. Everyone understands the process, so there is no need for them to explicitly state the nature of the exchange that is being made.

6 Schweizer, *Extortion*, p. 18.

If the process did not work this way, the lobbyist would have no incentive to tender his client's resources to the legislator. This is the general nature of the institutions that allow policymakers to engage in rent extraction. The payment might be campaign money, but it also might be that the legislator has a family member, or a staffer, who is looking for a job. The lobbyist can help. Or, the lobbyist could offer to take the legislator on a fact-finding trip to a desirable locale. Campaign contributions would appear to be used for political purposes, not as a direct benefit to the legislator, but legislators often put family members on their campaign payrolls, channeling campaign contributions directly as cash transfers to family members.[7] Legislators can lend money to their campaigns, and rather than have the campaigns repay the loans, have the campaigns pay them high rates of interest on those loans for years into the future.[8] Legislators rent office space they own to their campaigns. Legislators have found many ways to channel cash contributions back to their own pockets, and to provide favors to their family and friends. Payment can come in various forms, but behind any payment is always the idea that it is in exchange for favorable treatment. Those who are in the low-transaction cost group are in a position to engage in transactions.

The example above also applies to cases in which the lobbyist wants favorable legislation to pass. The legislator tells the lobbyist that his committee will be considering whether to bring that bill forward in the near future, and the lobbyist recognizes that some payment will increase the odds that the bill actually will make it out of committee. Is this bribery, or is it extortion? Is the lobbyist bribing the legislator to promote the bill, or is the legislator demanding payment to promote it? There may be an element of both, but the bottom line is that the payment is likely to be necessary to facilitate the passage of legislation favorable to the lobbyist, or to facilitate the tabling of unfavorable legislation. This is one of the ways that political capitalism plays out, as the political elite benefit the economic elite in exchange for the economic elite providing benefits to the political elite. Again, the fuzzy distinction between corruption and political exchange is apparent, and again it is clear that the elite have every incentive to design the rules so that these exchanges meet the letter of the law.

7 Schweizer, *Extortion*, provides many examples on pp. 75–77.

8 Schweizer, *Extortion*, p. 74 gives examples, including one in which a member of the California State Assembly was paid 18 percent on a loan. An 18 percent risk-free rate of return on a loan can be had in few places other than politics.

A frequently used mechanism legislators use to extract rents is to inform lobbyists who visit of an upcoming reception the legislator is holding, and invite the lobbyist to attend. Lobbyists understand that attending and contributing will enhance their chances of favorable treatment. As Schweizer describes, at the reception is a glass bowl on a table in the center of the room, and lobbyists understand that they put their checks in the bowl if they want their voices to be heard. There is no explicit talk about payment in exchange for political favors. Those in attendance know how the system works without anybody having to explicitly say so. Schweizer quotes an oil company executive who says, "If you are invited, you are expected to be there. There is an implicit aspect of the request that makes that clear. And when you get there, you better show up with a check."[9]

CONTINUING TRANSACTIONS

Dealing with legislative outcomes, one can never buy an outcome – it can only be rented. Legislation written by one legislature can always be undone by the next. So, the political elite can continue to extract payments for continuing to allow the status quo to remain. The way rent-seeking is depicted in the academic literature makes it appear that it is a one-time contest in which the rent is won and then the game is over. This is realistic in one sense, but it is worth examining more closely to see in what sense it is realistic. Take a case in which the rent is a monopoly privilege. One way to look at it is that there is a competition for the right to be the monopolist, and the winner ends up with the monopoly. But monopoly privileges granted through government can also be taken away by government. Some monopolies appear relatively permanent – electric utilities in the United States seem that way – but others that may have appeared equally permanent have been eroded. In the mid-twentieth century AT&T appeared to have a solid grasp on the monopoly right to provide long-distance telephone services in the United States as well as most local telephone services, but the monopoly was broken up in 1984.

If it is unrealistic to view the winner of the rent as entitled to that rent in perpetuity, then rent-seeking is not a one-time contest, and it is more realistic to view the rent as won one period at a time. The contest reopens periodically, and this year's winner of the rent will have to compete again to keep it next year. Even thinking about the contest reopening on an annual basis is somewhat unrealistic, because the rent is always subject to

[9] Schweizer, *Extortion*, p. 60.

renegotiation. Policymakers can at any time propose to remove or reassign the rent. The same holds true with rent extraction. It can take place continually. If a proposal to tax some group is dropped in exchange for a payment of some type from that group, the tax can be proposed again at any time. This is why political outcomes can be rented but not bought, and the same is true of politicians, who can be rented but not bought.

Legislation proposed solely for the purpose of rent extraction is referred to as a *milker*. A milker bill is introduced with the recognition that it will impose costs on a particular group with the motivation of getting that group to lobby against the bill's passage. Legislators have no desire to actually pass the legislation; they just want to extract rents from an interest group in exchange for dropping it. If the interest group does not step up to pay to stop it, legislators will not mind passing it as a penalty for their not being sufficiently engaged in the political process, but the hope behind the milker is that those being milked will pay up to stop it. Businesses cannot just tend to their markets. They must also remain connected to the political process to avoid bearing governmentally inflicted costs. Political capitalism does not allow firms to opt out of the system. They need to pay their dues so they can be part of the elite, who reap the benefits, rather than the masses who pay for those benefits. This is the nature of political capitalism.

Milker bills are not just sprung on unsuspecting victims, but evolve in stages that allow for continual rent extraction. The process may be initiated when a legislator announces an investigation or study into a particular issue. They will solicit input from those most affected, giving the potential victims of the legislation a chance to lobby early to kill the study. As the bill moves ahead, there will be questions about how the bill should be drafted and what should be included. Again, there is another chance to reduce the impact of the potential legislation, or perhaps even shift it to be favorable to those affected, as Kolko notes happened with Progressive Era regulation. Once the legislation is drafted, there is another opportunity to milk those whose interests would be harmed if it passed. From the standpoint of the targets of rent extraction, it would be good to kill the bill in committee rather than have it come to the floor for a vote.

Even more profitable are bills referred to as *double-milkers*, which can elicit support on both sides of an issue. Schweizer offers as an example digital piracy legislation that was being considered in Congress in the 2009–2011 period.[10] Content providers wanted very strict rules governing those who transmitted unauthorized copyrighted material, while internet

[10] Schweizer, *Extortion*, pp. 80–86.

service providers viewed strict rules as a threat to their livelihoods, should they be made liable for any content that was transmitted by their services. Legislation like this allows legislators to reap contributions on both sides of the issue, so regardless of which interest group wins, legislators prosper through rent extraction. Ultimately, depending on how much those on either side are willing to pay, the result will likely be a compromise, which may be seen as a victory, or partial victory, by both sides, but in which neither side gets everything they want.

These issues are never completely resolved, especially when there are interests on both sides. If a legislature proposes an excise tax on soft drinks, it is easy to conjecture that the soft drink industry will mobilize in opposition, but there will be little in the way of organized efforts in support. When there are organized interests on both sides of an issue, both sides will tend to come back to try to sway public policy more in their direction. Issues that have organized interests on both sides resemble the situation Gary Becker discussed in which the legislature acts as a political marketplace, weighing the political costs and benefits on each side to come to a policy outcome that balances the benefits at the margin.[11] What Becker did not emphasize is that legislators will measure the benefits of each side of the issue in terms of the rents that can be extracted. It is not unreasonable to believe that those who have the most to lose will invest more in the effort, and it may be, as Becker suggests, that the result is the lowest-cost outcome to achieve the legislature's policy goals. Nevertheless, one can see, with interest groups bidding on both sides of the issue, that the policymakers who collect the bids will end up the ultimate winners. Because the economic and political elite bargain with each other, an outcome that is lowest-cost to those bargaining – the economic and political elite – has the potential of imposing costs on those who are not able to enter the bargain – the masses.

One way for legislators to keep collecting is to pass temporary extenders in legislation rather than make legislation permanent. For example, the R&D tax credit in federal law has never been made permanent. Rather, it is renewed each year, allowing for rent extraction from those who favor it every year. In 2011 there were 154 tax extender bills passed, which temporarily retained some aspect of the tax code beneficial to some interest group.[12] If those provisions of the tax code were made permanent, the

[11] Gary S. Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, 98 (1983), pp. 371–400.

[12] Schweizer, *Extortion*, p. 31.

legislature would be giving up the opportunity to extract rents from the beneficiaries. The same principle holds for expenditures such as subsidies and government reimbursements. Rather than permanently change the legislation, an extender is passed which allows for additional lobbying as the expiration date for the extension approaches. These are the institutions of political capitalism.

VAGUE LAWS

The general public is well aware that legislation is often complex and vague, to the extent that it is not entirely clear even to experts who read the laws what they require. In 2010 Speaker of the House of Representatives Nancy Pelosi famously said about the Affordable Care Act, since known (with President Obama's approval) as Obamacare, "We have to pass the bill so that you can find out what's in it." Without delving into the intent of Speaker Pelosi's comment,[13] there is much truth to the observation that the content of legislation is not clear at the time it is passed. This is the case for several reasons.

One is that legislators design laws so that they provide a general outline with actual rules and enforcement determined by the agencies that will administer them. This allows legislators to duck the blame for any specific harmful mechanisms that ultimately are designed by the agencies. It also allows for another level of lobbying at the agency level to have legislation administered in a manner favorable to those covered by the legislation. As the next chapter discusses in detail, firms are likely to have more success dealing with the agencies that regulate them than with the legislature that initially approves the regulation. A consequence of the vagueness of legislation is that it requires expert opinion to interpret and negotiate laws. It is not a simple matter of reading and following the law. The vagueness with which laws are written opens employment opportunities for the staffers who write them. Staffers regularly leave their government jobs to join consulting firms that help guide businesses on how to comply with the laws they wrote. As authors of the legislation, they have the expertise to

[13] Speaker Pelosi says that the House of Representatives had drawn up their legislation but the Senate was dragging its feet and had not. Typically, different versions of legislation pass the House and Senate, which are then reconciled by a conference committee to allow both houses to again vote on the same legislation. Pelosi says that without a Senate version of the legislation, and ultimately the reconciled version, people could not know what would be in the final legislation. Note that this reconciliation process allows for another lobbying opportunity.

help advise on how to comply, and also have the connections to make their opinions authoritative.[14]

Another reason laws are deliberately vague is that it introduces an arbitrariness into the way they can be enforced. If it is unclear whether a law has been violated, those who have well-established connections can use those connections to have any questionable activities overlooked, whereas those who do are at odds with the power structure, or maybe are just viewed as not paying up when they should, can be pursued for violations. In 2016 FBI Director James Comey declined to pursue charges against Hillary Clinton for using her personal computer server to send and receive classified information, a clear violation of the law. Initially she claimed no classified information was on the server, although this later proved to be false. Meanwhile, when Mr. Comey was a US attorney in 2004, he successfully prosecuted Martha Stewart for lying during an insider trading investigation. While Stewart was never formally accused or tried for insider trading, she did end up with a jail term because she was accused of lying during Comey's investigation. As Clinton was cleared in 2016 – Comey said she displayed very bad judgment but that it appeared any violations of the law were inadvertent – many observers noted the difference in the way Clinton and Stewart were treated under the legal system. The difference appeared to be Clinton's close ties with the elite, in contrast with Stewart's.

If laws are vague, then everyone potentially is a violator, which gives additional power to the political elite. If they want to go after someone, that person has probably done something that might be construed as illegal. But with vague laws, those who are well-connected can get a pass. It is again worth emphasizing in the Martha Stewart case that while she was suspected of insider trading and investigated for it, she was never formally accused or tried, let alone convicted of it. She was convicted of lying during an investigation of an activity that did not turn up sufficient information for her to be prosecuted.

Whether Stewart was guilty of insider trading and whether Clinton was guilty of using her personal server to send and receive classified information is beside the point in this particular case. Neither was charged. Stewart was charged and spent time in jail for lying during the investigation, and the evidence that classified information was on Clinton's servers shows that she also lied during her investigation. Why did Comey pursue and convict Stewart for lying but not Clinton, when there was clear evidence Clinton lied?

[14] Schweizer, *Extortion*, pp. 112–120, offers many examples.

Vague laws allow for rent extraction because it is never clear whether the law has been violated. Thus, those with political power always have the ability to announce an investigation or to suggest the way laws were intended to be interpreted, leaving those with the potential to be accused of violations in the position of having to maintain political connections to get favorable treatment within an arbitrary system. As Microsoft grew in the 1990s, Bill Gates was proud of the fact that his company focused on its business and was rarely involved in lobbying and made minimal political contributions. When the Justice Department sued Microsoft for antitrust violations, Microsoft greatly increased its Washington presence and its lobbying activities. The company realized that without political connections it had become a target.[15] The system is designed to work in favor of the well-connected, and at the expense of those who are unwilling to cooperate with the power structure.

PRINCIPLES AND POLITICS

The above analysis seems to depict politicians as unprincipled individuals who are out to exploit the political system for their own benefit at every opportunity. The nature of the political process rewards legislators who act to maximize their personal payoffs rather than work to favor the public interest. Consider the political bargaining process in which legislators trade political support with each other to pass legislation. Ultimately, legislation requires majority approval to pass, and legislators build majorities through political bargaining. They can trade their votes on issues that have less interest to them for votes on issues that are more important to them. For them to enter the bargaining process requires that they be willing to trade their votes.

Consider a politician who always votes on principle. There is no reason for any other legislator to ever bargain with that legislator. If an issue comes up that conforms with the legislator's principles, the legislator will vote for it; if an issue comes up that conflicts with the legislator's principles, the legislator will vote against. There is no possibility for exchange, and no need to solicit the legislator's vote on any issue.

Now consider a legislator who votes pragmatically to further his own payoff. If an issue comes up that the legislator opposes, that unprincipled legislator can be enticed to support it anyway, given the right payoff. An unprincipled legislator's vote can always be bought. What if an issue

15 This is reported by Schweizer, *Extortion*, pp. 86–87.

comes up that the legislator supports? The legislator's vote still must be bought, because even though the unprincipled legislator favors passing that issue, the opposition will know that they can buy the legislator's vote with the right compensation. So even on issues the legislator supports, any coalition that wants to pass that legislation still must buy the unprincipled legislator's vote to keep the opportunistic legislator from switching sides for a better offer.[16]

Friedrich Hayek, in his well-known *The Road to Serfdom*, concludes that in politics the worst get on top because successful politicians are people who are most inclined to disregard the costs they impose on others to use the force of government to accomplish their ends.[17] Those who are more willing to take into account the costs they impose on others by using the force of government will not be as effective in using the apparatus of government. Add to this that people who see the merits in dealing with each other through voluntary exchange will naturally be more inclined to seek their fortunes in market activity whereas those who are inclined to think that government's role is to force people to conform to its mandates to accomplish its goals will seek out the power of government.

People who hold the public interest view of government as a positive description of government (as opposed to a normative aspiration) will be skeptical of the descriptiveness of the theory of political capitalism. One would like to think that those who command the power of government act in the public interest. Yet an examination of the incentives facing public policymakers shows that they will be more successful the less principled they are. This naturally will attract those who are least principled to policymaking positions. They are most successful when they pragmatically bargain with others, and the others who they are in a position to bargain with are the economic and political elite.

Principles and politics make an uneasy pairing. That being the case, it is not difficult to understand why public policy tends to be skewed to represent the interests of the elite rather than the masses. Legislation gets passed through logrolling, which is political exchange.[18] It may be as

[16] Timothy Beasley, *Principled Agents? The Political Economy of Good Government* (Oxford: Oxford University Press, 2006) suggests that politicians can respond to incentives to act in the public interest, but Randall G. Holcombe, "Principles and Politics: Like Oil and Water," *Review of Austrian Economics* 22, no. 2 (June 2009), pp. 151–157, develops the arguments presented in this section to conclude that principled politicians are at a distinct disadvantage in the political process.

[17] Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

[18] The framework for logrolling is analyzed extensively in the classic public choice book by James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of*

simple as “I'll vote for your bill if you'll vote for mine,” but political exchange can be more complex. Ultimately, votes are currency and the legislature has few enough members that they can keep track of IOUs and make sure that debts are paid. If they are not, legislators who renege on their debts will be excluded from future political exchange and therefore be rendered ineffective. The less principled a legislator is, the more successful that legislator can be in the political bargaining process. The political process itself contains a selection mechanism that favors unprincipled politicians over principled ones.

THE CIVIL AERONAUTICS BOARD

One of the examples Tullock used to illustrate the transitional gains trap was the Civil Aeronautics Board (CAB) that regulated the airline industry. The CAB makes an interesting case study because it was abolished in 1978, shortly after Tullock's 1975 article on transitional gains was published.[19] The CAB regulated air fares and airline routes. Any fare changes had to be approved by the CAB, and any new routes an airline wanted to fly had to be approved by the CAB. In practice, the CAB would approve increases in air fares, but discouraged air fare reductions. The CAB would approve new routes for airlines only if the airline looking for approval could establish that the route was not being adequately served. Effectively, the CAB was a government-created airline cartel, established in 1938 to stabilize and promote the airline industry. As such, it provided a great example of government regulation designed to provide rents to the airline industry, and a great example of the transitional gains trap.

A cartel is a group of producers who coordinate their activities to act as a monopolist. Monopolists generate their monopoly profits by restricting their output so they can charge higher prices. Because increases in the quantity supplied push prices down and decreases in the quantity supplied push prices up, the only way a monopolist can get a higher price is to produce less. When a cartel organizes, the individual members want higher prices, so they all must agree to restrict their outputs to keep prices up.

Constitutional Democracy (Ann Arbor: University of Michigan Press, 1962). They point out the efficiencies that can result from political exchange, but inefficiencies also result because government can force everybody to comply with the policies favored by some.

19 The role of the CAB as described in this section was terminated by the Airline Deregulation Act of 1978, but the CAB did remain as a government agency up through 1985. It is difficult to kill a government agency even after the purpose of that agency no longer exists.

The problem cartels face is that when prices are higher, the individual members all want to sell more, not less, so cartel members have an incentive to cheat on the cartel agreement and increase their output. When members cheat on the cartel and produce more, that pushes prices down, and the cartel tends to break down. For a cartel to be effective, its members must design a mechanism that keeps them from producing more, so they can keep their prices up.

The CAB regulations did exactly that. They kept prices up because the CAB would routinely approve any proposed fare increases, but not decreases. Thus, the CAB enforced the higher prices. Also, the CAB would not approve a new route for an airline unless it could demonstrate a need. If an existing airline was flying a route and serving all passengers who wanted flights, the CAB would not approve a competing airline for the route. The CAB regulations restricted output and enforced higher prices, just like a textbook model of a cartel. Left on their own, airlines would have an incentive to cheat on the agreement, but the CAB made cheating on the cartel illegal.

The CAB provided rents to the airlines by keeping fares high and restricting competition, which provided a transitional gain to the airlines. The transitional gain was dissipated by the airlines in a number of ways. One which was specifically encouraged by the regulations was that airlines invested in excess capacity. Because new routes were assigned only when the applicant for the route could show a need, airlines had an incentive to fly with empty seats to show that there was no need for other competitors on their routes. Unlike twenty-first-century airline travel, when the aircraft are almost always full, the pre-deregulation airliners almost always had many empty seats. If an airline wanted to initiate flights on a route already served by an existing airline, the airline already flying the route would argue to the CAB that there was currently excess capacity on that route, so there was no need for more capacity on it. The regulations encouraged excess capacity as a way to deter competition, and the airlines could afford to fly with excess capacity because the CAB kept air fares high.

Airlines spent money in other ways to lure travelers, including providing meals on flights of any length and regularly buying new aircraft. In addition, because of the higher air fares, unions for pilots and flight attendants were placed in a favorable bargaining position and were able to negotiate higher pay as a result. Airlines could afford to give in to wage negotiations rather than risk strikes that would interrupt their business. Regulation provided a transitional gain to airlines that was then capitalized into the value of their excess capacity in aircraft and union contracts.

Airlines earned a normal rate of return on their assets, but regulation caused them to overinvest.

After the 1978 deregulation, the airline industry, stable for decades under the CAB umbrella, saw a substantial change as the existing airlines, which had overinvested in aircraft and overspent on wages and salaries, found themselves rapidly uncompetitive. Of the largest eleven airlines in 1978, only three – United, American, and Delta – remained as independent companies in 2018. The remainder – Eastern, TWA, Pan Am, Northwest, Western, Braniff, National, and Continental – have either gone bankrupt or have merged with other airlines. In their place, new airlines have emerged that were not burdened by the transitional losses from the old regulatory regime. Airlines like Southwest, JetBlue, Spirit, Frontier, and Allegiant were all founded subsequent to deregulation, free to enter the industry in a way that would not have been possible under CAB regulation.

Recall that the trap that Tullock saw in the transitional gains trap was that once that transitional gain had been dissipated, to eliminate the rent would cause a transitional loss, making it politically difficult to reverse the inefficient policy. The reversal in the case of the CAB makes it an interesting case. It does appear that the CAB regulation was inefficient, because after it was repealed air fares decreased, the number of passengers and passenger miles flown increased, the number of flights increased, and air fares decreased, despite the fact that many of the legacy airlines that existed prior to deregulation went out of business. New airlines arose to more than replace the old ones.

One factor leaning toward deregulation was President Carter's appointment of Alfred Kahn, a Cornell economics professor, to head the CAB. Kahn, like many economists, saw the inefficiency of the CAB's regulation, but economic policy is not made by economists, it is made by politicians. One politician who came on board for deregulation was Senator Ted Kennedy of Massachusetts. The CAB regulated interstate airline flights, but intrastate flights were not regulated because the Constitution gives the federal government the right to regulate interstate commerce, but not intrastate commerce. Senator Kennedy noted that air fares were substantially less expensive between Los Angeles and San Francisco, an unregulated route within the state of California, than they were between Boston and Washington, DC, which was about the same distance and had regulated fares. Observing that the CAB regulation was imposing a cost on him and his constituents, Senator Kennedy supported deregulation, and the protected airlines were unable to muster enough support to stop it.

One lesson from airline deregulation is that rents are only temporary, and that a rent granted by one legislature can be taken away by the next. Recipients cannot take them for granted, which means they must continually lobby to maintain them. This, in turn, enables a continuing process of rent extraction by the political class that creates the rents. While many forces led to deregulation, Senator Kennedy's support shows that policies imposing costs on the politically powerful are particularly vulnerable. Kennedy, born in 1932, was only four years old when the CAB was established,[20] so obviously he had no influence over the agency's original design, but his rise in power did have an influence over the agency's demise. In a continually changing political landscape, rent recipients must continually be aware of new threats to their rents. The CAB provides a case study that demonstrates this.

TWO TYPES OF RENT-SEEKING WELFARE LOSSES

Following Tullock and Krueger, the welfare losses from rent-seeking arise because of competition for rents, but these losses can be divided into two different categories with different implications. First, there are resources that are consumed in the political process to try to influence political decisions and public policy. Those types of losses, emphasized by Tullock in his 1967 rent-seeking article, can be labeled political rent-seeking costs. The Tullock costs referred to in this and the previous chapter are normally depicted as political costs – real resources expended to try to influence public policy. Tullock's transitional gains trap focuses on a different type of welfare loss, which results from investment in assets associated with the receipt of rents once the rules and regulations have been established. Those costs can be labeled investment-related rent-seeking costs. First, the rules and regulations governing the receipt of rents must be established, Second, given those rules and regulations, rent-seekers must invest in some asset to be eligible to receive the rents defined by those rules and regulations.

Krueger offers examples of both types of welfare losses, although she does not identify them as such. Referring to import licenses, she says, "When licenses are allocated in proportion to firms' capacities, investment in additional physical plant confers upon the investor a higher expected receipt of import licenses. Even with initial excess capacity . . . a rational entrepreneur may still expand his plant if the expected gains from the

[20] The CAB was originally named the Civil Aeronautics Authority, created by the Civil Aeronautics Authority Act of 1938. It was renamed the Civil Aeronautics Board in 1940.

additional import licenses he will receive, divided by the cost of the investment, equal the returns on investment in other activities." In this example, Krueger cites no welfare losses from political activity to secure rents. All of the costs she describes come from investing in excess capacity to qualify to receive more rents. One could imagine firms lobbying to alter the way rents are distributed to benefit themselves, so in reality there probably were political costs incurred as the policy was being designed, but the point is that Krueger's example makes no mention of this. It takes the rules as given and then shows how the rules push firms to inefficiently invest in excess capacity. These are investment-related rent-seeking costs that are incurred as a result of the rules that are already in place.

Krueger offers another example. "A second sort of licensing mechanism frequently found in developing countries is used for imports of consumer goods. There, licenses are allocated *pro rata* in proportion to the applications for those licenses from importers-wholesalers . . . The result is a larger-than-optimal number of firms, operating on the downward sloping portion of their cost curves . . . In this case, competition for rents occurs through entry into the industry with smaller-than-optimally sized firms, and resources are used in that the same volume of imports could be efficiently distributed with fewer inputs if firms were optimal size." Here again Krueger is referring not to the lobbying and political costs associated with obtaining rents, but pointing out the investment costs necessary to obtain the asset that is associated with the flow of rents once the rules for creating the rents are in place. That investment uses real resources.

Krueger continues with a third example. "A third sort of licensing mechanism is . . . that government officials decide on license allocations . . . competition can also occur through allocating resources to influencing the probability, or expected size, of license allocations . . . trips to the capital city, locating the firm in the capital, and so on – are straightforward. Others, including bribery, hiring relatives of officials or employing the officials themselves upon retirement, are less so."[21] In this third case, Krueger is referring to the political resource costs associated with influencing political decisions and public policies.

The first two cases are more closely aligned with Tullock's observation about rents flowing toward specific types of investments, resulting in overinvestment in the assets that receive the rents. That is, they are more closely related to the type of welfare loss Tullock referred to in

[21] All three examples come from Krueger, "The Political Economy of the Rent-Seeking Society," p. 292.

"The Transitional Gains Trap." The third example describes attempts firms make to try to influence political decisions, which is more closely related to the Tullock costs he described in "The Welfare Loss of Tariffs, Monopoly, and Theft." The academic literature on rent-seeking has not made a clear distinction between these two types of welfare losses.

Chapter 5 offered arguments that those who create rents have incentives to do so in a manner that minimizes rent dissipation to maximize the value of the rents available to share between the rent-creators and the rent recipients. The political costs of rent-seeking should be minimized for the benefit of those who create the rents. The incentive also exists to minimize resource misallocation from overinvestment in assets associated with the receipt of rents. The simple way this can be done is to design rent-generating institutions in such a way that there is no incentive to invest in real assets to increase a recipient's share of the rents. This condition is easy to state but may be more difficult to implement.

MINIMIZING INVESTMENT LOSSES FROM RENT CREATION

The NYC taxi medallion system is an example of how resource losses can be minimized from investments in assets related to rent-seeking. To get the rents, those who own taxis must also own medallions, and the medallions create the barrier to entry. From the standpoint of resource use, the advantage of the medallions is that they cost almost nothing to produce. While they are valuable assets to the medallion owners, they extract almost no real resources from the economy as a whole.

Contrast this with the CAB's cartelization of the airline industry. To prevent other airlines from competing on its routes, airlines would have to demonstrate that there was no need for additional capacity on the routes they were flying, which they did by investing in excess capacity. Readers of a certain vintage will recall in the CAB's regulatory heyday that airliners always had empty seats. The striking difference between the NYC taxi medallions and the CAB route regulation is that, while it costs almost nothing to create a taxi medallion, airliners are very expensive to produce, so there was a substantial real resource cost associated with the excess capacity required to earn rents from the CAB regulation while there was none in the case of the taxi medallions. In fact, because the taxi medallions restricted the number of taxis, the medallion system creates an under-investment in taxis, not an overinvestment. To minimize the resource cost of rents, rent-creators should be looking at the NYC taxi example as a prototype, and the CAB example as a case to avoid.

George Stigler says the reason rent-seekers prefer regulatory benefits to cash transfers is that it is difficult to create a barrier to entry to prevent others from competing for cash, but regulation often has built-in barriers to entry.[22] Consider monopoly franchises given to electric utilities in the United States. While there is a substantial investment of real capital in power plants, the nature of the regulation gives firms monopolies in given geographic areas, so competing firms cannot benefit by trying to build their own power plants. This barrier to entry minimizes the investment-related welfare losses from electric utility regulation.

In many states electric utilities are regulated to receive a competitive rate of return on their assets, and this type of regulation does lead to an over-investment in assets, because with more assets, the utility has a bigger base on which to earn a return.[23] Despite the inefficiency of this regulation, it appears to have no discernible effect on electric utility rates, which one would expect if regulators viewed themselves as cronies of those they regulated rather than protectors of the public interest.[24]

There is a clear barrier to entry that prevents new firms from competing with existing electric utilities, minimizing investment-related rent-seeking losses from new entrants, but the rate of return regulation in some states creates an incentive for overinvestment for a different reason. The previous chapter discussed institutions that prevent, or cause, rent dissipation, and it appears that rate of return regulation on electric utilities is one of those institutions that increases the dissipation of rents. The regulation of electric utilities is discussed further in Chapter 7.

Clear barriers to entry are difficult to create and maintain, partly because economic advances can erode them. The example of Uber eroding the barrier to entry into the taxi business shows this, and a similar example in the electric utility industry is new types of electricity generation technology that allow small producers to generate more electricity than they use. Owners of solar panels, for example, want to be allowed to draw electricity from the grid when they need it, but to sell electricity back into the grid when they generate more than they use. Barriers to entry are not eternal, so

22 George J. Stigler, "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971): 3–21.
23 This is referred to as the Averch–Johnson effect after Harvey Averch and Leland L. Johnson, "Behavior of the Firm Under Regulatory Constraint," *American Economic Review* 52, no. 5 (December 1962), pp. 1052–1069.
24 The effects of regulation are examined by George J. Stigler and Claire Friedland, "What Can Regulators Regulate? The Case of Electricity," *Journal of Law & Economics* 5 (October 1962), pp. 1–16.

recipients of rents need to continually engage in the political process to maintain the barriers that generate their rents. Electric utilities lobby to keep solar and other generators off the grid, while those potential competitors lobby to gain access.

Consider the design of farm subsidies. If they are given as allotments to existing farmers who are grandfathered in, there is no incentive to invest in clearing and planting additional acreage to gain a share of the rents. Farm land is like power plants in the earlier example, and the rents go to existing producers with a barrier to entry for newcomers. If subsidies come in the form of parity price guarantees for sellers of crops, there then is an incentive to invest excessively in planting, because the benefits of the parity price come in proportion to the amount of produce brought to market. Farm subsidies have moved away from price guarantees and parity prices which created substantial surpluses in agricultural output, toward other mechanisms like acreage allotments that provide a more secure barrier to entry without the same inefficiencies as parity pricing.

This chapter extends the lessons of the previous chapter to show why rent-seeking losses are, in most cases, considerably smaller than models of competitive rent-seeking lead economists to believe. Rent-creators have the incentive to design institutions to minimize the welfare loss of rent-seeking, which maximizes the net benefit to rent-creators and rent recipients. But, not all institutions are equally efficient, and these chapters have illustrated cases in which rent-seeking institutions have broken down, creating the welfare losses that Tullock and Krueger described.

CONCLUSION

Rent-seeking is typically depicted in static terms, as a one-shot contest. The winner of the contest gets the rent. The previous chapter cast some doubt on depicting it as a contest. This chapter shows that it is an oversimplification to view rent-seeking as a single contest in which rents go to the winner. Gordon Tullock's explanation of transitional gains shows how rents can be dissipated over time through investments in assets associated with receiving the rents. Some of Anne Krueger's examples fit here. She describes systems in which licenses to import raw materials are granted in proportion to firms' production capacities, which at first gives a rent to firms in proportion to their production capacities, but over time leads firms to overinvest in production capacity to gain additional access to raw materials. A transitional gain accrues to those with production capacity when the policy is implemented, which is dissipated over time through excess investment.

The examples of rents being capitalized into taxi medallions and farmland also illustrate how over time the rent that is “won” ends up only providing a normal rate of return, despite causing an inefficient use of resources. But the taxi medallion example shows that the assets associated with the rents do not have to result in an inefficient use of real resources. It costs almost nothing to produce the medallions, so if their value falls, resulting in a transitional loss, there is no real resource cost associated with the financial loss suffered by the medallion owners. This points toward ways institutions can be designed to minimize the real rent-seeking costs, leaving more to be divided between the rent-seekers and the rent-creators.

The concept of rent extraction then makes a good complement to the transitional gains trap. Once rent recipients are trapped and dependent on that flow of benefits, policymakers are in a good position to demand payment to maintain that flow. Rent extraction can occur without transitional gains, but politically it should be easier to extract payment from those who are favored by public policy. Arbitrarily deciding to levy a tax on some group might be opposed on matters of fairness, but extracting rents from those who benefit from government protection sidesteps this concern. Many of these policies are largely outside the view of the general public. It would be difficult for a rent recipient to make a public relations appeal that the government is trying to take away some of its special privileges.

Tullock described policies that create transitional gains as unfortunate bad policy, but when combined with the idea of rent extraction, it becomes apparent that policymakers have an incentive to create those transitional gains so that they can later extract payment from the recipients. The ability to extract rents provides the incentive to create them. And, the possibility of rent extraction shows why rents are temporary benefits that must continually be pursued, not one-time winnings. The continued flow of rents is dependent on the political process, which is a major element of political capitalism.

Most people are not in a position to receive rents or to extract them. The economic elite receive rents and the political elite extract rents in exchange for their creation. The economic elite supports the political elite and the political elite supports the economic elite. The cost is borne by the masses. The theories of transitional gains and rent extraction provide additional building-blocks for the theory of political capitalism.

7

The Regulatory State

Governments undertake a wide range of activities, from protecting people's rights, producing public goods, redistributing income, to regulating the activities of its citizens. The concept of political capitalism finds its origins in the regulatory state, in the sense that Gabriel Kolko used the term to describe the nature of regulation during the Progressive Era.[1] The interaction of the political and economic elite for their mutual benefit predates Progressive Era regulation, but Progressivism allowed political capitalism to advance because the Progressive ideology demanded more government regulation of the economy. While political capitalism touches all areas of government activity, it most clearly operates through government's regulatory apparatus.

Many of the rights government defines and protects under the umbrella of the protective state are defined by regulation, and the degree to which they are enforced as well as sanctions for violations are often defined by regulation. Think about zoning and land use regulation, and the definition and enforcement of intellectual property as examples. In fact, people can only exercise rights to the degree that government acts to protect them, and government often stands more ready to define rights that benefit the elite, and to enforce rights that benefit the elite.[2] The productive state's parameters are defined by regulatory requirements for public projects, which emanate from the political demands of its citizens. The redistributive state

[1] Gabriel Kolko, *The Triumph of Conservatism: A Reinterpretation of American History, 1900–1916* (New York: The Free Press, 1963).

[2] Randall G. Holcombe, "The Economic Theory of Rights," *Journal of Institutional Economics* 10, no. 3 (September 2014), pp. 471–491, discusses this further. The idea that rights come from individuals' ability to bargain for them is further developed in Randall G. Holcombe, *The Economic Foundations of Government* (New York: New York University Press, 1994).

is based on regulations that define who is entitled to transfers and subsidies. Often, redistribution comes in the form of regulatory requirements rather than direct cash transfers.[3] The regulatory state also defines allowable economic interactions among individuals ranging from labor laws, requirements on business operations, licensing to engage in economic activity, and many other regulatory restrictions. For many reasons, the regulatory state appears at the foundation of political capitalism.

One of the fundamental ideas underlying political capitalism is that government regulators become "captured" by the interests they regulate, so regulatory agencies act in the interests of those they regulate rather than in the public interest. Regulatory agencies may be created with the intention of furthering the public interest, but over time their activities shift so that they increasingly favor those they regulate. Often, the 99 percent demand regulation to mitigate some problem they perceive, without considering that regulations are created and enforced by the 1 percent, who tend to look out for their own interests.

Regulatory capture was one of the main elements in Gabriel Kolko's description of political capitalism. Kolko described the way regulations, nominally written to protect the general public interest and to protect those with limited economic power from being exploited by those with concentrated economic power, were actually designed by the elite to further their own interests. The modern capture theory of regulation was introduced by Nobel laureate George Stigler in his 1971 article, "The Theory of Economic Regulation."[4] Stigler described the logic behind the argument that regulatory agencies ultimately serve the interests of those they regulate.

The only reason for governments to establish regulations is to require people to do things they would choose not to do, or prohibit them from doing things they would choose to do, were it not for the regulation. If people would voluntarily choose to do what the regulations required, there would be no reason to call on the coercive power of government to create and enforce the regulation. This creates a profit opportunity for regulators, because those who are being constrained by regulations might be willing to pay to avoid them. Those payments might be technically legal, like the rent extraction described in the previous chapter, or might be technically illegal. Regulation, by its very nature, establishes incentives for

[3] See Gordon Tullock, *Economics of Income Redistribution*, 2nd edn. (New York: Springer, 1997) for an extended discussion.

[4] George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971), pp. 3–21.

corruption and obscures the distinction between rent-seeking and corruption. The ideas developed in this chapter, as with previous chapters, are well established in the academic literature. This chapter shows how those ideas that are already well accepted by economists add to the theory of political capitalism.

THE CAPTURE THEORY OF REGULATION

George Stigler takes an economic approach to the analysis of regulation, discussing the motivations people have to demand regulation and the motivation of policymakers to supply regulation. Both the demand side and the supply side of the regulatory marketplace are can be explained in a straightforward manner, because they are so consistent with the ideas presented in earlier chapters. Groups demand regulation because they would benefit from it, and policymakers supply regulation so they can benefit. Examples from the previous chapter illustrate this. The New York taxi medallions create a barrier to entry into the New York taxi market, leading existing suppliers to support the regulation. Occupational and business licensure regulations similarly create a barrier to entry, producing the demand for regulation by those already licensed. Meanwhile, suppliers of regulation see it as a source of rent extraction. The political elite cooperates with the economic elite for their mutual benefit.

The capture theory of regulation sits at odds with public interest theories of regulation. Because the general public is diffused and poorly organized, it is unlikely that the masses will have the political clout to be effective demanders for regulation to protect their interests. Politically active groups tend to be smaller groups whose members can get concentrated benefits for themselves by imposing costs that are diffused among the masses. Consider the corn industry as an example that has been described in previous chapters. Corn producers are a concentrated and well-organized group and are in a position to demand regulation that will benefit their industry, whereas corn consumers are not organized and are not in a good position to become politically active as a group. Stigler explains the advantage of using government regulation: "The State has one basic resource which in pure principle is not shared with even the mightiest of its citizens: the power to coerce."[5]

Stigler lists four ways that interest groups can use the coercive power of the state for their benefit. He first considers direct cash transfers, but

[5] Stigler, "The Theory of Economic Regulation," p. 4.

remarks, "We have already sketched the main explanation for the fact that an industry with the power to obtain governmental favors usually does not use this power to get money: unless the list of beneficiaries can be limited by an acceptable device, whatever amount of subsidies the industry can obtain will be dissipated among a growing number of rivals."[6] Stigler makes the argument that rent-seekers have both the incentive and the means to avoid engaging in rent-seeking competitions that dissipate rents.[7] In this comment, Stigler notes the importance of barriers to entry, which points him to the second avenue for securing benefits: regulation to control entry of new rivals. Stigler offers many examples, ranging from the Civil Aeronautics Board to banking regulation to tariffs designed to limit the entry of foreign competitors. Another major area in which government regulation limits entry is occupational licensure. Well-organized professions, ranging from doctors and lawyers to hair stylists and interior designers, have managed to convince the state to mandate substantial requirements and state certification to be allowed to engage in those professions.

The third method Stigler identifies is regulation of suppliers of substitutes and complements. Stigler says, "The butter producers wish to suppress margarine and encourage the production of bread."[8] He notes that trade unions oppose the use of labor-saving materials and methods through building codes and related restrictions. Fourth, industries seek government price fixing. Government regulations restrict the ability of firms to set prices in many ways.

The demanders of regulation pay the suppliers by providing them with political support in the form of votes and financial contributions. The chapters on interest group politics and rent-seeking discussed in some detail the way these transactions take place.[9] Stigler says, "The fixed size of the political 'market,' however, probably makes the cost of obtaining legislation increase less rapidly than industry size. The smallest industries are therefore effectively precluded from the political process unless they have some special advantage such as geographical concentration in

[6] Stigler, "The Theory of Economic Regulation," p. 5.
[7] Stigler's article was published prior to Krueger's article on rent-seeking, so he does not use the rent-seeking terminology even though he clearly uses the idea.
[8] Stigler, "The Theory of Economic Regulation," p. 6.
[9] Elie Applebaum and Eliakim Katz, "Seeking Rents by Setting Rents: The Political Economy of Rent Seeking," *Economic Journal* 97, Issue 387 (September 1987), pp. 685–699, develop a model in which the creators of regulatory benefits charge rent recipients for the creation of the rents.

a sparsely settled political subdivision."[10] Thus, Stigler observes the competitive advantage of larger more concentrated interests that divides people into those who are able to capture the regulatory process – the elite – and those who are too politically insignificant to do so – the masses. The fact that the cost of gaining regulatory protection does not increase in proportion to the potential benefits provides an advantage to those who already have concentrated economic power. The result is a barrier to entry which allows rents to go to those who have the economic power necessary to capture regulatory agencies, and which in turn allows the regulators to extract payment from those who are regulated.

Not everybody can compete to capture a regulatory agency. Firms must be in a position to benefit from regulatory capture, and must have the political connections to be able to negotiate that regulatory benefit. Most people are not in that position. This barrier to entry generates a surplus so that some of the rents can be shared with policymakers. The capture theory of regulation describes a setting in which the rents gained by those who are regulated could not be claimed by most people; firms have to be in a position to negotiate to get them. The theory of regulatory capture describes a framework in which there is a barrier to entry that makes the generation of rents profitable for both the recipients of the rents and produces a profit opportunity through rent extraction for those who create the rents.

The ability of regulated firms to capture the agencies that regulate them will tend to grow over time. One can see that when regulatory agencies are created, those who will be regulated have a big incentive to be involved in the process. But consider a (hypothetical?) case where a regulatory agency is created purely to regulate an industry in the public interest. Over time, members of the general public, who are nominally being protected by the regulatory agency, have little incentive to monitor the activity of the agency. They are rationally ignorant. Meanwhile, the firms that are being regulated have a substantial incentive to monitor and lobby the agency.

WHO BENEFITS FROM REGULATION?

The idea that regulatory agencies represent the interests of the general public amounts to wishful thinking on the part of those who have an unrealistic assessment of the incentives involved in the regulatory process. The incentives of those being regulated are often already aligned with the

[10] Stigler, "The Theory of Economic Regulation," p. 12.

public interest, independent of any regulation. Sellers have an incentive to avoid selling their customers products that will make them ill, that are fire hazards, or that will harm their customers in other ways. Regulations, in addition to providing another level of assurance, often contain additional requirements that serve as barriers to entry, for the benefit of those being regulated. Is the general public really being served by regulations that require occupational licenses for barbers, florists, and interior designers, or is it more likely that the regulations are designed to protect those who are regulated by providing a barrier to entry?[11]

Consider the Public Service Commissions that most states have to regulate electric utilities. Electric utilities are given a state-protected monopoly over a given geographical area, and have their rates set by the Public Service Commission, supposedly to establish rates at a level equivalent to what would be charged in a competitive industry. But all of the information the Public Service Commission needs to set rates is controlled by the regulated firms, who can selectively filter it to make the most compelling case for higher rates. When rate hearings are held, industry representatives will be there in force. There will be little if any representation from the general public. This makes sense because if rates were a bit lower, each individual customer would save maybe a few dollars a month; not enough of an incentive to study up on the issue and take the time to attend a rate hearing. Meanwhile, a few dollars a month from each customer is worth millions of dollars to the firm, giving it a big incentive to make a strong case.

Personal matters may also come to bear. The members of the Public Service Commission will not know most of the general public who they supposedly represent, but will know the people from the regulated firms because they will regularly interact. In addition to that personal connection, the employees of the Public Service Commission, who have expert knowledge of the regulated industry, may find the industry to be a good prospect for future employment if they maintain a good relationship with those in the regulated firms. Indeed, one job for which they have specific expertise would be lobbying the Public Service Commission on behalf of the regulated firms. They already have the connections, and connections count.

Once regulations are designed, there may be ways for regulated firms to game them to their advantage. For example, electric utility prices are

[11] For a discussion of the ways that market mechanisms discipline firms to serve the interests of the general public, see Randall G. Holcombe and Lora P. Holcombe, "The Market for Regulation," *Journal of Institutional and Theoretical Economics* 142, no. 4 (December 1986), pp. 684–696.

commonly regulated to provide the firm with a competitive rate of return on its capital. This being the case, utilities have an incentive to overinvest in capital to increase their profitability.[12] This causes investment-related rent-seeking welfare losses, like those discussed in the previous chapter. Nominally, rates are regulated so the monopoly supplier mimics a competitive industry, but to see how unrealistic this is, consider how rare it is for an electric utility to go out of business, compared with firms that actually do have competitors.

The incentive structure underlying the regulatory state points toward regulation that benefits the well-informed, and that channels benefits to those who have connections and concentrated economic power. That is to say, it points toward regulations that benefit the regulated rather than promoting the public interest. Even regulations with the most persuasive public interest rationales tend to be captured by those who are regulated, because they have concentrated interests that give them an incentive to be well-informed, whereas most citizens have small and diluted interests, so tend to be uninformed. The lessons about the effectiveness of concentrated interests discussed in Chapter 4 apply directly to regulation. The hope that regulation works in the public interest is based more on wishful thinking than an understanding of the regulatory process.

BOOTLEGGERS AND BAPTISTS

Despite the fact that the regulatory apparatus tends to be captured by those it regulates, most regulation does have a public interest rationale, which not only provides political support for its passage but provides ongoing support for its maintenance. Bruce Yandle described the way that interest groups can work together to support public policies even though their interests are at odds with each other. He initiates his discussion by referencing post-prohibition laws that made the sale of alcoholic beverages illegal in parts of the United States.[13] The 18th Amendment to the US Constitution, ratified in 1919, made the sale of alcoholic beverages in the United States illegal. Prohibition was repealed by the ratification of the 21st Amendment in 1933, which left the issue up to the states. A number of

[12] This is referred to as the Averch–Johnson effect, after Harvey Averch and Leland L. Johnson, "Behavior of the Firm Under Regulatory Constraint," *American Economic Review* 52, no. 5 (December 1962), pp. 1052–1069.

[13] Bruce Yandle, "Bootleggers and Baptists: The Education of a Regulatory Economist," *Regulation* 7, no. 3 (May–June 1983), pp. 12–16.

states continued to restrict in various ways, or even prohibit, the sale of alcoholic beverages within their jurisdictions, which led to Yandle's colorful observation that these laws were supported by both bootleggers and Baptists.

The Baptists objected to the sale and consumption of alcoholic beverages on religious grounds. Their view was that the public interest was served by prohibition. The bootleggers, who were illegally selling alcoholic beverages in areas where it was prohibited, favored laws making it illegal because they were able to profit from their illegal sales. Ending prohibition would also end their ability to bootleg illegal alcoholic beverages. In a twenty-first-century replay, as states consider making the sale and use of recreational marijuana legal, both those who object to recreational marijuana use because they think banning marijuana is in the public interest and the underground sellers of illegal marijuana oppose legalization. Those who oppose marijuana use on public interest grounds are the "Baptists" and those who are profiting from illegally selling marijuana in underground markets are the "bootleggers."

Much of the regulatory state fits this bootleggers and Baptists story. Kolko's discussion of Progressive Era regulation depicts the Progressive reformers who wanted regulatory control of concentrated economic interests as the "Baptists" who viewed economic regulation as furthering the public interest. Meanwhile, Kolko depicts those subject to the regulation as the bootleggers who are able to shape those regulations for their benefit. Regulations to require ethanol to be added to motor fuels benefits those who grow and process corn – the "bootleggers" – but those regulations were supported by people who saw value in lowering the level of dependence on foreign sources of oil and environmental groups who viewed biofuels as renewable energy sources that were good for the environment – the "Baptists" in this story.

Product safety regulation shares a similar story, as those who champion the public interest benefits of mandating safer products team up with producers who see these regulations as a barrier to entry. Crashworthiness and pollution emission standards for automobiles make it costly to enter the industry, creating a barrier to entry to potential auto manufacturers, just as aircraft certification requirements make it costly for firms to enter the aviation industry. People want safe autos and aircraft – the "Baptists" – but existing producers – the "bootleggers" – want to protect their market position against new entrants. The testing required for the certification of airliners would likely occur without regulatory requirements, but those certification requirements prevent entry into the production of smaller personal aircraft. One result is a thriving "homebuilt" segment in light aircraft, because the producers cannot afford to certify their aircraft as production aircraft.[14]

The Food and Drug Administration's regulations to certify medical drugs as safe and effective offer another example. The "Baptists" want safe and effective drugs, while the "bootleggers" are the large pharmaceutical firms that favor regulations making it very costly to bring drugs to market, thus creating a barrier to entry to individuals and smaller firms who might develop effective medications. Those smaller developers are forced by the regulatory costs to ally themselves with the larger drug manufacturers in an arrangement that has the support of both those who are regulated and a general public that perceives a regulatory benefit.[15]

Most regulations have some public interest rationale behind them, and a group of "Baptists" that support them. This public interest support facilitates the passage and maintenance of the regulatory environment. The capture theory of regulation explains why regulation tends to work to the advantage of those who are regulated – the "bootleggers" – who not only do not object to the regulation, but actively work to shape it to their advantage. Despite public interest arguments for regulation, the general public has little incentive to become informed or to understand the operation of the regulatory process. Nevertheless, one reason the regulatory state thrives is that despite regulatory capture, regulation is also supported by those who perceive a public interest rationale behind it. Regulation is a key component of political capitalism because the elite capture the regulatory process while members of the masses have no power to do so, but regulations that benefit the elite often have substantial support from the masses who perceive public interest benefits from the activities of the regulatory state.

[14] Companies can build kits for people to build their own airplanes, but the rule is that the builder must do 51 percent of the building. One ambiguity is drawing that 51 percent line, but many manufacturers of kits would be happy to produce and sell completed aircraft, except that they are prevented from doing so by Federal Aviation Administration regulations that make it too costly to certify those aircraft. They are still flying, but as home-builts.

[15] Despite the Baptist viewpoint on drug regulations, they may do more harm than good by preventing safe and effective drugs from reaching the market, or delaying their introduction. See Sam Peltzman, "An Evaluation of Consumer Protection Legislation: The 1962 Drug Amendments," *Journal of Political Economy* 81, no. 5 (October 1973), pp. 1049–1091 for a discussion of this idea.

ELECTRIC UTILITIES: UNNATURAL MONOPOLIES

Electric utilities provide an interesting example of regulatory capture, because the conventional wisdom among economists is that they are natural monopolies. The theory of natural monopoly is built on the idea of an industry that has economies of scale, so that the larger the firm, the lower its unit costs. This makes some sense for electric utilities, because there is a large infrastructure cost associated with electricity delivery. If there were many electric companies serving an area, it is easy to envision that because of the cost of extending the network of utility poles and wires, the larger the number of customers served by that network, the lower would be the average cost of the network per customer. Thus, larger firms would be in a position to offer lower rates to customers than smaller firms and still remain profitable. The result is that competitive forces would push an increasing number of customers away from smaller firms toward larger firms, and as smaller firms went out of business the larger firms would continue to grow until eventually there would be only one large firm in the industry. This is referred to as a natural monopoly because competitive forces naturally lead the industry to be served by only one firm.

One problem with this theory as applied to electric utilities is that, in practice, it appears not to be descriptive. In fact, rather than competition leading to fewer and fewer firms in the industry, there were a large number of electric utility firms in major cities, all competing with each other, that asked to be combined and regulated. Gregg Jarrell reports that in Chicago there were 45 electric utility companies in 1905, which in that year combined and agreed to state regulation.[16] New York City had a similar situation. The electric utility that serves NYC in the twenty-first century is Consolidated Edison. Consolidated out of what? Yes, all of the electric utilities that were competing with each other until they agreed to be combined into a regulated monopoly.

State-wide electric utility regulation began in Wisconsin and New York in 1907, and Jarrell reports that by 1910 the electric utilities themselves were the main champions of regulation. Between 1907 and 1914, 27 states established public service commissions and imposed state-wide regulation of electric utilities. As electric service spread around the nation, most areas were first served by firms that were granted monopoly franchises without any competitors having a chance of entering.

[16] Gregg A. Jarrell, "The Demand for State Regulation of the Electric Utility Industry," *Journal of Law & Economics* 21, no. 2 (October 1978), pp. 269–295.

The history of electric utility regulation shows that utility monopolies fit the capture theory of regulation better than they fit the natural monopoly theory. In light of this, it is interesting to consider why the natural monopoly theory of regulation remains relatively unchallenged by economists. The theory that most economists espouse serves the interests of those with the political connections that enable them to capture the regulatory apparatus.

FINANCIAL REGULATION

The financial industry is one of the more heavily regulated industries in the United States and worldwide. The beginning of the Great Depression is often dated to the stock market crash in October 1929, and the Depression itself is often blamed on the financial collapse the stock market crash initiated. One result was a host of financial and banking regulations in the 1930s. Intended to stabilize financial markets, the recession that began in 2008 provides some evidence that regulation may be destabilizing. At least, financial markets appear to be susceptible to breakdowns despite being heavily regulated.

Heavy regulation requires costly compliance, which gives an advantage to big firms over small, because compliance costs do not increase in proportion to firm size. Luigi Zingales notes that the banking industry has become more concentrated as the regulatory burden on banks increased. There were 14,434 banks in the United States in 1980, which shrank to 8,315 in 2000 and 7,100 by 2009. The number of banks has continued to shrink since then. Meanwhile, in 1984 the five largest banks controlled 9 percent of US bank deposits, but they controlled 21 percent by 2001 and nearly 40 percent by 2008.[17] Increased concentration in the banking industry led some policymakers to conclude that certain banks were "too big to fail." If a bank is deemed too big to fail, the implication is that if they suffered losses that would drive them to bankruptcy, government would step in to support them to put them back on their feet.

While one can debate what the effect would have been to actually allow these financial firms to fail, one can also see that the people who run those firms – members of the economic elite – have every incentive to put such a policy into place. Looking back at the increased concentration in the banking industry as regulatory oversight tightened, it is not difficult to

[17] Luigi Zingales, *A Capitalism for the People: Recapturing the Lost Genius of American Prosperity* (New York: Basic Books, 2012), p. 51.

conjecture that the regulatory state – political capitalism – enabled some banks to grow to be too big to fail. Regulations imposed a barrier to entry and a cost on smaller banks that caused the increased concentration in the industry. When the five largest banks controlled 9 percent of bank deposits in 1984, those banks would on average have controlled less than 2 percent of the market, making it difficult to argue that any bank was too big to fail. When the five largest controlled 40 percent in 2008, banks that controlled more than 8 percent might fall into that too big to fail category. The regulatory state created a situation in which the political elite felt obligated to bail out the economic elite, who they deemed too big to fail.

Firms designated too big to fail enjoy profits as long as they can make them, but have assurance of government support if they suffer major losses. As Zingales says, "Unless he is highly risk averse, an individual who has a share of the upside and none of the downside has a strong incentive to take on a lot of risk. This structure of incentives is typical of Wall Street, and it explains why managers take on excessive risks."[18] Zingales goes on to note that when lenders are on the hook for losses, they impose strict rules on borrowers to ensure the loans will be repaid. "When large banks borrow, however, their lenders don't impose those rules. That's because they know that the government considers the banks 'too big to fail.' The lenders therefore know they will be always be paid back, either by the bank or by the taxpayers."[19]

Zingales goes on to note the problems of cronyism that have distorted public policymaking in the financial industry, where members of the economic elite move into the public sector to become a part of the political elite.

> The problem is that people who have spent their entire lives in finance have an understandable tendency to think that the interests of their industry and the interests of the country always coincide. When Treasury Secretary Henry Paulson [former CEO of Goldman Sachs] went to Congress in the fall of 2008 arguing that the world as we knew it would end if Congress did not approve the $700 billion bailout, he was serious. And to an extent he was right: *his* world – the world he lived and worked in – would have ended had there not been a bailout. Goldman Sachs would have gone bankrupt, and the repercussions for everyone he knew would have been enormous. But Henry Paulson's world is not the world most Americans live in or even the world in which our economy as a whole exists.[20]

Zingales offers a charitable explanation for why, when the housing bubble burst causing people to default on their mortgages, and therefore

[18] Zingales, *A Capitalism for the People*, p. 57.
[19] Zingales, *A Capitalism for the People*, pp. 57–58.
[20] Zingales, *A Capitalism for the People*, p. 68, italics in original.

causing the value of mortgage-backed securities to fall, government bailouts went to the 1 percent – the elite – in the financial industry rather than those in the 99 percent – the masses – who were forced out of their homes as they lost their jobs and were unable to pay their mortgages. The government regulations that have increased concentration in the financial industry for the benefit of the economic elite who run the big banks have, through the reduction in competition, created a system in which risk is shifted to the taxpayer, shielding the economic elite from the negative consequences of their activities. The elite keeps the profits; the masses shoulder the losses. After the 2008 financial crisis, the passage of the very complex Dodd–Frank "Wall Street reform" act imposed additional costs on banks which had a disproportionate impact on smaller banks, leading to increased concentration in banking and reinforcing the "too big to fail" status of the large banks (despite claims to the contrary by the Act's supporters).

David Stockman has argued that the bailouts following the 2008 financial crisis were unnecessary. "There has never been a shortage of solvent banks, thrifts, and finance companies to serve the auto and housing finance needs of the nation's diminished pool of creditworthy borrowers." He says by approving the bailouts, policymakers "snatched defeat from the jaws of victory."[21] Why? Stockman, less charitably than Zingales, cites crony capitalism. The political and economic elite conspired to engineer policies to benefit themselves at the expense of the masses.

Nominally, financial regulations are designed to limit instability in the financial system. Instead, they lead to rent-seeking, cronyism, and destabilizing risk-taking. The idea that regulation promotes the public interest is wishful thinking. Regulations can further the public interest when the interests of the public and the elite coincide, but when one understands the process by which regulations are created and enforced, it should be apparent that they benefit those who create and enforce them. Regulation favors the elite over the masses.

LABOR REGULATIONS

Most of the examples in this volume deal with cases in which elites in government conspire with elites in business for their mutual advantage, but it is worth noting that labor unions have a long history of political

[21] David A. Stockman, *The Great Deformation: The Corruption of Capitalism in America* (New York: Public Affairs Press, 2013), p. 40.

activism that has created regulatory transfers to workers by imposing costs on others. Regulatory requirements often mandate more workers than are necessary to do a job, a practice known as featherbedding, and may mandate benefits and working conditions for workers more generous than market transactions would provide. Certainly, there are public interest arguments for all these policies – the bootleggers and Baptists model applies – but the point is that despite the almost exclusive use of business cronies as examples, labor union leaders also are members of the low-transaction cost group, and have successfully bargained for benefits using their political connections.

Despite the Taft–Hartley Act of 1947 that made featherbedding in labor contracts illegal, some union contracts required firemen on trains into the 1990s, though they were not necessary on the diesel locomotives that had replaced steam engines. Cabooses, manned with union workers, were required at the ends of freight trains until 1982. Added costs contributed to the decline of rail shipping in favor of trucks. But trucking had their own impediments imposed by the Interstate Commerce Commission before substantial deregulation in the 1970s and 1980s that often prevented truckers from picking up loads to backhaul, meaning that half their trips could be with empty trucks. And high labor costs imposed by the United Auto Workers union made automobiles produced in Detroit increasingly uncompetitive, leading to a decline in Detroit's auto industry as auto manufacturing spread to more business-friendly locations.

Many of these specific effects were due to union contracts, not government regulations, but a series of regulations gave unions a stronger bargaining position, including the Railway Labor Act of 1926, the Norris–La Guardia Act of 1932, the National Labor Relations Act of 1935, and the Fair Labor Standards Act of 1938. This refers to labor law in the United States, but laws give elite union leaders even more bargaining power in the EU and in other places around the world.

Minimum wage laws and other regulations requiring employee benefits paid for by employers nominally are created to benefit workers, but price low-skilled workers out of the market. This tends to favor union workers, who tend to be more skilled, over non-union workers. A union's bargaining strength is increased if it can price low-skilled workers out of the market, which reduces competition for union labor.

Private sector union membership has fallen precipitously in the United States, from about one-third of the workforce in the 1950s to between 6 and 7 percent in the 2010s, partly because of changes in regulations and partly

 https://doi.org/10.1017/9781108637251.008

because union contracts often made union workers uncompetitive compared to non-union workers.[22] Political capitalism is a system in which the elite cooperate with each other for their mutual benefit, and with regard to organized labor, it is not the workers who are members of the elite but the union leaders. The theory of political capitalism suggests that union leaders want to maintain their own elite positions, not necessarily the positions of those who pay the union dues that provide their incomes.

REGULATION AND CORRUPTION

One definition of corruption calls it the misuse of government power for personal gain. There is some ambiguity in defining both misuse and personal gain. The previous chapter recounted examples where lobbyists seeking to have legislation favorable to their clients give legislators campaign contributions and other benefits with the hope of reciprocity, even though no explicit deal has been made. Both lobbyists and legislators understand how the system works, however. Passage of the legislation depends on payment being made. Do such transactions constitute misuse of personal power? Do campaign contributions, or job offers to cronies, constitute personal gain? One conclusion of the chapters on interest group politics and rent-seeking is that those who have the power to write the rules have a strong incentive to write them so that their political exchanges comply with the rules, not only because it precludes legal action being taken against them but also because it can provide a barrier to entry that allows the elite a mechanism for excluding the masses from the bargaining process.

Chapter 6 noted that there is not a clear line between corrupt activities and rent-seeking and interest group politics.[23] These activities describe political exchanges in which those who participate in the exchanges benefit, typically at the expense of the masses. For this type of activity to occur, both parties must be in a position to benefit each other, and the party that acts with the authority of government must be in a position to use

[22] The costs union policies imposed on the economy are discussed by James D. Gwartney and Randall G. Holcombe, "Unions, Economic Freedom, and Growth," *Cato Journal* 30, no. 1 (Winter 2010), pp. 1–22.

[23] Toke S. Aidt, "Rent Seeking and the Economics of Corruption," *Constitutional Political Economy* 27, no. 2 (June 2016), pp. 142–157, also notes the close connections between rent-seeking and corruption that has rarely been acknowledged in the academic literature.

discretion to provide a benefit to the party that is seeking favorable treatment from government. Discretion in the use of political power opens the door to political exchange. Two areas of government activity that are susceptible to corruption are regulation and government contracting.

Regulations are always subject to interpretation, partly because it is difficult to foresee every circumstance under which a regulation will apply, and also because regulations are deliberately designed to be vague. There is always the possibility that a regulator could be bribed to ignore regulatory violations. In many cases, the violation might only be noticed by the regulator and the individual or firm subject to the regulation, and a bribe could be paid with nobody outside the transaction being any the wiser. Such an exchange clearly would be corrupt. But due to the vague nature of many regulations, regulators can use their discretion to simply declare that those being regulated are in compliance. An exchange takes place, but everyone involved can claim that they were in complete compliance with the law.

Government contracting shares this characteristic with regulation. If a contract is let, someone must get the contract, and those with political connections can benefit from a political exchange that gives the contract to their cronies. "Objective" criteria are often designed to favor one bidder over another. While the process has the appearance of calling for competitive bids on projects, those who make the decisions often know ahead of time who they want to win the bidding and design the specifications for the contract to give their cronies an advantage.

Privatization is often touted as a method of providing government services more efficiently, but it invites corruption because it opens the door to letting contracts to cronies. Further, when government is paying for the privatized output, contracts are often written to favor those who get them. Cost-plus contracts mean that the private contractor cannot lose on the deal, and even give contractors an incentive to spend more if their return is contracted to be a percentage of their costs.[24] When government decision-makers are in a position to use

[24] This aspect of government contracting has been known for a long time. See, for example, Charles J. Hitch and Roland N. McKean, *The Economics of Defense in the Nuclear Age* (Cambridge: Harvard University Press, 1960) for an analysis of government contracting. I examined wastewater treatment plant privatization, expecting to find cost savings, but the data did not show any. Reading the privatization contracts, they tended to be cost-plus contracts, not only eliminating any incentive for cost saving but creating the incentive to spend more. See Randall G. Holcombe, "Privatization of Municipal Wastewater Treatment," *Public Budgeting & Finance* 11, no. 3 (Fall 1991), pp. 28–42.

their discretion, it should not be surprising that they use it in ways that benefit themselves.

Private ownership of the means of production is a characteristic of political capitalism. When those who own the means of production profit from voluntary exchanges with willing customers, the market disciplines those who own the means of production, leading them with an invisible hand to act in the best interest of everyone. When those who own the means of production profit from government contracts, that market discipline is absent and profits accrue because of cronyism and connections.

Government contracting is a part of the budgetary state, but most of the "big government" in big government countries, when measured by spending, is transfer programs and human resource programs. Expenditures on the core functions of government – police, courts, military, infrastructure, education – tend to be between 10 and 15 percent of GDP in most countries, with human resource expenditures making up most of the difference in government spending as a share of GDP across countries.[25] Favoritism and corruption is more likely in those core functions,[26] where cronies can get big contracts, so corruption tends to be more a function of the amount of regulation in a country than the amount of government spending.

There are fewer possibilities for corruption in redistribution programs, because recipients are not in a good position to offer benefits to those in government, and because rules that qualify recipients are often less vague than other regulations. There are opportunities for fraud, to be sure, but not so much for the political exchange that characterizes the common view of corruption.

Transparency International publishes a Corruption Perceptions Index comparing the perceived level of corruption in more than 100 countries,[27] and the World Bank also has undertaken a ranking.[28] Two interesting things about these rankings are that, first, there is a strong correlation between the level of corruption in nations, as measured by these indexes,

[25] James Gwartney, Randall Holcombe, and Robert Lawson, "The Scope of Government and the Wealth of Nations," *Cato Journal* 18, no. 2 (Fall 1998), pp. 163–190.

[26] Christopher J. Boudreaux, Boris N. Nikolaev, and Randall G. Holcombe, "Corruption and Destructive Entrepreneurship," *Small Business Economics* (forthcoming).

[27] Their index can be found at www.transparency.org.

[28] See http://worldbank.org/data-catalog/worldwide-governance-indicators. This is discussed by Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper No. 5430 (September 2010).

and the degree of government regulations in nations. More regulation is associated with more corruption.[29] But while corruption is positively correlated with government spending when looked at alone, if the level of regulation is controlled for, spending is not correlated with corruption. This is consistent with the idea that the discretion associated with the regulatory state leads to corruption. If the size of government expenditures varies mostly because of redistribution, and if corruption also is associated with government contracting, there will not be much variation in contracting among nations if their core functions are around 10 to 15 percent of GDP.

The strong correlation between regulation and corruption suggests that one strategy for limiting corruption is to deregulate. If there are no regulations, nobody has to be bribed to avoid them.

While nominally regulations are designed to further the public interest, an examination of the incentives underlying regulation shows that they are often designed by the elite to further their interests, to create barriers to entry, and that the ultimate effect is to reduce the efficiency of the economy. Ironically, then, corruption may actually increase economic efficiency because it provides a mechanism whereby businesses can buy their way out of the burdens regulation places on them.[30] The theory of political capitalism suggests that many regulations are produced for the benefit of the elite, and that they do reduce economic efficiency, in which case corruption might make everybody better off by providing a mechanism whereby people can avoid costly regulations.[31] The economy would be even more efficient if those regulations were not imposed in the first place, but given the existence of inefficient regulations, corruption may grease the wheels of commerce and enhance efficiency.

[29] Empirical claims in this section are based on Randall G. Holcombe and Christopher J. Boudreaux, "Regulation and Corruption," *Public Choice* 164, nos. 1/2 (July 2015), pp. 75–85. For this particular claim, the degree to which economies are free of government interference is measured by the Fraser Institute's Index of Economic Freedom, found in James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World 2014 Annual Report* (Vancouver, BC: Fraser Institute, 2014). A linear regression using Transparency International's index as the dependent variable and the Economic Freedom of the World index as the only independent variable produces a t-statistic of −13.07 and an R^2 of 0.54, indicating a strong negative relationship. More economic freedom is associated with less corruption.

[30] See, for examples, Axel Dreher and Martin Gassebner, "Greasing the Wheels? The Impact of Regulations and Corruption on Firm Entry," *Public Choice* 155, nos. 3/4 (June 2013), pp. 413–432, and Nabamita Dutta and Russell Sobel, "Does Corruption Ever Help Entrepreneurship? *Small Business Economics* 47, no. 1 (June 2016), pp. 179–199.

[31] This is the theme of Andrei Schleifer and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics* 108, no. 3 (1993), pp. 599–617.

This section began by noting the ambiguities involved in identifying corruption. It is easy to see when someone accepts a payment for sidestepping the rules, but it may be difficult to identify what constitutes a payment. What if someone who works for the government land use planning agency happens to mention to a developer who wants permits to undertake a major project that he has a nephew who's looking for work, and the developer says his company has an opening and hires the government worker's nephew? When the permits are then expedited, is this corruption? It is even more difficult to see whether regulations have actually been sidestepped. If a building permit is issued or a business license granted, could that be evidence of corruption? The ambiguities are even greater with elected officials who simultaneously are making public policy and fundraising for future political campaigns. The previous chapter on rent extraction makes the point.

The elite have an incentive to eliminate corruption that benefits them by designing regulations that make their activities legal. Consider the issue of whether lobbyists exchanging campaign contributions for favorable legislation is corrupt. Legislators can remove the ambiguity by designing regulations that allow those contributions. If they also require that contributions be disclosed as a matter of public record, it allows them to monitor those who enter the demand side of the political marketplace with the idea that they may be able to extract additional payments from them. An under-the-table bribe can hide the identities of demanders for legislative favoritism whereas disclosure requirements can create information valuable to those who receive the payments. The larger point in the fuzzy line between rent-seeking and corruption is that the elite have the incentive to design regulations that make legalize what might otherwise appear to be corrupt exchanges.

THE REGULATORY BASIS OF POLITICAL CAPITALISM

Looking at the economic theories that provide a foundation for political capitalism – rent-seeking, rent extraction, the creation of transitional gains, regulatory capture – all find their basis in government regulation. Policymakers would not be able to create rents, and firms would not be able to capture regulatory agencies, without the government's ability to create economic regulation. Certainly the economic elite can benefit from policies that give them cash transfers, but as Stigler noted, one problem that often arises with cash transfers is that it is difficult to restrict who can get the cash, so rent-seeking competitions can emerge that erode the value of those benefits. Regulatory benefits can be more valuable because regulations can be designed to limit the eligible beneficiaries.[32]

When the Interstate Commerce Commission was established to regulate railroads in 1887, the public interest view was that this would protect those with little economic power – farmers and small business people – from exploitation from the railroads that had substantial and concentrated economic power. But by regulating rates, many commentators noted that this limited competition and helped the railroads by effectively establishing a cartel. The benefit was not a cash transfer but a regulatory transfer that limited competition by guaranteeing a regulated price. Similarly, railroads got substantial land grants in exchange for extending their routes into the Western states. The policy clearly limited the group that was able to receive benefits, because few firms were in a position to build rail lines through sparsely inhabited territory. This created a barrier to entry into rent-seeking, preventing competition while securing benefits for the economic elite.[33]

The budgetary state also evolves toward political capitalism through regulatory actions that limit who can get government contracts, creating terms and conditions that favor cronies over outsiders who would like to compete. The regulatory state lays the foundation for political capitalism because regulation is designed to require certain actions and prohibit others. When required actions are a prerequisite to receiving rents, those who cannot meet the requirements are excluded. More directly, regulations can prohibit potential competitors from becoming actual competitors.

REGULATION AND POLITICAL ENTREPRENEURSHIP

Political bargaining occurs when regulations are established, and then after they are established, to try to adapt to their consequences. In some cases regulations might be adopted solely to further the interests of some component of the economic elite, but often regulations are demanded by broader general public. The bootleggers and the Baptists favor the same regulations, albeit for different reasons. Railroad regulations are a good example, because while there is a good argument that ultimately those

32 Stigler, "The Theory of Economic Regulation."

33 A discussion of the federal government's policies toward railroads in the late nineteenth century can be found in Gabriel Kolko, *Railroads and Regulation: 1877–1916* (Princeton: Princeton University Press, 1965) and Richard White, *Railroaded: The Transcontinentals and the Making of Modern America* (New York: W. W. Norton, 2011). Both describe how those policies worked for the benefit of the railroads rather than the public interest.

regulations worked to the advantage of the regulated railroads, rail customers pushed for regulations to limit the degree to which the railroads could use their economic power to exploit shippers. The Progressive ideology pushes people to think of government as an organization that looks out for their economic interests. The problem, discussed extensively in this and previous chapters, is that despite the demands of the masses, ultimately public policies are designed by the political and economic elite. Political entrepreneurs have an incentive to see that there is some profit in the laws that are passed, and the political elite are in a position to receive a payoff when the laws they pass benefit the economic elite. The masses are not in a position to engage in political entrepreneurship.

Looking at the regulatory state, the predictable outcome is rent-seeking and regulatory capture, with regulation working to hamper the productivity of the market economy for the benefit of special interests.[34] Many examples already discussed – the Civil Aeronautics Board cartelization of airlines, the barrier to entry created by New York City taxicab medallions, the regulation of railroads, the government regulation of electric utilities – illustrate the point. Regardless of the intentions of those who originally proposed the regulations, political entrepreneurs have an incentive to design them for the mutual benefit of the political and economic elite. Because regulations find their strength in the coercive power of government rather than in the voluntary agreement that characterizes market exchange, political entrepreneurs are led to create regulations that provide benefits for a few at the expense of the many. The elite are in a position to bargain to avoid the costs of regulation, but the masses in the high-transaction cost group are not.

Regulation lays a foundation for political capitalism because regulation provides an incentive for the regulated to pay to avoid the costs of regulation, and those transactions can be made more efficiently if corrupt activity to avoid regulation becomes legal. Corruption erodes barriers to entry that increase the profitability of regulators and the regulated, providing the incentive for the creators of regulation to design them such that they have the discretion to legally determine regulatory enforcement. Given the vague nature of much regulation, it is very susceptible to being interpreted

[34] Regulation could be in the public interest, but Randall G. Holcombe, "Political Entrepreneurship and the Democratic Allocation of Economic Resources," *Review of Austrian Economics* 15, nos. 2/3 (June 2002), pp. 143–159, explains why there are always more opportunities for political entrepreneurs to create policies that transfer resources from some to others than to create policies that benefit everyone.

in ways that benefit the elite. Political capitalism is the evolutionary outcome of the regulatory state.

REGULATION AND POLITICAL CAPITALISM

Taking a public interest view of government, it appears that regulation is a mechanism that can control the activities of individuals so that they act in the public interest and are prevented from engaging in activities that benefit themselves at the expense of others. This was the motivation behind the substantial growth of the regulatory state that began in the Progressive Era. The idea behind Progressivism is that the role of government is not just to protect people's rights but also to look out for their economic well-being, and regulation is one of the major Progressive tools (along with redistribution) to accomplish that goal. The regulatory state can curb the abuses of those with economic power, and improve the economic well-being of those with little economic power.

This Progressive view of regulation pits the economic interests of some against the economic interests of others. In a pure market system, where all economic exchange occurs only on mutually agreeable terms, economic transactions benefit everyone involved in them. The Progressive regulatory state is explicitly designed to benefit some at the expense of others. Shippers demanded railroad regulation to prevent railroads from charging unfairly high rates. Electric utilities are regulated for the same reason, to protect consumers from overcharging by monopoly utilities. Medicinal drugs are regulated to assure consumers they are safe and effective, imposing substantial costs on drug manufacturers who are required to prove that their drugs meet those standards. Unlike a market economy, where transactions occur to the mutual benefit of all parties to the transactions (otherwise, they would not voluntarily engage in them), the Progressive view of regulation is to impose costs on some for the benefit of others.

In fact, regulation does not work like this because regulations are designed by the political and economic elite, who, like everyone else, look out for their own interests. The capture theory of regulation, developed in the second half of the twentieth century, is now a well-established component of academic economics. The idea that over time regulation increasingly furthers the interests of those who are regulated has been strongly supported in the academic literature for decades. It is a key component of the theory of political capitalism, because regulation is a key component of the bargains that the economic elite make with the political elite.

While this theory of economic regulation recognizes that regulation tends to benefit the regulated, it has not been explicit in recognizing that there is a group of insiders – the economic elite – who are in a position to bargain for regulatory benefits, while the masses are not in a good position to do so. This chapter reviews a well-established body of economic ideas on regulation which, when viewed in the context of the elite theory developed in Chapter 3, concludes that the benefits of regulatory capture are only available to a limited elite group of individuals. Regulation imposes costs on some for the benefit of others, and it should not be surprising that the elite, who have the power to impose regulations on others, would design them so that the elite benefit from what they create.

THE THEORETICAL FOUNDATIONS OF POLITICAL CAPITALISM

The first seven chapters have taken theories that are well-established in the social sciences to build a theory of political capitalism. The elite theory developed by sociologists and political scientists describes how elites are able to network to control political and economic institutions for their benefit, but elite theory does little to explain the mechanisms by which the elite are able to exercise this control. Public choice theory fills that gap through its theories of interest group politics, rent-seeking, and regulatory capture that describe the mechanisms the elite use. But public choice theory, which takes an individualistic approach to the analysis of political decision-making, does not identify the elite as those who are able to receive the rents and capture the regulatory agencies. Elite theory fills this gap, so that taken together, elite theory and the public choice analysis of political processes explain both who benefits from the political process and the mechanisms they use to get those benefits. The building blocks for a theory of political capitalism are well-established in the social sciences, and these first seven chapters have assembled them to explain how political capitalism works, and why it is best understood as a distinct economic and political system – a system of political economy.

How descriptive of real-world economic and political systems is this system of political capitalism? What factors lead political capitalism to develop out of a capitalist economy? What is the relationship between capitalism and political capitalism? How can political capitalism be controlled? Having developed the theory of political capitalism, the remainder of the book looks at these questions.

8

Capitalism Versus Democracy

The traditional view of economic and political systems, discussed in Chapter 2, characterized political and economic systems as independent of one another. The twentieth-century view characterized political systems as existing on a continuum from dictatorship to democracy, and economic systems as existing on a separate continuum from capitalism to socialism. One of the conclusions from Chapter 2 is that political and economic systems are unavoidably interdependent, a conclusion that applies to political capitalism, and to all political and economic systems.[1] Economic analysis often takes place in an abstract framework based on preferences and production technology, with no mention of institutions, but all interpersonal interactions take place within some institutional framework, and political institutions are always lurking behind economic transactions, even when they are not recognized explicitly. Noting the interdependence between political and economic systems, this chapter discusses some tensions that arise when combining democratic government with a capitalist economy.

The Cold War era during the second half of the twentieth century, which pitted the Western bloc capitalist democracies against the Eastern bloc socialist dictatorships, ended with a victory by the capitalist democracies after the fall of the Berlin Wall in 1989, followed by the breakup of the Soviet Union in 1991. Francis Fukayama, in a well-known book, declared this to be the end of history, in the sense that democratic government was the final form of human government and capitalism was the ultimate end to the

[1] Torsten Persson, "Do Political Institutions Shape Economic Policy?" *Econometrica* 70, no. 3 (May 2002), pp. 883–905, notes that different electoral rules and political regimes affect economic policy. He does not take an economic systems approach to political and economic institutions, but his findings are consistent with a systems approach.

evolution of economic systems.[2] Fukuyama focuses heavily on the evolution of ideas and notes the triumph of Western liberalism in both the economic and political spheres, but does not focus as much on the actual operation of democracy and capitalism, although he does note the lack of success in alternative economic systems. The failure of fascism became evident after World War II, and the failure of socialism became evident after the fall of the Berlin Wall. Dictatorships fell as people valued political freedom as an end in itself.

Those observations explain the triumph of the ideas of democracy and capitalism, but do not look at the way they interact as they attempt to coexist. Furthermore, when Fukuyama's book was published in 1992, the world was still stunned by the rapid upheaval in the political and economic systems of the Eastern bloc. Even into the mid-1980s few people foresaw the rapid changes that loomed ahead for those Eastern bloc countries. So yes, the ideas of democracy and capitalism had triumphed and looked unassailable in 1992 partly because in the war of ideas between dictatorship and democracy, between socialism and capitalism, a decade before there was no clear indication of which side would ultimately win that war. After victory, it is easy to side with the victor.

Deirdre McCloskey likewise focuses on ideas, writing about the triumph of capitalism, but from a different angle. She argues that the widespread acceptance of what she calls bourgeois values laid the foundation for the Industrial Revolution and the subsequent massive increase in the global standard of living.[3] The values she cites – love, faith, hope, justice, courage, temperance, and prudence – laid an ethical foundation for the development of capitalism. Her arguments are persuasive, but although she depicts capitalism's triumph as an economic system, as does Fukuyama, she does so for a different reason, even though both base their arguments on ideas: ideas of Western liberalism in the case of Fukuyama, and of bourgeois values in the case of McCloskey. McCloskey sees an ethical triumph that paved the road for capitalism to succeed.

Despite her focus on the triumph of capitalism, McCloskey also recognizes the features of political capitalism described here. She says that in general, government projects "are directed not at the general betterment

[2] Francis Fukuyama, *The End of History and the Last Man* (New York: Free Press, 1992).

[3] Deirdre N. McCloskey, *The Bourgeois Virtues: An Ethics for the Age of Commerce* (Chicago: University of Chicago Press, 2006), *Bourgeois Dignity: Why Economics Can't Explain the Modern World* (Chicago: University of Chicago Press, 2010), and *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (Chicago: University of Chicago Press, 2016).

but at enriching special interests at the expense of the generality."[4] She describes government regulation as "interference at best inspired by antique theories . . . and at worst by conspiracies to benefit existing rich people backed by violence."[5] Government benefits the elite at the expense of the masses. Echoing Gabriel Kolko's observations about Progressive Era regulation, she observes, "The Interstate Commerce Commission, supposed to keep down rail rates charged to farmers, was swiftly captured by the railways and commenced keeping rates up. Because the rich and powerful run the government, the poor and other powerless have regularly been hurt by government regulation."[6]

McCloskey's description of government regulation, based on George Stigler's capture theory,[7] is entirely consistent with the theory of political capitalism. It is easy to see that the rich and powerful are the elite – the members of the low-transaction cost group – and that the poor and other powerless are the masses – the members of the high-transaction cost group. McCloskey's celebration of the virtues of capitalism clearly recognizes the elements of political capitalism that have crept into the economic and political systems.

McCloskey says government spending "benefits politically well-connected construction unions and the owners of paving firms, not little kids from the inner city."[8] Again expressing the view that the elite are able to manipulate the system for their benefit, McCloskey says, "It's the Golden Rule: Those who have the gold, rule."[9] And again, "in consequence of the way politics actually works the American farm program, say, benefits not poor farmers but big farmers with access to senators from farm states."[10] She goes on to observe, "The spoofing Golden Rule – those who have the gold, rule – suggests why governments are nasty tools for fixing social problems."[11] And more: "The power elite runs things, I repeat."[12]

McCloskey begins her trilogy by saying it is "an 'apology' for capitalism in its American form."[13] This opens the question of the American form of capitalism. McCloskey has in mind a system of free markets and mutually agreeable voluntary exchange, but the passages just cited show she recognizes the darker features of political capitalism in the American form of

4 McCloskey, *Bourgeois Equality*, p. 141.
5 McCloskey, *Bourgeois Equality*, p. 143.
6 McCloskey, *Bourgeois Equality*, p. 144.
7 George J. Stigler, "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971), pp. 3–21.
8 McCloskey, *Bourgeois Virtues*, p. 43.
9 McCloskey, *Bourgeois Virtues*, p. 45.
10 McCloskey, *Bourgeois Virtues*, p. 47.
11 McCloskey, *Bourgeois Virtues*, p. 50.
12 McCloskey, *Bourgeois Virtues*, p. 70.
13 McCloskey, *Bourgeois Virtues*, p. 1.

capitalism. Her pro-market sentiment and critical appraisal of government intervention are apparent, but she does not consider whether the advance of capitalism also brings with it more government intervention as a natural consequence.

DEMOCRATIC GOVERNMENT

When one thinks casually about democratic government, the idea that comes to mind is a government that carries out the will of the majority, as revealed through democratic political processes. Recall Rousseau's conclusion that the policies that emanate from democratic decision-making constitute a social contract.[14] Rousseau envisioned a general will that was revealed through democratic government, and argued the ethical responsibility of citizens to abide by policies produced by democratic government; that is, policies that embodied the general will. This is consistent with the idea that the role of government is to carry out the will of the majority, and the idea that decisive electoral victories constitute a mandate to implement the political platforms of the winners. And, this is consistent with the Progressive ideology that one role of government is to look out for the economic well-being of its citizens. Policies that further their economic well-being are revealed through a democratic decision-making process.

This idealistic view of government conveys more power to the political elite, because the masses envision a process whereby their individual views are aggregated to form the general will, as Rousseau depicted it, which is then carried out by those who wield the power of government. While the whole notion of a general will is problematic – there is no public interest beyond the individual interests of those who make up the public – another problem with this view is the idea that those who hold political power will use it to further the interests of others – the masses – rather than their own interests. But this view of government serves a symbolic purpose that benefits the elite: it conveys legitimacy to the actions that government undertakes.[15]

If a tyrant takes over and rules a country by force, citizens recognize that the only claim the tyrant has to government power is that nobody else has sufficient power to overthrow the tyrant. People will resist obeying the

[14] Jean Jacques Rousseau, *The Social Contract, or Principles of Political Right* (Translated by G. D. H. Cole. www.constitution.org/jjr/socon.htm. 1762).

[15] Murray Edelman, *The Symbolic Uses of Politics* (Urbana: University of Illinois Press, 1964).

tyrant's mandates when they can get away with it, making enforcement of the tyrant's mandates a costly proposition. But if those same mandates come from a democratic government, people are more likely to follow them because, like Rousseau, they view government's actions as carrying out the general will. Government, following this democratic ideology, is not imposing its policies on its citizens; it is carrying out the policies its citizens have chosen. Compliance is much easier to command when people buy into the ideology of democracy.

Democracy can be viewed in (at least) two ways. One way is to view democratic elections as a peaceful method of selecting who will exercise the power of government. In this view, democracy is a method of determining who exercises government power, but not a method of determining what powers they will be able to exercise. This was the vision of the American Founders, who designed a government of constitutionally limited powers. Those who exercised the power of government were limited only to those enumerated powers given to government by the Constitution. That vision of democracy has given way to the broader vision that Rousseau described in which democratic government carries out the will of the people.[16] Democracy is not only a method of selecting who exercises the power of government but also a mechanism that determines what policies and activities government pursues.

This broader vision of democracy is at odds with capitalism because it gives government the license to override market activities, under the justification that government's actions represent the general will. The weakness of this justification has been exposed in the preceding chapters. The elite, who exercise the power of government, represent their own interests, not the interests of the masses.

PROGRESSIVISM AND DEMOCRACY

The Progressive ideology, which views one role of government as looking out for people's economic well-being, works best within the ideology of democracy. There are some economic policies that further everyone's well-being, but the original basis of Progressivism was to create a more balanced division of economic power by furthering the economic well-being of some at the expense of others, with those others being people

[16] I have discussed this ideological shift in detail in Randall G. Holcombe, *From Liberty to Democracy: The Transformation of American Government* (Ann Arbor: University of Michigan Press, 2002).

who the masses perceived were abusing their economic power. The railroads were viewed as exploiting rail shippers with excessively high rates, other monopolies (Standard Oil is a classic example) were viewed as taking advantage of their monopoly status, banks were viewed as taking advantage of borrowers.

From the very beginning, Progressivism sought to control the power of the economic elite by taxing and regulating them, for the benefit of the masses. The railroad regulation, antitrust law, the income tax, all were supported by the masses because they were aimed at looking out for the economic well-being of the masses at the expense of the elite. From its beginnings, Progressivism was redistributive, based on the idea that the economic well-being of some – the masses – should be promoted by reducing the economic well-being of others – the elite. The idea that government policy should benefit some at the expense of others has always been an element of Progressivism.[17]

Twenty-first-century Progressivism is even more explicitly redistributional. The welfare state is designed to transfer wealth from the wealthiest to those who have less. The idea that the wealthiest are taking advantage of the less fortunate is at best a minor component of the Progressive ideology in the twenty-first century. The rich just have more than anyone else, so they should "share the wealth," to use a phrase that was used by President Obama. The idea that the rich have not earned their wealth, or that the poor deserve more, is irrelevant to the Progressive idea of sharing the wealth.[18] A component of the modern Progressive ideology is the quest for equality, which means more than just equality of opportunity but also

[17] A darker side of Progressivism was the support of eugenics by Progressive economists in the late nineteenth and early twentieth centuries. Thomas C. Leonard, *Race, Eugenics, and American Economics in the Progressive Era* (Princeton: Princeton University Press, 2016) discusses the issue. While there may be an intellectual connection between the idea that the economy can be managed to increase social welfare by trading off the well-being of some to enhance the well-being of others and managing human procreation for similar reasons, exploring this in further detail would be a diversion from the arguments presented here and for present purposes is best left as a footnote.

[18] Still, the Progressive view questions whether the rich deserve what they have. In a well-publicized speech given by President Obama in Roanoke, Virginia on July 13, 2012, he said, "If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you've got a business, you didn't build that. Somebody else made that happen." One reason Progressives can argue the wealthy should share the wealth is the view, often but not always unstated, that those who have wealth do not deserve it any more than those who do not.

equality of outcome. It legitimizes the taking from some for the benefit of others.[19]

In many circumstances taking what belongs to some for the benefit of others would be viewed as immoral,[20] but the ideology of democracy supports the idea that when it is done by democratic government, such actions are a realization of the general will. Once people accept the idea that democratic government has the right to take from some for the benefit of others, the door has been opened for the acceptance of the policies of political capitalism.

Kolko's argument in developing the idea of political capitalism was that those Progressive policies designed to limit the economic power of the elite for the benefit of the masses in fact worked for the benefit of the elite, and held down the masses. Regardless of whether Kolko was correct in his assessment, this shows the possibility that the policies implemented by democratic government might not represent the general will, but rather the will of those who have the power to implement the policies. Nobody lobbies the legislature by saying they want some special interest benefit that will impose costs on others. Everybody represents their arguments for special interest benefits as policies that further the public interest. It is in the public interest to protect the domestic steel industry from lower-cost foreign imports? It is in the public interest to require motor fuels to contain 10 percent ethanol? It is in the public interest to create monopoly suppliers of electricity and prevent others from competing with them?

The fact that these policy issues can be debated, with persuasive arguments on both sides, shows how the Progressive ideology opens the door for those who design the policies to see that they are designed to favor their designers. Was Kolko correct that Progressive Era regulation benefited the regulated, or is the conventional wisdom of historians correct that Progressive Era regulation reined in the economic power of the economic elite for the benefit of the masses? The fact that this can be debated shows the lack of clarity in determining whether government policies really are in the public interest. One source of this lack of clarity comes from the fact that the public interest is nothing more than the individual interests of all those people who make up the public, and another source is that when

[19] Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944) makes a persuasive case that policies that are designed to produce equality of outcomes necessarily compromise equality of opportunity. The most able must be handicapped to move toward a more equal outcome.

[20] For a good statement of this view, see Murray N. Rothbard, *The Ethics of Liberty* (Atlantic Highlands, NJ: Humanities Press, 1982).

policies are explicitly designed to help some by imposing costs on others, there is an inherent ambiguity in determining whether the whole group is better off. Ultimately, the determination ends up being made by those who design the policies – the elite.

Most citizens are rationally ignorant, because they have no power to change those policies, and often arguments play into the biases of citizens anyway.[21] But the ideology of democracy facilitates setting aside any rational analysis, because the democratic ideology concludes that policies implemented by the legislature are approved through a democratic decision-making process that furthers the general will. The ideology of Progressivism says one of the roles of government is to take from some for the benefit of others, and the ideology of democracy says that when a democratic government does this, it is furthering the general will. Democracy has the symbolic value of lending legitimacy to anything done by a democratic government.

THE EXPANDING SCOPE OF GOVERNMENT

The ideological war between capitalism and socialism was decisively won by capitalism, as Fukuyama observed, following the collapse of the Berlin Wall. Socialism still has its advocates, but in addition to seeing the triumph of the capitalist democracies, people value their individual freedom independently, as an end in itself. Despite some advocates of socialism, the scope of government does not increase because people demand bigger government, or more government control over their lives. It expands program by program, policy by policy, as people perceive problems and believe the government should do something to address them. There can be widespread demands for government interventions in specific policy areas even among those who, overall, prefer less government interference in their lives.

In health care, government policy allowed employers to provide health insurance to employees as a tax-free benefit, which was an extension of the provision of company doctors by some employers. Prior to World War II, some employers hired company doctors who would provide medical services to their employees, so if companies decided to provide health

[21] Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton: Princeton University Press, 2007), notes that because one vote does not affect an election outcome, voters can find it rational to maintain and vote on the basis of irrational beliefs.

insurance rather than company doctors to their employees, equal treatment would suggest that the provision of health insurance should not be taxed, just as the services of company doctors were not treated as taxable income.[22] Government, as an employer or former employer, provided health care to military veterans through VA hospitals. As tax rates rose and more health insurance was provided by employers, many poor people and the retired elderly were financially strained by health care expenses, leading to Medicaid and Medicare. As government became increasingly involved in the financing of health care, market forces became ineffective constraints on medical suppliers, leading to increased regulation and a more general provision of health insurance through Obamacare.[23]

This expansion of the scope of government was not in response to demands for bigger government, it was in response to citizens who, through the democratic process, thought government should do something about these various problems people had in financing their health care. Often, the problems people perceived were the result of prior government interventions. One government policy is designed to address a perceived problem, and that intervention causes other problems, which then leads to the popular demand to address the problems caused by the earlier policy. Government expands over time as it addresses the problems caused by previous government interventions.[24] One intervention leads to another, not because people want bigger government but because they want government to address specific problems. The fact that these problems often are the effects of previous government policies may go unrecognized, but even if the effects of previous interventions are recognized, people still have hope that additional government intervention can address them.

Citizens have had ongoing concerns about the stability of the financial industry, leading to increasing regulation. In the 1930s banking became more heavily regulated in response to the banking failures during the Great Depression. Federal deposit insurance was created, insulating depositors from bank failures, interest rates that banks could offer depositors were regulated by the Federal Reserve, and savings and loans were created as

[22] Unions tended to favor the provision of health insurance rather than company doctors, partly because of the belief that if there was a question about liability as a result of a work-related injury, company doctors would tend to side with their employers.

[23] An excellent discussion of the evolution of American health care is found in Paul Starr, *The Social Transformation of American Medicine* (New York: Basic Books, 1982).

[24] This is the theme of Sanford Ikeda, *Dynamics of the Mixed Economy: Toward a Theory of Interventionism* (London: Routledge, 1997).

financial institutions that could accept only savings deposits, with the idea that those deposits would be longer-term and more stable, which would facilitate making home mortgages. Savings and loans were always allowed to pay depositors a higher interest rate than banks, but were not allowed to have checking accounts.

These reforms not only addressed issues related to the stability of the banking industry, they also facilitated home ownership, another issue in which people thought government should do something. The Progressive ideology that government should look out for people's economic well-being was instrumental in these financial industry reforms. Many of these policies went awry in a major way in the 1970s due to rising inflation. People wanted higher interest rates on their saving, and nonbank financial institutions established money market mutual funds to accommodate them, resulting in losses of savings deposits from banks and savings and loans. This forced regulators to raise allowable interest rates, which threatened the viability of savings and loans. They were in the position of earning 5 to 6 percent on the mortgages they had issued, but had to pay 8+ percent to their depositors. The only way for them to survive was to greatly expand in size so they could issue new mortgages at higher rates. Why would depositors risk their money by depositing them in these precarious savings and loans? Because there was no risk. Their deposits were federally insured.

The federal government created the Resolution Trust Corporation in 1989 to implement an orderly shutdown of savings and loans, and the last savings and loan closed its doors in 1995. Most went out of business, though some were converted to commercial banks. Problems caused by one government policy led to an expansion of government through other policies to address these new problems, not because people wanted bigger government but because they wanted government to address specific problems.

Facilitating home ownership has been an ongoing issue with the federal government, which was addressed by the establishment of Fannie Mae, a government-sponsored holder of home mortgages, in 1938, and Freddie Mac, a "competing" government-sponsored corporation with the same mandate, in 1970. The idea was to create a secondary market in mortgages so mortgage lenders could sell their mortgages if they wanted the money for any reason. This would enable them to issue more mortgages. In 1977 Congress passed the Community Reinvestment Act with the intention of expanding the availability of mortgages in low-income neighborhoods. Mortgage lenders were increasingly encouraged to lend to less affluent borrowers, to reduce down-payment requirements, and loosen the financial requirements borrowers had to meet to qualify. This was more feasible for lenders because of the secondary market provided by Fannie Mae and Freddie Mac. Lenders did not have to hold the mortgages and bear the associated risk. They could sell the mortgages to Fannie and Freddie.

As long as housing prices rose, this posed minimal problems, because borrowers who could no longer pay their mortgages could sell their houses, pay off their mortgages, and have money left over. But after the housing crisis in 2008 caused housing prices to plummet, and the accompanying recession left many without jobs, some could not pay on their mortgages and could not sell their houses because they would receive less than they owed on their mortgages. Again, one sees that the citizen demand that government do something leads to interventions that cause additional problems, which leads to the demand that government do something to solve these problems. People are not demanding bigger government. They are asking for government to address some specific issue, which leads to an increase in the scope of government over time.[25]

The big issue in the banking industry has been stability, although other issues (such as facilitating home ownership) have played a role. But the series of regulations designed to increase the stability of the financial industry ultimately has been destabilizing. It has created financial institutions that are "too big to fail," encouraging risk-taking on the part of those institutions and leaving taxpayers to bear the risk. In the face of this instability, people argue that the government should do something, and what it has done has made the problem worse.

One can debate whether the Dodd–Frank Act passed in 2010 helped or made existing problems worse, but the fact that debate is possible leaves the door open for those who design government policies to do so in ways that benefit the elite – the low transaction cost group that actually determines what government does when people demand that government do something. The idea that public policy is designed to further the public interest is wishful thinking. The well-established theories discussed in previous chapters offer an alternative view, which is that public policy is designed to further the interests of its designers. When economists analyze individual behavior in market settings, they assume people act to further their own

[25] See Stan J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," Ch. 13 in Randall G. Holcombe and Benjamin Powell, eds., *Housing America: Building Out of a Crisis* (Oakland, CA: Independent Institute, 2009) for an excellent discussion of the factors that led to the bubble in housing prices and the policies that were designed to address the resulting crisis.

interests. Is it reasonable to assume that their motivations are different when those people act in political settings?

The same general pattern has occurred in energy markets. The 1970s saw policies promoting energy conservation and domestic energy independence. The federal government created the Synthetic Fuels Corporation in 1980 to promote domestic production by partnering with private sector companies to explore alternatives such as coal gasification and the development of shale oil. The program was financially beneficial to the partnering companies, but produced little fuel, consistent with the ideas of political capitalism. The ethanol program is another example of an energy policy that provides benefits to the well-connected, without any noticeable benefits to energy security or the environment, but with obvious benefits to those with political connections. Priorities have shifted from domestic production to environmental protection and sustainability, raising objections to previously favored energy sources like fracking and shale oil.

These areas offer some examples in which the scope of government expands, policy by policy, not because people want bigger government, but because any time a problem arises people say the government should do something to address it. Popular demand for the government to do something is based on wishful thinking rather than an understanding of how government actually works. People have a top-down mentality, not seeing the way that the spontaneous order that emerges in a decentralized society often can better address issues than a top-down government mandated policy designed by the elite. So government grows one policy at a time. Once initiated, government programs almost never die.

Even if government policies are created with good intentions, an understanding of political capitalism shows that ultimately they will work for the advantage of the elite and well-connected. They may benefit the masses if the interests of the elite and masses coincide, but often they will not, simply because of the nature of government. Because government forces people to comply with its policies, the most productive route for the elite often is to design policies that transfer rents to them, paid for by the masses.

POLITICAL INSTITUTIONS

Douglass North, one of the pioneers in what has been referred to as the new institutional economics, defines institutions as "the humanly devised constraints that structure political, economic, and social interaction."[26] North divides institutions into formal institutions, which have third-party enforcement, and informal institutions like customs, traditions, and codes of conduct. The institutions of democratic government operate under both formal and informal rules. Elections and the constitutional and legal rights and responsibilities of citizens and policymakers, are examples of formal institutions. Logrolling and political exchange are informal institutions. A Representative who solicits the support of a colleague to pass legislation and then will not repay that debt can be informally sanctioned, and might lose the opportunity to engage in future political exchange, but laws do not enforce the terms of political exchange, as they do with market exchange. Participants in market exchange have a legal obligation to pay their debts; participants in political exchange do not.

Some of the institutions that support political capitalism are formal; others informal. The exchange of support between the economic and political elite is often informal, in that there are no third-party sanctions that enforce those exchanges. The elite do favors for each other, often enforced through the doctrine of continuous dealings. People who fail to reciprocate favors find that others are not willing to continue favoring them when they get nothing in return. Those favors are often embodied in formal institutions. Regulatory protection for a firm, for example, is written into law and is enforced by government. The regulatory environment, rules of legal liability, and tax laws are examples of the formal institutions of political capitalism.

If one can see the effect of institutions on people's relative and absolute well-being in obvious cases like slavery and royalty, one should not be surprised that in looking more carefully at institutions, that democratic institutions also contain elements that give advantages to some over others. Early twentieth-century institutionalist John R. Commons emphasized the degree to which institutions influence economic outcomes.[27] This is difficult to see in economic models that characterize an economy in a general equilibrium framework, where outcomes are the result of interactions among the utility functions of demanders and the production functions of suppliers with no explicit recognition of institutions. The effects of

[26] Douglass C. North, "Institutions," *Journal of Economic Perspectives* 5, no. 1 (Winter 1991), p. 97.

[27] John R. Commons, *Institutional Economics: Its Place in Political Economy* (New York: Macmillan, 1934).

institutions are assumed away. Thus, economists have tended to deemphasize the influence of institutions on people's relative well-being. Political capitalism pushes institutions toward the forefront.

An exception to the observation that economists tend to ignore institutions is the attention they have given to the institutions of capitalism as a source of inequality. David Ricardo, in 1817, projected that over time, because of the scarcity of land, land owners would gain an increasingly large share of a nation's income;[28] Karl Marx argued that capitalist institutions were inherently unfair because they gave income to capitalists that rightfully belonged to laborers;[29] and more recently Thomas Piketty argued that the nature of the capitalist system inherently shifts wealth toward the upper end of the income distribution.[30] These are examples of economists who argued that economic and political institutions give advantages some over others. Joseph Sitgliz's argument that the political system rigs the rules to favor some over others clearly points toward the way that institutions affect outcomes.[31] Piketty says inequality is mostly the effect of capitalist institutions whereas Stiglitz cites political institutions as the primary driver of inequality, but both recognize the effect that institutions have on outcomes. Recognizing the interdependence of political and economic institutions, one can see that the institutional structure more generally affects the prosperity and status of those who live within those institutions.

Once people recognize that institutions are a major factor affecting people's relative and absolute well-being, it is a small step to recognize that the institutional structure of political capitalism rests on a well-established theoretical framework described in the preceding chapters. Political institutions, like any institutions, affect people's standing in society and favor some over others. The ability of elites to design institutions for their benefit leads a market economy toward political capitalism.

DEMOCRATIC INSTITUTIONS

When examining the institutional foundations of political capitalism, keep in mind that the Founding Fathers of American government did not intend

[28] David Ricardo, *Principles of Political Economy and Taxation*, 3rd edn. (London: John Murray, 1821 [1st edn. 1817]).

[29] Karl Marx, *Capital* (Chicago: Charles H. Kerr & Company, 1906).

[30] Thomas Piketty, *Capitalism in the Twenty-First Century* (Cambridge, MA: Harvard University Press, 2014).

[31] Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers the Future* (New York: W. W. Norton, 2012).

to create a democracy, in the sense of having a government that carried out the will of the people, or the will of the majority. They created a constitutionally limited government, and intended for democracy to be used as a method for selecting and replacing those who held government power, and even then, democracy was for the most part indirect. The Constitution of the United States creates a government of limited and enumerated powers, and in the 10th Amendment limits the powers of government only to those enumerated. The idea was not that a democratic government would carry out the will of the majority, but that elections were one of the mechanisms that could help constrain government so that it would not exceed its constitutionally limited enumerated powers.

That has changed over the centuries. First, the idea of a constitutionally limited government has been replaced by the ideology of democracy – the concept that the role of government is to carry out the will of the people as revealed through the democratic decision-making process. Second, the idea of the constitutionally limited role of government has been replaced by the ideology of Progressivism, with its belief that one of the roles of government is to look out for people's economic well-being. And, as previously emphasized, this Progressive idea was not to support only policies that enhanced everyone's economic well-being. From the beginning, the Progressive ideology embraced imposing costs on some to provide benefits to others.

Although the stated intent of Progressive policies always is to further the public interest, the institutions of democracy have evolved toward a decision-making process that favors the elite and well-connected over the masses. Kolko has argued that from the beginning, Progressive policies furthered the interests of the elite over the masses, and the theoretical foundation outlined in the previous chapters has explained why this tends to be true. Accepting the idea that democratic government embodies the will of the people, coupled with the idea that one role of government is to look out for people's economic well-being lays the foundation for political capitalism because despite the stated intentions of Progressivism, public policy will be designed to further the interests of its designers – the elite. Would anybody argue that those who hold political power tend to use it to impose costs on themselves to provide benefits to others? Under the ideology of Progressivism, the masses campaign for more government control over the economy, and that increasing control benefits those who write the rules, and do so for their own benefit.

THE TYRANNY OF THE MAJORITY

One of the apprehensions that the American Founders had regarding democratic government was the potential for a majority to exploit the minority.[32] The potential problem is obvious, and well-expressed in the quip, "Democracy is two wolves and a sheep voting on what to have for dinner." Alexis de Tocqueville used the phrase tyranny of the majority to describe the potential problem he saw with American democracy in his 1838 book, *Democracy in America*,[33] but the problem is more likely when majorities are unified by favors beyond politics, such as racial, religious, or linguistic ties. A majority defined along these lines can endure and exploit minority populations for substantial amounts of time.

Slavery in the American South when Tocqueville was writing is an example, followed up by Jim Crow laws that institutionalized racial discrimination for another century. Racial, ethnic, and religious coalitions have taken control of governments and exploited outsiders in many places. Majority coalitions without other ties beyond politics keeping them together are less stable, because coalition members are prone to defect if they get a better offer from outsiders. The problem of holding political coalitions together is similar to trying to maintain a cartel. Still, the problem is that despite shifting majorities there is always the potential for a majority coalition that can exploit those not in the coalition.

Seeing the potential problem, the American Founders designed a constitutionally limited government and deliberately insulated those who exercise the power of government from democratic pressures. The government the Founders created was a constitutionally constrained republic, not a democracy. As originally envisioned in the Constitution, the government of the United States was designed to be one-sixth democratic. The government was designed with three branches of government to check and balance each other and limit government power. This would only work if the three branches were of roughly equal power. Members of the House of Representatives, one-half of the legislative branch, were directly elected by citizens. That is the democratic part of the original design. Members of the Senate were chosen by the state legislatures to represent the interests of the state governments as the Constitution was originally written. This was changed with the passage of the 17th Amendment in 1913 which requires

[32] This is the political external cost that James M. Buchanan identified in "Politics, Policy, and the Pigouvian Margins," *Economics* n.s. 29, no. 113 (February 1962): 17–28.

[33] Alexis de Tocqueville, *Democracy in America* (New York: W. W. Norton, 2007 [orig. 1838]).

direct voting for Senators. Prior to 1913, the Constitution insulated the Senate from democratic pressures by having Senators chosen by state legislatures to represent state government interests, rather than be directly accountable to citizens.

Federal judges, including Supreme Court Justices, have always been appointed by the president and confirmed by the Senate. The appointment process coupled with their lifetime tenures insulates the judicial branch from democratic pressures. The president was to be selected by an electoral college. In the event that no candidate receives a majority of electors' votes, the House of Representatives chooses the president from five candidates with the highest number of electoral votes – changed to three candidates by the 12th Amendment ratified in 1804. The Founders believed that in most cases nobody would receive an electoral majority so in most cases the president would be selected by the House of Representatives.[34]

The idea behind the electoral college was to insulate the selection of the chief executive – the president – from democratic pressures. The Constitution specifies that the states decide how to choose their electors and the Constitution allows states to choose their electors as they see fit. Originally, the most common method of selecting electors was to have them chosen by the state legislatures, but by the 1820s almost all states had gone to direct voting for electors. The original design of the electoral college was intended to insulate the selection of the president from democratic pressures, although the system rapidly evolved into democratic voting for President.

The US government was clearly not designed to be a democracy, in the sense of being a government that carried out the will of the majority, or the general will, or similar concepts. Democratic elections were used as a method of replacing leaders in a peaceful and orderly manner, but the Founders deliberately designed a government so that those who held the power of government were insulated from democratic pressures, and not directly accountable to voters. The original government was designed to be one-sixth democratic in the sense that only the House of Representatives was directly accountable to the voters. The House is one-half of one of the three branches of government.

[34] The notion that the Founders intended to design a government one-sixth democratic is discussed in more detail in Randall G. Holcombe, *From Liberty to Democracy: The Transformation of American Government* (Ann Arbor: University of Michigan Press, 2002) chapter 4.

The Founders designed a government of limited and enumerated powers, and the 10th Amendment to the Constitution, part of the original Bill of Rights, says, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people." The power of majorities was limited by insulating those who held government power from direct accountability to citizens coupled with a Constitution that limited the scope of government only to those powers specifically enumerated in the Constitution.

The threat of the tyranny of the majority remains, with minorities in the United States and many other countries claiming with some justification that government policies work against their interests, but the constitutionally constrained republic established by the American Founders has evolved substantially in the more than two centuries since the Constitution was ratified. Those who hold government power are more directly accountable to democratic pressures and citizen demands, because Senators are now elected directly by the voters and because presidential electors are selected by popular vote. In addition, the Constitution has been interpreted much more broadly over the centuries so that the 10th Amendment would appear to have little relevance. For example, the Supreme Court ruled that the Social Security program conforms to the requirements of the Constitution, but it is difficult to find any place in the Constitution that lists the creation of a compulsory retirement program as one of the federal government's enumerated powers.

The US government was designed to be a constitutionally limited government, not a democracy that carried out the will of the majority. In European monarchies the transformation to the ideology of democracy was more direct. Power has shifted from the crown to the people with the idea of constraining the power of the crown, but also with the idea of a democratic government that carries out the will of the people rather than the will of the crown. But a majority has the potential to be just as tyrannical as a king or dictator.

THE TYRANNY OF THE MAJORITY AND PROGRESSIVISM

A government with limited and enumerated powers has limited opportunities for engaging in discretionary activities that can benefit some at the expense of others. As constitutional constraints have eroded on the scope of government, more opportunities present themselves for using the force of government to transfer benefits from some to others, sometimes through direct taxation and cash transfers and sometimes through regulations that impose costs on some for the benefit of others. The widespread acceptance of the Progressive ideology has contributed heavily toward the ability of government to benefit some at the expense of others. The Progressive ideology, which expanded the role of government beyond the protection of individual rights to looking out for people's economic well-being, often explicitly incorporated imposing costs on some for the benefit of others.

One of the motivations for Progressivism was to rein in the economic power of the trusts in the late 1800s. It was designed to impose costs on some – the economic elite – for the benefit of others – the masses. Twenty-first-century Progressivism has this same slant, providing people with "free" education, health care, and other benefits. But those things are not free, because if some are entitled to them, others have to pay for them. Rather than have those who consume them pay, one frequent Progressive answer is to get the rich to pay. Whenever the idea that the rich should pay their fair share comes up, it always comes with the implication that their fair share is more than they are paying now.

The theory of political capitalism shows that the explicit redistributional ideology behind Progressivism works for the benefit of the elite. Even if the original intent behind distributional policies was to benefit the masses, public policies are designed by the elite, and one would expect for policies to work for the benefit of those who design them.

The tyranny of the majority is only possible if government constraints do not prevent some to use the power of government for their benefit at the expense of others. Essentially, the Progressive ideology was developed to allow the tyranny of the majority – to allow the masses to use government to benefit them at the expense of the elite. The theory of political capitalism says that if government is given the power to benefit some at the expense of others, the beneficiaries will not be the masses, but the elites who design government policies.

THE TYRANNY OF MINORITIES

The theories that form the basis for political capitalism show that while a majority can use the democratic political process to benefit themselves by imposing costs on minorities, smaller groups can also use the political process to benefit themselves at the expense of the majority. Theories of interest group politics explain why smaller more concentrated interests have an advantage in the political process which enables them to generate concentrated benefits for themselves by imposing diffused costs on the general public. While a tyranny of the majority is a threat under democratic government, there is an ample amount of academic research that points toward a tyranny of minorities.[35] Because they make public policy, the elite who are in the low-transaction cost group can enact policies that benefit themselves even if they impose costs on the masses who face high transaction costs.

As the democratic political process has evolved to incorporate the Progressive ideology that one role of government is to look out for people's economic well-being, and recognizing that since the beginning of the Progressive Era that has included imposing costs on some for the benefit of others, the door has been opened for those who seek economic benefits from government to stake a legitimate claim to government favoritism. Claiming that costs should be imposed on some for the benefit of others, whether those who deserve to bear the costs are the railroads, Robber Barons, trusts, big corporations, or the rich, has become completely acceptable and even admirable in contemporary politics.

The problem has been, since the beginning of Progressivism, that those who are targeted by the masses to bear those costs are the elite who design public policy. The 99 percent has argued for giving more power to the 1 percent, to mitigate what they view to be the abuses of the 1 percent. The theory of political capitalism shows where this leads. The elite minority is given the power to design economic policy for their benefit, and as they do so, the masses call for even more government intervention, which opens further opportunities for the elite minority to use the force of government to impose greater costs on the masses.

Surely most people recognize that public policy is actually designed by a small group of elites. It is somewhat surprising, then, that the people who complain about elite abuse of the power they wield campaign for more government oversight and more government control, giving those elites even more power. Joseph Stiglitz, a Nobel Laureate in economics, writes, "It's one thing to win a 'fair' game. It's quite another to be able to write the rules of the game – and to write them in ways that enhance one's prospects of winning. And it's even worse if you can choose your own referees."[36] Yet recognizing how the system works, Stiglitz's recommendation to rectify this unfairness is to give more power to the elite who are able to write the rules for their own benefit.

35 Eamonn Butler, *Public Choice – A Primer* (London: Institute for Economic Affairs, 2012), chapter 5, uses this terminology.

36 Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers the Future* (New York: W. W. Norton, 2012), p. 59.

A tyranny of the majority is always a threat lurking behind democratic government, but in twenty-first-century Western democracies political institutions have evolved so that elite minorities are exploiting the political process for their own benefit, at the expense of the majority.

POLITICAL COMPETITION

Political competition is often depicted as occurring between parties. In the two-party system of the United States, competition takes place between Democrats and Republicans. Even in countries with multiple parties, those parties are viewed on a left-to-right continuum with political competition occurring between parties on the left and on the right. The more significant but less visible dimension of political competition is between incumbents and challengers. Those who have political power conspire to keep it, and have more in common with each other than with others in their same party who do not have that power.

In a typical US election, a Democrat will run against a Republican, one of them being the incumbent and the other the challenger. One dimension of political competition is party competition, and that party competition certainly exists and at times can be fierce. Another dimension is that one candidate is the incumbent hoping to keep power and the other is the challenger hoping to take that power. The more significant dimension of political competition is between those with power versus their challengers for that power, not the competition of one party against another. This is true in political capitalism, but also true of government in general.

Legislatively designed institutions in American democracy always have the effect of favoring incumbents over their challengers. One example is the election of members of the House of Representatives from single-member districts rather than at large, so that incumbents do not have to compete against other incumbents in elections.[37] Each Representative has monopoly power over representation in the Representative's district. The Constitution assigns each state a number of representatives proportional to its population, but does not specify that representatives be elected in single-member districts, let alone gerrymandered districts that give incumbents even more of an advantage. In the past, representatives were sometimes elected at large within a state, or in multimember districts, but

[37] This is explained in W. Mark Crain, "On the Structure and Stability of Political Markets," *Journal of Political Economy* 85, no. 4 (August 1977), pp. 829–842.

single-member districts rapidly became the norm, because of the advantage that gives to incumbents.

Another example is the seniority system, which makes it more difficult for challengers to win against incumbents. Because seniority is valuable, and the incumbent always has more seniority than the challenger, the seniority system gives incumbents an advantage over any challenger when running for reelection.[38] The committee system, with assignments also based on seniority, further gives advantages to incumbents because committee assignments are rarely taken away from legislators, giving them a property right in the power that comes with those assignments.[39] Add to this the franking privilege, which allows legislators to send mail at no charge, the paid staff they have both in the capital and in their home districts, and the government-paid travel expenses, and incumbents have many advantages over challengers.

Another natural advantage is the free news coverage they get, because they are in power. The result is greater name recognition for incumbents. To wage a successful campaign against an incumbent, a challenger must offset the advantages of incumbency by campaign advertising to boost the challenger's name recognition. For this reason, incumbents favor campaign finance and expenditure limitations. Those financial limitations make it more difficult for challengers to offset the name recognition and other advantages that incumbents enjoy.

If incumbents were more aligned with members of their own party, whether incumbents or challengers, than with incumbents of the other party, they would favor a more level playing field, or if they were in the minority party, advantages to challengers (such as term limits) that could increase their party's representation. Yet all incumbents favor those incumbent advantages, most of which were put into place by incumbent legislators themselves. Incumbents are more closely allied with incumbents of other parties than they are with challengers in their own parties. Incumbents share membership in the elite, and work together to protect their elite status. The division between incumbents and challengers is a more significant dimension of political competition than the division between parties.

38 I have discussed this in Randall G. Holcombe, "A Note on Seniority and Political Competition," *Public Choice* 61, no. 3 (June 1989), pp. 285–288.

39 This is further explained in Randall G. Holcombe and Glenn R. Parker, "Committees in Legislatures: A Property Rights Perspective," *Public Choice* 70, no. 1 (April 1991), pp. 11–20.

The interests of Democrats in Congress have more in common with Republicans in Congress than with Democrats who are challenging Republican incumbents. Electoral competition between Democrats and Republicans is minor when compared to electoral competition between incumbents and challengers.

Consider a private sector example of a firm that sets up a competition among members of its sales force. All the sales people compete against each other and the top salesperson wins a vacation. One might conclude that the sales people are competing against each other, and indeed they are, but the more significant dimension of competition is that firm's sales versus other firms selling competing products. In that sense, all the sales people are on the same side, working to boost their company's sales and making sales that might have gone to other companies.

In the same way, while Democrats and Republicans are competing against each other like the sales people in the previous paragraph, the more significant dimension of political competition is between incumbents and challengers. The incumbents are members of the elite who are on the same side, working to preserve their elite status against challengers who want that elite status for themselves. One characteristic of this political competition is that should a challenger win, that challenger then becomes an incumbent in the next electoral cycle. Challengers who win then become members of the elite coalition of incumbents, and their incentives change from making it easier for challengers to making it more difficult.

Because elections tend to pit members of one party against another, it is easy to perceive competition among parties, but the more significant dimension of political competition is between incumbents and challengers. The elite band together to reinforce their elite status.

DOES CAPITALISM SOW THE SEEDS OF ITS OWN DESTRUCTION?

"Can capitalism survive? No. I do not think it can," Joseph Schumpeter said.[40] His reasoning was not that capitalism was flawed as an economic system, but that as capitalism evolved, the people who benefitted most from it would not stand up to defend it in the political arena. Democracy would overwhelm capitalism as popular opinion turned against it, and as

[40] Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 2nd edn. (London: George Allen & Unwin, 1947), p. 61.

capitalism's beneficiaries saw less of a connection between their prosperity and the capitalist economic system.

As capitalism matures, individual ownership of business evolves into corporate ownership, and the owners have less of a personal connection to what they own. When people own intangible shares in a business run by others rather than tangible property that they use in their own work, they see less connection between their interests and the prosperity that has been produced by capitalism. "Thus, the capitalist process pushes into the background all those institutions, the institutions of property and free contracting in particular, that expressed the needs and ways of the truly 'private' economic activity."[41] Schumpeter notes the labor laws that have done away with free contracting for labor services, and other regulations that restrict the types of exchanges businesses are allowed to engage in, echoing the ideas of John R. Commons. The growth of corporations has separated the owners of businesses from the businesses they own.[42] "Dematerialized, defunctionalized and absentee ownership does not impress and call forth moral allegiance as the vital form of property did. Eventually there will be *nobody* left who really cares to stand for it – nobody within and nobody without the precincts of the big concerns."[43] Schumpeter goes on to say,

> The capitalist process, so we have seen, eventually decreases the importance of the function by which the capitalist class lives. We have also seen that it tends to wear away protective strata, to break down its own defenses, to disperse the garrisons of its entrenchments. And we have finally seen that capitalism creates a critical frame of mind which, after having destroyed the moral authority of so many other institutions, in the end turns against its own ... The bourgeois fortress thus becomes politically defenseless. Defenseless fortresses invite aggression especially if there is rich booty in them.[44]

Schumpeter goes on to say, "The capitalist process not only destroys its own institutional framework but it also creates the conditions for another. Destruction may not be the right word after all. Perhaps I should have spoken of transformation."[45] Schumpeter foresaw a transformation toward socialism, but the development of the public choice theories described earlier, which took place after Schumpeter wrote, points toward

[41] Schumpeter, *Capitalism, Socialism, and Democracy*, pp. 141–142.
[42] This idea follows the theme of separation of ownership from control in the corporate form that is found in Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New Brunswick, NJ: Transaction Publishers, 1932).
[43] Schumpeter, *Capitalism, Socialism, and Democracy*, p. 142.
[44] Schumpeter, *Capitalism, Socialism, and Democracy*, p. 143.
[45] Schumpeter, *Capitalism, Socialism, and Democracy*, p. 162.

a transformation to political capitalism. Under socialism, the means of production are owned in common, making it more difficult for the elite to profit from them. Political capitalism embodies private ownership of the means of production, allowing the elite to write the rules so that the economic elite benefit from the capital they own. An economic transformation should be expected to benefit those who design the transforming policies, so that transformation would be unlikely to take ownership of the means of production away from the owners, but rather convey additional protections and profits to those in the economic elite.

Capitalism creates larger firms and more concentrated economic power. The masses call for more government oversight and control of the economy, following the Progressive agenda, and the resulting growth of government provides the economic elite with the means to conspire with the political elite to use the force of government to create policies for their own benefit. Thus, the ideology of Progressive democracy pushes capitalism toward political capitalism.

CONCLUSION

Democracy, as perceived in the twenty-first century, is fundamentally at odds with capitalism. The ideology of twenty-first-century democracy envisions a political system designed to use the force of government carry out the will of the people as revealed through the democratic decision-making process. This vision of democracy undermines capitalism, which is based on secure property rights and voluntary exchange. In a Progressive democracy, property rights can be attenuated as the government sees fit, and the terms of economic transactions can be dictated by those who exercise government's power.[46]

The ideology of Progressivism has so permeated twenty-first-century politics that citizens readily accept that one of the more important roles of

[46] Terry L. Anderson and P. J. Hill, *The Birth of a Transfer Society* (Stanford, CA: Hoover Institution Press, 1980), trace the government's interference with the terms of market exchanges to the Supreme Court case of *Munn v. Illinois* (1877) which ruled that the state of Illinois could set grain elevator rates. Prior to that case, the terms of market transactions were determined by the parties to the transactions themselves. The fact that the case made it to the Supreme Court shows that there was disagreement as to whether the government had the right to interfere with the terms of private exchanges, with the Court deciding that it did. In the twenty-first century people take it for granted that the government can dictate the terms of labor contracts, specify the characteristics of goods and services people are allowed to sell, and dictate the terms of private exchanges in just about any way.

government is looking out for the economic well-being of its citizens, as revealed through the democratic process. The question has shifted to which citizens should be favored by the government's economic policies. Some favor a growth in the welfare state to transfer more resources to those at the bottom of the economic ladder. Others favor policies that subsidize businesses and protect them from foreign competitors. Still others want government to rein in the power of the economic elite for the benefit of the masses. The common element in all cases is the acceptance of the legitimacy of democratic government to use its power to benefit some at the expense of others.

The institutional foundation of capitalism is private property and rule of law. One of the features of capitalism is that people have secure rights to their property and everyone is treated the same under the objective standards of law. Transactions in a capitalist economy occur through voluntary exchange and mutual agreement. Progressive democracy undermines the foundations of capitalism because rule of law is replaced by the general will, to use Rousseau's terminology. Property rights cease to be secure, because the general will often mandates the transfer of the property (and other rights) of some to others. Voluntary exchange and mutual agreement give way to a system in which government takes from some to give to others. In this system, there is an obvious benefit to being a part of the group that decides who benefits from government policy and who sacrifices for the benefit of others.

According to Progressive ideals, Progressive democracy would produce policies for the benefit of the masses, but the reality is that the designers of public policy create the policies they prefer, for their own benefit. The elite have the power to design public policy. They are concerned for the well-being of the masses to the extent that policies affect their productivity, because a more productive economy creates a larger sphere over which they can exert control.

The Progressive democratic ideology replaces the voluntary transactions of the marketplace with policies implemented through the force of government. Capitalism then is displaced by a democratic decision-making process that gives the elite the ability to use the force of government to their advantage. That system is political capitalism.

If an invading force were to take over a country's government and use the power of government for its own advantage, that government would be castigated for its abuse of power. Democratic government gives the elite the advantage that they can claim that their exercise of power is implementing the will of the people. The tension between capitalism and democracy is the tension between voluntary exchange and the force of government. The American Founders recognized this tension and designed a constitutionally limited government deliberately insulated from the demands of its citizens. As the ideology of democracy has displaced the ideology of liberty, the force of government has encroached upon the voluntary exchange of markets. As this has happened, profits that once were the result of producers satisfying consumers who voluntarily transacted with those producers have increasingly come less from productive activity and more from using the force of government to provide benefits to rent-seekers and political entrepreneurs. Capitalism has been displaced by political capitalism.

The democratic ideal suggests that in a democracy, government is controlled by the people – by the masses. But government is never controlled by the masses; it is always controlled by the elite. Millions of people can never work together to create public policy. Even if they had an interest in doing so, negotiations would be too cumbersome to get anything done. The transaction costs are too high. That is why democratic government is representative government, and representative government is always controlled by an elite. A small subset of the population is designated as having the right to use the force of government to impose their policies over the masses.

Elite control of government comes from the elite being able to wield sufficient power to prevent challengers from replacing them. Sometimes control of government rests on overt force, as when a military dictatorship threatens violence against anyone who moves to displace it. Democracy facilitates maintaining control over the force of government because of the perception that those in power, and the democratic mechanism that put them there, were chosen by the masses. But democratic government still operates by force, just as all governments do, and combined with the Progressive view that one role of government is implementing economic policies that favor some over others, democracy and capitalism are inherently at odds with one another.

The Cold War ideology of the twentieth century depicted capitalism and democracy as allies, standing against socialism and dictatorship. When democracy is widely viewed as a system in which an elected government is charged with carrying out the will of the people, the ideology of democracy undermines the institutions of capitalism.

9

The Institutional Evolution of Political Capitalism

The activities that constitute political capitalism – the rent-seeking, regulatory capture, and interest group politics, all favoring the elite over the masses – are enabled by the institutions that define the relationship between market participants and those who exercise government power. The previous chapter discussed the role of political institutions, and particularly the institutional evolution toward Progressive democracy, that has enabled the elite to gain more control over the institutions that define the way people interact in the economy. Progressivism gives the elite who hold political power license to enact policies that favor some over others, and democracy gives the policies they enact the legitimacy of having been approved through a democratic process.

This chapter focuses on the economic institutions that underlie political capitalism. The mechanisms the elite use – the rent-seeking, regulatory capture, and interest group politics – have been described earlier, and have a well-established presence in the academic literature. This chapter looks more directly at the institutional structure produced by those mechanisms. Economic analysis often examines individual institutions but rarely steps back to look at the influence of the entire set of institutional arrangements. Even when they explicitly look at the effect of institutions, economists typically employ an equilibrium framework in which demanders are defined by their utility functions and suppliers by their production functions. The equilibrium framework within which economic analysis occurs is the result of the interactions between demanders an suppliers, which is taken to represent the status quo. Institutional analysis then looks at the effect of one specific institutional feature within a general equilibrium framework that explicitly recognizes no other institutions.

The implied institutional framework is capitalism – a market economy in which the means of production are owned privately – but the specific institutions of capitalism that underlie the economy are rarely explicitly recognized in the framework. The assumptions are that property rights are clearly defined and enforced, and that economic resources change ownership only through voluntary exchange. For this to happen, property rights must be defined and enforced somehow, people must be free to make transactions they view are in their interests, and must be prevented from engaging in involuntary transfers of resources through theft and fraud. The institutions that define what constitutes a property right are especially significant. The institutions that serve these functions necessarily provide advantages to some over others. This chapter explains why this is so, and why institutional evolution tends to pull capitalist economies toward political capitalism.

John R. Commons emphasized the influence of institutions on economic activity.[1] Institutions define how people can acquire ownership of property, what property rights government enforces, and under what terms transactions are allowed, among other things. Demand and supply conditions could be very different in the economist's general equilibrium model depending on the institutional structure underlying the economy, yet this goes unrecognized in a model in which institutions are implied but not explicitly represented. Commons emphasized that the way property rights are defined and enforced is far from self-evident in a capitalist economy. There are a number of reasonable alternatives, some of which are considered below, that affect what people are allowed to do, and affect the relative well-being of some compared to others. These institutions of capitalism are an appropriate place to start, then going on to consider how they are related to political capitalism.

The way property rights are defined and protected, what transactions are allowable, regulatory restrictions on the terms under which transactions are allowed, and the tax system all play a role in determining people's economic outcomes. There is a tendency among economists to overlook the influence of institutions, because most economic models do not explicitly take them into account. Economic models have suppliers who are willing to produce and sell goods, depending on the price, and demanders who are willing to buy them, again contingent on the price, and the interactions between suppliers and demanders are often modeled as offers to buy and sell without any explicit recognition of the institutional framework within which exchanges take place. But it is readily apparent that

[1] John R. Commons, *Institutional Economics: Its Place in Political Economy* (New York: Macmillan, 1934).

what people are in a position to offer to buy and sell is contingent upon the economic institutions within which they operate. Peruvian economist Hernando de Soto has persuasively made the case that the crucial difference that keeps poor economies from developing and separates them from prosperous economies is the quality of economic institutions.[2] Where property rights are poorly defined, where economic activity is subject to heavy government regulation, and where rule of law is displaced by a legal system that favors some over others, people's economic well-being suffers.

Economists have focused largely on the economy-wide influence of institutions, when they have considered the influence of institutions at all. Yes, some institutional structures are more conducive to prosperity than others,[3] but institutions also affect people's relative well-being, in addition to overall economic productivity. This is obvious under certain institutional structures. As the previous chapter noted, where slavery has been allowed, formal institutions have lowered the well-being of slaves for the benefit of the free. When some people are designated as members of a royal class while others are commoners, or where there is a caste system dividing people into classes, those designated as members of the upper class benefit from the institutional structure relative to those outside the upper class. Political capitalism contains this same type of class system, except that the elite fall into that class as a result of informal institutions rather than formal and legally enforced institutions. However, those who are members of the elite can use their connections and political power to create formal institutions for their benefit in ways that the masses cannot.

CAPITALIST INSTITUTIONS

The institutions supporting capitalism have evolved as capitalism itself has evolved. Some institutional developments came from the bottom-up, as people discovered ways of interacting that improved their productivity which were then copied and spread by others. The evolution of payment systems provide an example, as payments evolved from hard money to bank notes to checking accounts to credit cards to electronic transfers. Some institutional developments were top-down, as those who had the

[2] Hernando de Soto. *The Other Path: The Invisible Revolution in the Third World* (New York: Harper & Row, 1989) and de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).

[3] For a good foundation on the institutional effects of economic performance, see Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990).

power to alter the institutional structure imposed changes that affected others. Banking regulation provides many examples. The evolution of the monetary system, and all capitalist institutions, has been the result of both bottom-up innovations by some individuals that spread to others and top-down changes designed by those in authority.

With simple transactions, the institutions of capitalism can be largely self-enforcing. Street vendors selling goods to people passing by can keep an eye on the goods they have for sale and prevent people from walking off with them (even if there is additional outside enforcement from government police, for example). When vendors sell their goods, simultaneously exchanging the goods for money, the transaction is self-enforcing because the vendor only gives the goods to the buyer when the money is tendered, and the buyer only tenders the money when the goods are delivered. Value is simultaneously exchanged.

As transactions become more complex, as property becomes more dispersed, and as agreements cover events that take place over longer periods of time, the institutions to support those activities also must become more complex. Even relatively simple transactions, if they occur over time, will be facilitated by more complex institutions that often incorporate third party enforcement. If a homeowner contracts with a house painter to paint her house, which takes time, the homeowner will want some assurance that if payment is made, the house will be painted, and the painter will want some assurance that if the house is painted, the payment will be made. If transactions like this rely on trust, that greatly limits the market into which the painter can operate to only those individuals who know the painter well enough to trust him.[4] In an economy where the government enforces contracts, where a government license is required to engage in business, and where organizations such as a Better Business Bureau can rate vendors and alert potential customers to problems, homeowners can have more confidence when they deal with vendors they do not know personally. When there are disputes, government courts adjudicate them and government has the power to enforce court judgments.

The observation that these institutions have arisen in response to a more complex economic environment is not intended to pass judgment on their

[4] In an interesting discussion of less-developed societies, Jared Diamond, *The World Until Yesterday: What Can We Learn from Traditional Societies?* (New York: Viking, 2012) cites advantages of societies that operate based on trust and reciprocity rather than impersonal market transactions. While agreeing with some of his points, how many people in contemporary societies would find it advantageous to move back to the more primitive existence of traditional societies?

merits. Occupational licensure may be advantageous because it gives potential consumers some confidence that the licensed professional has met some government standard, facilitating transactions by producing a measure of trust among people who do not know each other personally. Occupational licensure also creates a barrier to entry, limiting competition and shifting market power toward those who are licensed. The point is not that these institutions are beneficial or harmful, but rather that they have arisen in response to demands by both suppliers and demanders as the transactions that are occurring in the market economy have become more complex. Also note that these institutions convey advantages to some over others. Occupational licensure is a prime example. Regardless of whether it provides benefits to consumers or the economy as a whole, it conveys advantages to those who are licensed at the expense of those who would like to engage in a licensed profession but do not have a license to do so.

The degree to which the institutions have developed in an economy – both private and government institutions – determine whether particular transactions will be feasible. The transaction cost framework comes into play here with regard to market transactions. Institutions can lower transaction costs so that mutually advantageous exchanges can be made. In an economy in which transactions are based heavily on trust rather than third party contract enforcement, an agreement between a homeowner and a house painter to paint the homeowner's house may not be feasible if the homeowner has no personal knowledge of the painter. With the institutions mentioned in this section, such a contract becomes feasible.[5]

Institutions can also raise transaction costs. Consider someone who would like to hire a relative to undertake some home renovations. If the relative does not have a contractor's license, that transaction might be illegal. Some economic institutions are designed to facilitate transactions; others are designed to prevent them.

[5] Douglass C. North, John Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded History* (Cambridge: Cambridge University Press, 2009), note that everyone has individual characteristics, such as physical characteristics, intelligence and various abilities; and socially ascribed characteristics, which attach to the social position a person occupies as opposed to any personal characteristics. The president of a country, or of a company, interacts with people based on that position, and if replaced, the new president takes on those socially ascribed characteristics. In the example of the painter, a wider range of opportunities for commerce opens up if the person getting her house painted can rely on the person's socially ascribed characteristics to choose a painter not personally known to the homeowner prior to requiring the painter's services. This, in turn, requires institutions that allow people to rely on those socially ascribed characteristics.

Think back to the general equilibrium framework discussed in the introductory section of this chapter. Both the supply of and the demand for house painters will be heavily dependent on the economic institutions available to lower transaction costs between people who have no personal knowledge of each other. A general equilibrium model depicts the quantities supplied and demanded to be a function of the price, rarely taking into account the effect of institutions on supply and demand. The challenge of arranging for a house to be painted is relatively minor. Now imagine building a shopping center rather than painting a house. The owner must establish clear title to the land, contract with those who will do the construction, and also contract with the businesses that will occupy the completed shopping center. The owner will typically borrow money for construction, requiring some assurance for lenders that the loans can be repaid. One form of assurance is that typically, many of the spaces in the shopping center will be leased prior to the construction of the shopping center. This requires enforceable contracts on those who sign leases so that the owner and the lender are not left with empty storefronts that generate no revenue.

Markets for the painting of houses and the building of shopping centers depend heavily on the institutional framework within which transactions occur, not just the utility functions of demanders and the production functions of suppliers. An economic model in which the demands of demanders are based on a utility function and the amounts suppliers are willing to supply at different prices are based on their production functions leaves out the effect institutions have on the willingness of demanders to demand and the willingness of suppliers to supply.

Property is commonly viewed as ownership of something tangible, but the law recognizes property as a bundle of rights. People can use tangible assets in certain ways, but not in others. The long-standing common law doctrine of nuisance restricts people from using property in a manner that creates a nuisance to others, but regulatory restrictions have extended the way people can use tangible assets well beyond the law of nuisance. Zoning laws provide a clear example. People are allowed to develop real estate in certain ways but not in others. Zoning laws can prohibit people from using property for commercial purposes, regardless of whether those uses would create a nuisance to anyone, or even when a use would be beneficial to all of those directly affected.[6]

[6] For example, zoning laws often restrict land to residential use only, even when commercial activity near residences would be beneficial to nearby residences. Land use planners have recognized this and made more provisions for mixed use development in the twenty-first

Restrictions on land use provide easy examples, but regulatory restrictions in other areas also have major effects on the rights people have to use their property and their labor. Occupational licensure restricts people from engaging in professions without government approval, and other regulatory restrictions affect the transactions that are allowed by those who are government-approved.[7] Patent and copyright law assigns rights to the use of ideas, providing monopoly rights to patent and copyright holders only because of the legal protection patents and copyrights provide.

Regulatory restrictions on entry into other economic activity may be even more severe. As noted in Chapter 7, many cities have placed hard caps on the number of taxicabs allowed in a city, so that potential new entrants who want to use their own property to compete in that market are prohibited from doing so. Some people who own automobiles are allowed to use them as taxis; others are not. The Federal Aviation Administration requires aircraft manufacturers to go through a costly certification process before they are permitted to market aircraft. Consider a designer of small personal aircraft who might want to go into business, producing one aircraft and then selling it to get the revenue to produce the second and third. This is not possible because it would cost millions of dollars to get the first aircraft certified so the manufacturer would be allowed to sell it.

Some readers will be thinking that this regulation of personal aircraft is entirely reasonable, but the point here is not to argue that provisions of the regulatory state are, or are not, reasonable. The point is that economic institutions determine what people are allowed to own, how people can use their property, and what types of transactions they are allowed to undertake. The requirement that production aircraft be certified harms the small designer–builder and benefits larger established manufacturers. It is plausible that the more reasonable a regulation sounds, the more likely it is to be put into place when regulations are designed through a democratic decision-making process. It will be supported by the bootleggers and the Baptists. Regardless, the regulatory state imposes institutional constraints that affect how people can use resources at their disposal, sometimes

century, as a reaction to the perception of negative effects resulting from suburban zoning. A more complete discussion of land use issues is found in Randall G. Holcombe and Samuel R. Staley, *Smarter Growth: Market-Based Strategies for Land-Use Planning in the 21st Century* (Westport, CT: Greenwood, 2001).

[7] See Dick M. Carpenter II, Lisa Knepper, Angela C. Erickson, and John K. Ross, *License to Work: A National Study of the Burdens from Occupational Licensing* (Washington, DC: Institute for Justice, 2012).

mandating certain activities and other times prohibiting certain activities, for the benefit of some, and to the detriment of others.

Someone who wants to own an aircraft, or own a taxicab, will find institutional limits on the allowable use of one's property. The Food and Drug Administration's regulation of the production of medicines is another example. It takes millions of dollars to bring a new drug to market, pricing out smaller innovators who, if they have a significant innovation, must sell it to a large drug company as the only way to make it feasible to eventually market the new drug. If consumers were allowed to buy any drug they wanted, or any aircraft they wanted, without government's regulatory restrictions, the balance of economic power would be different. For present purposes, whether one views these institutions as desirable or undesirable is beside the point. Economic institutions are often advantageous to some, but disadvantageous to others.

Capitalism, as an economic system, is more than just the interaction of the utility functions of demanders and the production functions of suppliers. Demand and supply in all markets depend on the institutional framework within which demanders and suppliers interact, and that institutional framework is rarely taken into account in the general equilibrium setting within which much economic analysis takes place. These institutions are not just some degree of government intervention overlaid on a market economy. They change the nature of transactions, of incentives to engage in various types of economic activity, and ultimately the nature of the economic system itself. These institutions alter the nature of the economic system to the point where a complete understanding requires recognizing that different institutional settings create qualitatively different types of economic systems.[8]

As John R. Commons observed,

> The common-law and popular notion of property as physical things is, therefore, but an elliptical statement of what common-sense can take for granted without the pedantry of explaining every time that what is meant by property is the *uses* and not the thing. The trouble is that, by using this common-sense notion of uses, not only the courts and business men, but also theoretical economists, pass over from the

[8] See, for example, Masanobu Ido, *Varieties of Capitalism, Types of Democracy, and Globalization* (London: Routledge, 2012), which analyzes differences in economic and political institutions by country. Japanese capitalism is not the same as Italian capitalism, to take two examples that have chapters devoted to them in the book. Political systems are similarly differentiated. It is not just that some countries are more democratic than others, but also that democratic institutions vary in fundamental ways from country to country, with effects that shape the economy. Torsten Persson and Guido Tabellini, *Political Economics: Explaining Economic Policy* (Cambridge, MA: MIT Press, 2000) undertake an extensive analysis of the effects of different democratic institutions on economic policy.

significance of "uses" in the sense of producing an increase in the supply of goods, to its exact opposite meaning in the business sense of an increase in the power of owners to command goods from other persons in exchange. The one is *producing power* which *increases* the supply of goods in order to increase the quantity of use-values; the other is *bargaining power* which *restricts* the supply of goods in proportion to demand, in order to increase or maintain their exchange value. Bargaining power is the willful restriction of supply in proportion to demand in order to maintain or enlarge the value of business assets; but producing power is the willing *increase* of supply in order to enlarge the wealth of nations.[9]

Commons is observing the substantial influence that institutions have over the terms under which people can voluntarily agree to transact with one another in the market, explicitly recognizing that supply and demand depend on institutions. Even in the most primitive of societies, institutions, often informal, determine who has ownership rights over property, and as market economies advance, institutions that determine how people can acquire, use, and dispose of property also become more complex. The law of nuisance, which says that people cannot use their property in ways that create nuisances for their neighbors, evolves into zoning and land use regulations, noise ordinances, licensing requirements, and even discriminatory restrictions that prohibit some people from using their property in ways that are allowed by their neighbors. Restrictions on entry into various markets or even outright grants of monopoly franchises to companies, are common and widely accepted.

The economist's depiction of an institution-free general equilibrium leaves out the institutions that must be present for a market economy to operate. There must be some mechanism in that general equilibrium economy to prevent fraud and theft, and more fundamentally, to define property rights so people know what is theirs to trade, and know that sellers have the right to sell what they are offering. This is true in the most basic market economy in which people are completely free to trade what they own, but in a more advanced economy that has regulated prices, regulations on what is allowed to be sold, financial disclosure requirements for publicly traded corporations, and even the ability to organize as a limited liability corporation, the institutions of capitalism play a large role in determining the outcomes it produces.

It is not the case that capitalism is essentially the product of mutually agreeable exchanges which are then modified by institutions. The markets within which those exchanges take place could not exist without a set of

[9] John R. Commons, *The Legal Foundations of Capitalism* (Madison: University of Wisconsin Press, 1924), pp. 20–21, italics in original.

institutions to support them. Geoffrey Hodgson notes that "This does not simply mean that the state is necessary to correct 'market failures' or that empirically the role of the state has been important. The state was vital to bring capitalism into being and is needed to sustain its existence."[10] He goes on to observe that capitalism "requires special forms of state"[11] that protect property rights, preserve rule of law, and that has internal checks and balances. Hodgson's view is that capitalism cannot exist without government institutions to support it. Those institutions tend to evolve along with the evolution of the economy, with a tendency to evolve into political capitalism.

The law as it applies to financial markets has a huge influence on economic activity, but an influence unseen by most of the general public. The law as it applies to real estate is more apparent, especially to those who own property. Zoning laws and more comprehensive land use planning dictates how people can use their property, regulatory restrictions further limit what types of businesses can operate in specific areas, and property taxes represent another constraint on property use.[12] Economic outcomes are heavily influenced by the legal and institutional environment in which people interact. It is not only that they make the economy more efficient or less efficient, but that they also convey advantages to some and impose disadvantages on others.

THE LIMITED LIABILITY CORPORATION: AN EXAMPLE

A clear example of an economic institution that affects both aggregate welfare and the relative well-being of individuals is the limited liability corporation. It greatly facilitates the raising of equity financing for commercial purposes, shifts control of the wealth within a corporation away from owners toward corporate managers, and allows those managers to take risks with other people's money that they might be reluctant to take on with their own.[13]

[10] Hodgson, *Conceptualizing Capitalism*, pp. 7–8.

[11] Hodgson, *Conceptualizing Capitalism*, p. 10.

[12] In my home state of Florida, agricultural property is taxed at a significantly lower rate than residential or commercial property, even when the residential or commercial property has no structures on it. This leads land owners who are holding property for future development to engage in agricultural activities on the property that they might otherwise leave unused, grazing cattle, or establishing tree farms. Tree farms are especially popular because once the trees are planted, little maintenance or oversight is needed until the trees are harvested decades later.

[13] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New Brunswick, NJ: Transaction Publishers, 1932).

Limited liability facilitates the raising of funds by enabling corporate officers to sell shares to many smaller investors, many of whom would not be willing to invest if they were personally liable for the corporation's debts beyond what they had invested. Firms can grow larger faster than they could in the absence of limited liability. Limited liability shields corporate managers from some potential negative consequences of their actions, shifting the costs to others, even as it allows them to amass more economic power by attracting funds from those who would be reluctant to invest without the shield of limited liability. Limited liability also enlarges the separation of ownership from control, because limited liability means owners – stockholders – have less at stake.[14] The shift in economic power that arises because the law enables limited liability corporations is but one example of the way that institutions shape the economic environment.

The separation of ownership from control in a limited liability corporation means that owners have no say in the day-to-day operation of a corporation. Though corporate officers can choose to become part-owners by buying stock, owners only have the power of collectively voting on who controls the corporation, and often voting on other matters as well. But as individuals, owners have no control over the corporations they own. Larger shareholders have some leverage over management because they have more voting power, but smaller shareholders have nearly the same incentives to be rationally ignorant as do voters in political elections. The only mitigating factor is that shareholders can sell their shares, unlike constituents in political settings. This provides an incentive to become informed, and perhaps an incentive to sell shares (or buy more), but little incentive to vote those shares, excepting again larger shareholders.

The separation of ownership from control opens up the possibility of opportunistic behavior on the part of corporate executives. They can use their positions as decision-makers in a corporation to transfer resources from owners to themselves. Corporate law brands this as self-dealing and makes it illegal for corporate officers to use their positions for personal benefit at the expense of shareholders. Self-dealing is illegal for anyone with fiduciary responsibility, such as a trustee or attorney. But drawing the line on what constitutes self-dealing is not entirely clear in a system in which corporations can grant their officers stock options and in which directors – who are closely connected to officers – determine the salaries of the officers.

[14] Geoffrey M. Hodgson, *Conceptualizing Capitalism: Institutions, Evolution, Future* (Chicago: University of Chicago Press, 2015), pp. 226–230, discusses the evolution and effects of the limited liability corporation.

Are laws against self-dealing reasonable? Are they overly strict, or too lax? For present purposes, the relevant fact is that those laws exist, and because they do, the institutional structure facilitates widespread investment in the shares of publicly traded corporations, as well as the establishment of trustee relationships in a variety of situations. Capitalism would be different if there were no laws against self-dealing, or even if the laws against self-dealing were different from those that actually exist. Institutions such as this that affect the nature of the economic system are rarely considered explicitly in economic analysis.[15] When they are analyzed, analysts look at them one institution at a time, without taking explicit account of the broader institutional structure. Looking at the institutional framework as a whole, it is apparent that institutions determine the nature of the economic system, and that different people are advantaged under one set of institutions relative to another.

The corporate form also allows the corporation to have an indefinitely long life. Owners and corporate officers can come and go as the corporation lives on. Owners can sell their shares to personally divest from a corporation, which requires a stock market that brings with it another set of institutions that can facilitate – or interfere with – investment in corporations. Different financial markets require different degrees of financial disclosure for listed companies, another institution that can affect the profitability of investments and the amount of investments.

The larger point is that the institutions that stand between the utility functions of demanders and the production functions of suppliers define the nature of the economic system. The limited liability corporation, and all the rules that govern it, is but one example of an institution that people have designed, and that has evolved over time, that affects not only the overall productivity of the economy but also the distribution of wealth and power in the economic and political system. The limited liability corporation is not a spontaneous creation in the evolution of capitalism; it is a legal innovation that is the result of human design, interjected into the economy by government, with rules enforced by government.

[15] The issue of agency cost is discussed extensively in the literature on institutional economics. A key early article is William H. Meckling and Michael Jensen, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (1976), pp. 305–360.

INTELLECTUAL PROPERTY: ANOTHER EXAMPLE

The concept of intellectual property illustrates the influence of institutions over economic outcomes. Unlike physical property, for which the use by one person typically precludes the use by others, the use of an idea by one person does not preclude its use by anyone else. If someone has a guitar and another person takes it, the first person no longer has use of the guitar. But if someone writes a song and another person sings it, this does not preclude the songwriter from singing it too. Once written, everyone who knows the song can sing it without depriving anyone else of the opportunity to sing it. If someone develops a new way of designing a guitar and builds one with that new design, if another person takes that newly designed guitar, the original builder no longer has use of the guitar. But if someone observes the new design and copies the design for their own guitar, the original designer has not been deprived of the use of the new design.[16]

There are solid arguments for and against patent and copyright protection of ideas. On the one hand, once ideas exist it is costless for others to use them, so patent and copyright protection creates monopoly ownership over an idea solely as a result of government enforcement. Economists normally believe that monopolies are inefficient, and in the case of intellectual property, the government creates and enforces the monopoly. On the other hand, the possibility of such protection creates an incentive to innovate, offering an efficiency argument going in the other direction. Further, if someone develops an idea, fairness implies that the developer be able to profit from the effort. The degree to which the government should grant and enforce intellectual property rights – or whether intellectual property deserves any government protection at all – can be debated. The point is that any institutions that do so will convey advantages to some and disadvantages to others.

Information as a commodity has characteristics different from physical goods. If one person sells information to another, the seller still has the information. Conversely, the buyer of information has no way of knowing its value until the information is transferred and the buyer has it. But if the buyer already has it, there would seem to be no reason to purchase it. Patent and copyright laws commodify information because a seller can sell the exclusive right to use it, precluding the seller from using it, and the

[16] An example is the Buzz Feiten guitar tuning system, which was patented in 1998. Guitar builders and owners must license the system from Buzz Feiten if they want to use it, even though without patent protection the design would be easily copied once potential copiers saw the system in operation.

seller can disclose the information to the buyer while still preventing the buyer from using it if it is patented or copyrighted. While it is possible that these institutions could develop through private contract, what if one party sells information to another, and later discovers a third party using it? Did the third party independently discover it? Did one of the parties to the transaction violate the nondisclosure agreement and share it with the third party, or sell it to the third party? Patent and copyright law addresses these problems by stating who has the right to use information, regardless of how they came to acquire it.

From the perspective of political capitalism, there is no reason to take sides on the question of whether people should be able to patent or copyright their ideas. The point is that whether they can will convey benefits to either those who develop the ideas or those who want to use the ideas of others. Institutions influence economic outcomes. Following United States law, people can patent or copyright, among other things, computer programs, business plans, photographs, music, and books. People cannot patent or copyright fashion designs or culinary recipes. If someone writes a computer program, it can be copyrighted so that others cannot use it without the permission of the copyright holder. If a restaurant owner designs a great new recipe for seafood, the owner has no legal protection and anyone can legally copy it. If someone writes a song, the songwriter can copyright it so that nobody else can play it in a commercial setting without paying royalties to the song's author.[17] If someone designs a new fashion, as soon as it is shown to the public, other firms can begin producing knockoffs because fashions cannot be patented or copyrighted.

If someone designs a new medicine in a laboratory, it can be patented. If someone designs a new recipe in a kitchen, it cannot. In the twenty-first century, one issue has been high and rising prices of medical drugs. These high prices are the result of a combination of institutions. One is patent

[17] Even this is not quite true, because copyright owners register their musical compositions with music licensing organizations like BMI and ASCAP, who then collect royalties from users of copyrighted music and distribute it via a formula to copyright holders. The formula is related to actual use of the music but does not directly correspond with it, because it is infeasible to directly measure how often a particular composition is played. For example, clubs that host musical performers pay royalties, but exactly which compositions are played in those clubs is not compiled. The point here is that even though there are institutions that provide intellectual property rights to composers, the actual institutions that collect royalties affect the amount of royalties collected. Some composers will be overcompensated relative to the amount their music is played while others will be undercompensated. If measurement were done differently, composers would receive different shares from the royalties the licensing organizations collect.

protection, which grants the patent holder monopoly rights to produce the drug. The system is designed so that the owner of the idea has a monopoly and can charge monopoly prices. Another is the growth of third-party payer systems, so that neither the patient taking a drug nor the doctor prescribing it pays the cost of its use. The combination of price-insensitive buyers and sellers with legal monopolies produces higher drug prices than would exist if drugs, like culinary recipes, could not be patented, and if drugs, like restaurant meals, were paid for directly by the consumers. And, defenders of the patent system would point out, without patent protection, many drugs that have expensive development costs would never be produced. The point is not to either praise or condemn these institutions, but to point out how institutions affect economic outcomes.

In the twenty-first century user interfaces can be patented, which has led to disputes between developers of computer hardware who claim competitors have violated their patents through unauthorized copying of their user interfaces. Imagine the situation if user interfaces had always had patent protection. The original automobiles were designed to be steered using a tiller, but it appears that Alfred Vacheron first used a steering wheel in 1894. The innovation was rapidly copied so that within a few years all automobiles used them.[18] Imagine the situation at the turn of the twentieth century if user interfaces could be patented, so that the standard arrangements of gas, brake, and clutch pedals became the intellectual property of one manufacturer, along with various types of steering devices. Each manufacturer would likely have developed their own user interfaces, slowing standardization of controls in automobiles and making it more difficult for drivers to transition from one type of automobile to another. Whether user interfaces should be patentable is beside the point. To allow it provides benefits to some and imposes costs on others.

In some cases the American legal system conveys ownership rights to the developers of ideas, if the ideas are embodied in a computer program or a song. In other cases it does not, if the ideas are embodied in a fashion or a recipe. This is but one example of the way that legal institutions convey benefits to some at the expense of others. To assign a right to one party takes away a right from another. If recipes can be patented, then restaurant owners would be deprived of the right to use their kitchen equipment to follow those recipes. To give the right to the developer of the recipe takes away a right from other restaurant owners. If songs can be copyrighted,

[18] Information on the innovation of the steering wheel is from Wikipedia. Regardless of whether it is correct, the automobile user interface provides a good example.

then to give the right to the author deprives other musicians from using their musical instruments to play those songs. Should a songwriter have the right to prohibit (without payment) a guitar owner from using his guitar to play a song the guitar player knows? The point is that without copyright on music, the musician has the right; with copyright, the songwriter has the right.[19]

ECONOMIC PROGRESS AND INTANGIBLE PROPERTY

As capitalism evolves, an increasing share of wealth is held as intangible assets. Rights to intangible assets are more difficult to define and more difficult to protect than rights to tangible assets. A textile mill owner in 1800 could see the boundaries of his property, could contract to buy the materials and labor to have the physical plant built, and if necessary could hire security guards to protect his clearly identifiable property. Rights to property were closely associated with physical property. In the twenty-first century, the bulk of capital ownership is in shares of publicly traded corporations. The rights of actual owners are defined in securities law, and there is no clear association of ownership with physical property.

In August 2017 the General Electric Company had a market capitalization of $221.5 billion. Someone who owned $1 million in General Electric stock would own 0.0000045% of the company. The stockholder could not point to any physical property she owned, nor would ownership convey to her the right to use any physical property. Following securities law, she would have the right to vote her shares when the company sent out proxy ballots and would have the right to sell those shares. And, as noted earlier, she would have limited liability for any actions taken by the company.

Bill Gates became the wealthiest person in the world because he owned a substantial share of Microsoft, a company he cofounded, and Microsoft was able to prosper because patent and copyright laws gave the company ownership rights over its intellectual property, so the company could sell software to buyers who could have easily made copies for themselves had Microsoft's software not been given government protection through those laws. What, exactly, did Bill Gates own? The bulk of Microsoft's wealth was

19 As already noted, this oversimplifies the actual institutions governing composers' rights to the music they have composed, because composers register their music with performance rights organizations like BMI and ASCAP, which collect royalties for them.

in intangible property that was valuable only because government designed its laws to protect it.[20]

What does Warren Buffet, CEO and largest shareholder of Berkshire Hathaway, own? Berkshire Hathaway is a conglomerate that owns several companies outright, including BNSF Railway, Lubrizol, and Flight Safety International. It also owns substantial shares of the Coca-Cola Company, IBM, and Apple Computer. While all the individual companies Berkshire Hathaway owns do own physical property, Buffet's wealth is in intangible property – Berkshire Hathaway stock – that has control over those physical assets. Buffet's control over those physical assets comes from his role as the company's CEO, not from his ownership.

What one can own, and what rights an owner has, is increasingly defined by humanly designed laws and institutions as capitalism matures. Intangible property has value only because of the institutions that define it and the rights that ownership to it conveys. The advances of capitalism have seen an ever-increasing share of wealth embodied in intangible property, which means that increasingly sophisticated institutions must be designed to define and enforce ownership rights. This applies mostly to capital. While rules do define and limit ownership rights to land and labor, as capitalism advances, capital is held less and less as physical property and more and more as financial assets that have only an indirect connection to the physical assets underlying the financial assets.

Thus, the evolution of capitalism naturally leads to an increased role for government to define what people can own, especially in the area of intellectual property, and what rights owners actually have. One can envision a rancher carrying a rifle into his pasture to protect his ownership of his herd, but it is difficult to envision the owners of General Electric stock engaging in any comparable activity to protect their ownership of shares in the company. Growth of the regulatory state seems an unavoidable by-product of capitalist development. Growth of the budgetary state may occur because wealthier societies demand more government goods and services, or because democratic politics allow citizens to vote themselves larger transfers. These are by-products of the income growth that capitalism brings. The growth of certain aspects of the regulatory state appears to be directly a by-product of the more

[20] Some might argue that private contracts could serve the same purpose, but the substantial amount of software "piracy" that exists even with government copyright protection indicates that the market value of software is derived mainly from its copyright protection.

sophisticated ownership structures that create the intangible property that underlies capitalist development.

As government gains an increasing control over the definition and enforcement of economic rights, it is natural that those who control the process will write the rules to their benefit, and will choose like-minded individuals to adjudicate the rules.[21] This may be attributable to selfishness and greed on their part – personal characteristics that critics are prone to associate with capitalist institutions – but people naturally tend to see things through their own eyes and tend to perceive their interests to be the public interest. It stands to reason that those who hold the reins of government power will tend to use it to their advantage, meaning that if more complex market arrangements require increased government oversight, market capitalism will have a tendency to evolve toward political capitalism as capitalism evolves.

The advance of capitalism brings with it growing government design and enforcement of an increasingly complex set of economic rights, which naturally are controlled by the elite. Indeed, what defines them as the elite is their power to write and enforce the rules. By definition, there is no escape from control by the elite, because the elite are those who control the system. The American Founders sought to control the power of the elite through constitutional constraints on the scope of government and checks and balances so that some elites would have the power to constrain others. Setting aside for the moment how effective these constraints can be, it would appear that because the role of government to define and enforce rights grows as capitalism matures, those constraints also would have to be increasingly effective as capitalism matures. Otherwise, capitalism evolves into political capitalism.

INSTITUTIONAL EVOLUTION

As capitalism evolves, institutions evolve along with it, sometimes to facilitate new types of transactions and other times to prevent transactions from taking place. Think of the evolution of payment systems from cash to checking accounts to credit cards to electronic fund transfers, which bought along institutional changes developed by banks and other private sector financial institutions, but also brought with it financial regulation as government both facilitated advances and regulated the allowable

[21] An elaboration of this argument appears in Randall G. Holcombe, “The Economic Theory of Rights,” *Journal of Institutional Economics* 10, no. 3 (September 2014), pp. 471–491.

activities. The Progressive Era regulation of railroads, featured in Kolko's analysis of political capitalism, is an example of institutions that evolved as a result of economic progress. They placed unprecedented restrictions on the terms of voluntary exchanges, restricted competition, and gave government the power to dictate many of the terms under which transactions were allowed.

Economic advancement requires a set of institutions that facilitates production, innovation, and exchange. Those institutions necessarily become more complex as economic activity becomes more complex. Hernando de Soto's account of factors that keep less-developed economies from advancing leans heavily on an institutional structure that creates ambiguous property rights, that does not adhere to rule of law, and that places heavy regulatory barriers on those who want to start a business or enter a market.[22] In contrast, Mancur Olson describes what he calls market-augmenting government: a set of institutions that protects property rights, enforces rule of law, enforces contracts, and provides a stable and predictable environment that enables economic activity with a long time horizon.[23] Some institutions foster economic growth; others hinder it. Olson notes that institutions purposefully designed by government are important elements in fostering prosperity. In Olson's view, government has an important role to play.

Echoing Olson's view on the interaction between capitalism and government, Geoffrey Hodgson says "capitalism, property, money, markets, and corporations typically depend on, and are partly constituted by the state."[24] He goes on to note, "The central role of the state within capitalism means that we must address politics as well as economics."[25] Predating Olson and Hodgson, Adam Smith argues, "The acquisition of valuable and extensive property, therefore, necessarily requires the establishment of civil government."[26]

As capitalism evolves, government institutions play an increasingly significant role. Some might argue that government is not necessary, and

22 Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper & Row, 1989), and *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).

23 Mancur Olson, Jr., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

24 Geoffrey M. Hodgson, *Conceptualizing Capitalism: Institutions, Evolution, Future* (Chicago: University of Chicago Press, 2015), p. 7.

25 Hodgson, *Conceptualizing Capitalism*, p. 11.

26 Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937 [orig. 1776]), p. 670.

institutions can be developed privately to facilitate the advances of capitalism. Government banking regulation may not be necessary if privately developed institutions can accommodate the changes in payment systems that have accompanied the evolution of the economy. But government regulations were put into place, perhaps because advances in payment systems could not be made without them, or perhaps because the elite who were in a position to redesign institutions to facilitate their interests did so. Whether government institutions were necessary, in banking or anywhere else, is beside the point when those who hold the power of the regulatory state implement them when they see fit.

An informal economy can run without government support, or as de Soto describes in the case of Peru's informal economy, despite government impediments to economic activity. But de Soto also notes that economic advancement is limited without productive government institutions. Market-augmenting government institutions must evolve to support the ever more complicated economic transactions that characterize modern capitalism. In a setting where government defines and enforces property rights, adjudicates disputes, and regulates the terms under which economic transactions can occur, a more complex market economy brings with it more complex government institutions to regulate it. Setting aside whether government is necessary to develop new institutions to accompany a more complex capitalism, government in fact designs and alters institutions in response to an evolving economic system.

Economic growth brings with it more complex transactions, and more transactions that are not self-enforcing. In an increasingly information-driven economy, government creates property rights in information that would not exist otherwise. Thus, government enforcement of property rights and of contracts requires a larger and more sophisticated government. The growth of a capitalist economy brings with it a growth of government. One can conjecture that all of the functions of government could, in theory, be undertaken by market institutions; private police, private arbitration in place of government courts, private production of infrastructure.[27] In fact, throughout the world

[27] See, for examples advocating this type of orderly anarchy, Murray N. Rothbard, *For a New Liberty: The Libertarian Manifesto* (New York: Macmillan, 1973) and David D. Friedman, *The Machinery of Freedom: Guide to Radical Capitalism* (Chicago: Open Court Publishing Company, 1973).

these institutional functions are the province of government.[28] A more complex economy requires more complex government institutions to provide the parameters within which voluntary exchange takes place. As the scope of government expands with the economy, growing government lays the foundation for political capitalism to displace market capitalism.

History suggests that the devolution of capitalist economies may be more the result of the growing influence of the elite rather than any necessity of the growth of the regulatory state as capitalism matures. Market economies thrived in Iraq from 500 AD to 1100, in Northern Italy from 1000 to 1500, and in the Netherlands from 1100 to 1800, and in all cases saw the market institutions eventually erode and standards of living fall.[29] The evidence appears more consistent with Olson's interest group theory in his *The Rise and Decline of Nations*[30] than with any necessity for the regulatory state to expand in response to the evolution of capitalism.

MARKET-AUGMENTING GOVERNMENT

Economists have provided a good accounting of institutions that foster prosperity and economic growth. The Economic Freedom of the World (EFW) index, produced annually by the Frasier Institute, was designed to quantify economic freedom, with the idea that the measure of economic freedom can then be used to gauge the effects of economic freedom.[31] A subsequent literature using the EFW index has shown that its level is strongly correlated with the level of per capita income in a country and that the change in a country's index is strongly correlated with a change in per capita income. Increases in a country's EFW index lead to increases in that country's income.[32] Thus, the components of the EFW index can be used

[28] For my view on the feasibility of orderly anarchy, see Randall G. Holcombe, "Government: Unnecessary But Inevitable," *Independent Review* 8, no. 3 (Winter 2004), pp. 325–342.

[29] Solid evidence is provided by Bas van Bavel, *The Invisible Hand? How Market Economies Have Emerged and Declined Since AD 500* (Oxford: Oxford University Press, 2016).

[30] Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

[31] James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World 2014 Annual Report* (Vancouver, BC: Fraser Institute, 2014).

[32] See Niclas Berggren, "The Benefits of Economic Freedom: A Survey," *Independent Review* 8, no. 2 (Fall 2003), pp. 193–211, Jakob De Haan, Susanna Lundstrom, and Jan-Egbert Sturm, "Market-Oriented Institutions and Policies and Economic Growth: A Critical Survey," *Journal of Economic Surveys* 20, no. 2 (April 2006), pp. 157–191,

as a good description of the institutions of market-augmenting government.

The EFW index is compiled from five broad areas, with 42 different subareas. The five broad areas are size of government, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulation of the economy. As measures of economic freedom, those areas are relatively straightforward.

Smaller government means more economic freedom. Lower taxes, lower government expenditures, and less reliance on government enterprises mean that people are able to engage in economic activity with less government interference.

Legal structure and security of property rights is a key element, because if property rights are not secure, people have less of an incentive to maintain or increase the value of their property. The extreme case would be government confiscation of property, a phenomenon not unknown around the world. Legal structure means rule of law – a legal system in which everyone is subject to an objective set of laws. The relationship to political capitalism is especially clear in this component. Without rule of law, some are treated more favorably than others, giving people an incentive to devote their entrepreneurial activities toward gaining government favoritism rather than engaging in economically productive activity.

Access to sound money means having a domestic currency that is stable in value. Low inflation, and low variance across time in the inflation rate, means that people have less uncertainty and less concern about losing value of their monetary assets. Access to sound money also includes allowing domestic residents to own and trade in foreign currencies. This component of economic freedom also facilitates productive economic activity so is a component of market-augmenting government.

Freedom to trade internationally also is an obvious element of economic freedom and, economists would argue, an important element in producing prosperity. Trade allows people to specialize and enhance their productivity, creating more wealth for everyone. While most economists support this idea, it has less support among the general public, who perceive domestic jobs lost to foreign producers while not seeing that they get enhanced

James Gwartney, Robert Lawson, and Randall Holcombe, "Economic Freedom and the Environment for Economic Growth." *Journal of Institutional and Theoretical Economics* 155, no. 4 (1999), pp. 643–663, and James Gwartney, Randall Holcombe, and Robert Lawson, "Economic Freedom, Institutional Quality, and Cross-Country Differences in Income and Growth," *Cato Journal* 24, no. 3 (Fall 2004), pp. 205–233, for supporting evidence.

consumption opportunities, a more productive domestic economy and greater exports, which is where foreigners spend their money when they sell into domestic markets, and where foreigners get the funds to invest in the domestic economy.[33] The policies of political capitalism are in part founded on the anti-trade bias people hold, which supports policies promoted by domestic companies to limit foreign competition through tariffs, quotas, and regulatory barriers. Looking at trade policy specifically, the general public tends to support policies that protect the economic elite from foreign competition; in other words, the general public often supports policies that reinforce political capitalism.

Regulation of credit, labor, and business is clearly a component of economic freedom, in that all regulations are designed either to force people to do things they otherwise would choose not to or prohibit them from doing things they otherwise would choose to do. If people would voluntarily choose to do as regulations mandate, there would be no reason for the regulations. Chapter 7 discussed in detail how the regulatory state fosters political capitalism, but as with free trade, popular opinion often sides with the regulatory state for various reasons, including curbing the abuse of concentrated economic power. The regulatory state lies at the very foundation of political capitalism.

Taken as a whole, the EFW index is strongly correlated with prosperity, both the level of income and economic growth, so its components might be judged as the components of market-augmenting government. Taking the components of the index individually, each component is also strongly correlated with prosperity, with one exception: the first component – size of government. The highest-income countries tend to have larger governments, as measured by their taxes and expenditures, than lower-income countries.

There are several possible reasons why more prosperous countries tend to have larger governments. One is that poorer countries are less able to collect tax revenues, and there are again several reasons why. First, poorer countries tend to have larger informal sectors, making it difficult for governments to track and tax economic activity. In the corporate world, where most income is paid to employees by employers, it is easier to force employers to report employee incomes and to withhold taxes from employee paychecks. Employers find it difficult to avoid these

[33] See Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton: Princeton University Press, 2007) for a discussion of the way popular opinion diverges from the views of economists on the advantages of international trade.

requirements, because it would take only one disgruntled employee to report a violation of the tax laws. When people are self-employed, or working for cash, taxes are easier to evade. A second reason is that citizens of a higher-income country can afford to pay a greater percentage of their incomes in taxes, and may be more inclined to do so, to support a larger social safety net.

Another reason why more prosperous countries tend to have larger governments is that those more prosperous countries do, in fact, tend to spend more on redistribution. A few core functions of government, including the provision of infrastructure, military and police services, courts, and education, tend to make up 10 to 15 percent of Gross Domestic Product in most countries. The higher level of government spending in more prosperous countries is almost entirely transfer payments.[34] Among prosperous countries, however, those with larger governments tend to have slower economic growth.[35] It appears that an increase of about 10 percentage points in government spending as a share of GDP results in about a 1 percentage point reduction in a country's economic growth rate. For example, a country with government spending at 55 percent of GDP would have about 1 percent lower economic growth than a country with government spending at 45 percent of GDP. Considering that an economic growth rate of 3 percent would be a good growth rate for a developed economy and 4 percent would be excellent, a 1 percentage point reduction in the rate of economic growth is substantial.

Even though more prosperous countries tend to have larger governments, the evidence suggests that big government does not cause prosperity, it is the result of prosperity. This leads to yet another reason why government may be larger in more prosperous countries. Referring to the previous section, economic growth may naturally bring with it more government growth. This is not inconsistent with the other possible reasons why there tends to be a positive correlation between prosperity and size of government across countries. The components of the EFW index correlate strongly with prosperity, with the notable exception of government size.

If economists have such a good idea of the market-augmenting institutions that lead to prosperity, why have countries not implemented those

[34] James Gwartney, Randall Holcombe, and Robert Lawson, "The Scope of Government and the Wealth of Nations," *Cato Journal* 18, no. 2 (Fall 1998), pp. 163–190.

[35] This also is documented in Gwartney, Holcombe, and Lawson, "The Scope of Government and the Wealth of Nations."

institutions? While there is widespread agreement among economists that the institutions in the EFW index give a good indication of public policies that would increase prosperity, it is easier to identify those institutions than it is to change the institutional structure to conform with them. If making the change was easy, it would already have been done.[36] Daron Acemoglu notes that while there are potential efficiency gains from institutional improvement, institutions in poor countries often do not improve because despite overall gains, the elite would suffer losses, and it would be difficult to come up with institutional changes that would make everyone better off.[37] The elite implement institutional changes, after all, and if changes could not assure benefits to those who have the power to change them, institutional improvement is unlikely to occur.

Most economists would agree that the EFW index is a good indicator of productive institutions, and the consensus opinion of both economists and the general public has moved in that direction since the collapse of the Berlin Wall in 1989 followed by the breakup of the Soviet Union in 1991. As late as the 1980s many prominent economists argued the merits of central economic planning over a market economy, but those arguments have fallen by the wayside. Arguments for government intervention in the economy now are oriented toward controlling the abuses of capitalism, not replacing it with socialism, as Chapter 2 explained. But while the capitalism–socialism debate has been essentially settled, there has been little recognition that another economic system – political capitalism – threatens market capitalism. The institutions of political capitalism are not the institutions of market-augmenting government.

CONCLUSION

Economists have not sufficiently recognized the way that institutions tilt the playing field to the advantage of some over others. While there has been widespread recognition that institutions may work to the advantage of a privileged few, there has been almost no recognition of the fact that economic outcomes in general are substantially influenced by the institutional framework, not just the utility functions of consumers and the

[36] That is the theme of Mancur Olson, Jr., "Big Bills Left on the Sidewalk: Why Some Nations Are Rich, Others Poor," *Journal of Economic Perspectives* 10, no. 2 (Spring 1996), pp. 3–24.

[37] Daron Acemoglu, "Why Not a Political Coase Theorem? Social Conflict, Commitment, and Politics," *Journal of Comparative Economics* 31, no. 4 (December 2003), pp. 620–652.

production functions of producers. The ability of individuals to form limited liability corporations provides a good example. At first glance, this institution does not seem to fit the case of tilting the playing field to favor some over others, but the fact is that some people are much better off because of it. Similarly, laws giving ownership rights to intellectual property, or zoning laws to govern land use, do not appear to be biased or unfair on the surface (although they can be opportunistically applied to benefit those who exercise government power). These examples illustrate that a different set of rules, even if they are objective, apply to everyone, and satisfy the definition of rule of law, will produce different outcomes.

As an economy becomes more complex, a more complex set of rules and more complex monitoring and enforcement mechanisms are required to support the economy. Cattle farmers can look over their pastures and see whether any of their herd is missing. Stockholders in widely held corporations may have only a vague notion of what they actually own, and without a sophisticated set of institutions could be in a position in which corporate management could appropriate the wealth of the corporations for themselves. Of course, if this were easily possible and a frequent occurrence, people would not buy stock in corporations, and that business form would not be viable. In large part, the institutions that enable publicly traded corporations are government-designed and government-enforced. Cattle farmers can take on a large part of protecting their property themselves. Owners of corporate stock need third-party definition and enforcement of property rights, and government takes on those roles. As capitalist institutions evolve, government institutions evolve along with them, and government activity becomes more comprehensive and more complex. Most people have a good idea about what police departments do. Fewer people understand what the Federal Trade Commission or the Securities and Exchange Commission do.

A more complex economy brings with it a more complex government, and when it is more difficult for citizens to understand exactly what government does, it becomes easier for those who exercise the power of government to do so for their own benefit. There are factors inherent in the maturing of capitalism that facilitate the evolution of capitalism into political capitalism.

10

Public Policy and Political Capitalism

In the nineteenth century, when economics and politics were studied together as political economy, the connection the academic discipline saw between the economy and public policy was more obvious and more explicit than when the discipline divided into economics and political science at the beginning of the twentieth century. As the twentieth century progressed, the effects of public policy became increasingly more distant from the economist's depiction of the economy. The lack of institutional content in the standard models economists use for policy analysis was discussed in the previous chapter. Equilibrium in those models is generated by balancing those consumer preferences against supplier production functions, with no explicit recognition of institutions or public policy.

Economists do use these models to analyze public policy, but they do so by starting with a general equilibrium setting and then assuming a single change in public policy to see its effect. Essentially, the method is to start with a status quo, assuming that the status quo is an equilibrium, make one change in the model which represents the policy to be analyzed, and see the effect of that change. While this method can be useful for examining the effect of one policy change, it does not take into account the effects that other existing policies and institutions have on determining the characteristics of the initial status quo.[1] And more significantly for the study of political capitalism, this method does not analyze the political feasibility of

[1] For a critique of this methodology, see Meir Kohn, "Value and Exchange," *Cato Journal* 24, no. 3 (Fall 2004), pp. 303–339. Furthermore, as noted by R. G. Lipsey and Kelvin Lancaster, "The General Theory of Second Best," *Review of Economic Studies* 24, no. 1 (1956), pp. 11–32, a policy that might result in an improvement in welfare under some initial conditions may not under alternative initial conditions. This Lipsey and Lancaster critique of welfare economics has not been sufficiently taken into account, but is of secondary importance to the main message of this chapter.

the policy under examination. Economic analysis shows the effects of policies, if those policies were enacted, but enacting them falls under the heading of political science, and there is no assurance that the policies recommended as optimal by these models could actually be implemented. Essentially, this method is designed to tell policymakers, "Here's the optimum; you figure out how to get there."

Consider some standard examples of economic policy analysis. An industry creates an externality – a common example is air pollution created by the industry's factories – and the model shows that placing a corrective tax on the externality equal to the external cost can increase welfare.[2] Or, for goods that are joint in consumption, the standard model shows that markets will underproduce them, and also shows the optimal quantity to produce which, if government produces it, can increase welfare.[3] The models purport to show, with no explicit institutional content, that reliance on the market will produce a suboptimal outcome, and that there is a welfare-enhancing outcome that, in theory, the government could produce.

The economics discipline calls this situation in which there is a theoretically better outcome market failure. Theoretical welfare economics, a branch of economics that purports to analyze how well-off people are,[4] derives the conditions for a welfare-maximizing allocation of resources, and calls anything prevents the economy from arriving at that

2 This is the standard Pigouvian remedy, suggested by A. C. Pigou, *The Economics of Welfare* (London: Macmillan, 1920), although Pigou recognized the practical difficulties of implementing this policy that would be optimal in theory. See also James M. Buchanan, "Politics, Policy, and the Pigouvian Margins," *Economics* n.s. 29, no. 113 (February 1962), pp. 17–28 for an example showing how the standard Pigouvian solution could decrease welfare. Buchanan's demonstration is a special case of the more general point by R. G. Lipsey and Kelvin Lancaster, "The General Theory of Second Best," *Review of Economic Studies* 24, no. 1 (1956), pp. 11–32.

3 The classic articles, with the classic model, are Paul A. Samuelson, "The Pure Theory of Public Expenditure," *Review of Economics and Statistics* 36 (November 1954), pp. 387–389, and "A Diagrammatic Exposition of a Theory of Public Expenditure," *Review of Economics and Statistics* 37 (November 1955): 350–356. The first article's title implies this is *the* theory of public expenditure. Samuelson received some criticism for the title, resulting in a less definitive title for the follow-up article.

4 A complete critique of welfare economics would divert attention from the point being made here, which is that it may not be possible, in reality, to arrive at the outcome which is optimal in theory. However, the benchmark of Pareto optimality that welfare economics uses is likely not optimal anyway, because in the real world welfare is improved as a result of continual economic progress, not by arriving at some static Pareto optimal outcome. This line of reasoning is more fully developed in Randall G. Holcombe, *Entrepreneurship and Economic Progress* (London: Routledge, 2007) and *Producing Prosperity* (London: Routledge, 2013).

theoretical optimum a market failure.[5] The implied premise is that if the market fails, there is room for government to step in to fix the market failure. Economists show mathematical conditions for the theoretical optimum without demonstrating that there are any real-world policies that could attain that optimum. This presents a high bar for the market, and as James Buchanan notes, once the implied premise is stated explicitly, there is no reason to believe the government can reach this theoretical optimum just because the market does not.[6] Markets may not be perfect, as theory defines perfect, but governments are not perfect either.

As noted in the previous two chapters, this problem is not limited to practitioners of abstract economic theory. Many people, when they see problems, argue that the government should do something about them, imagining what an omniscient benevolent government might do rather than what a real-world government actually will do. The idea that if things are not ideal the government should enact policies to make them so is promoted by the general public and by academicians who make careers out of designing policies that, in theory, would improve the world. One problem is that the theoretical world in which most of them live is governed by an omniscient benevolent dictator who always does what their theories suggest, but the real world is not.

Two major impediments to actually producing outcomes that are welfare-enhancing in theory are information and incentives. Policymakers do not always have access to the information that the model shows would be required to implement the optimal policy, and even if they do, they do not always have the incentive to implement it. Looking at these two examples of externalities and joint consumption goods, there is no way to know in practice what would be the optimal tax on an externality, or what would be the optimal quantity of a public good to produce. Both depend on the unobserved preferences of individuals (in the first case, the utility loss people

[5] The theoretical foundations for welfare economics, found in Pigou's *The Economics of Welfare*, were further developed in the 1950s and 1960s. Two articles summarizing the theory at the time, both by Francis Bator, are "The Simple Analytics of Welfare Maximization," *American Economic Review* 47, no. 1 (March 1957), pp. 22–59, and "The Anatomy of Market Failure," *Quarterly Journal of Economics* 72, no. 3 (August 1958), pp. 351–379. Those articles continue to be descriptive of welfare economics into the twenty-first century.

[6] James M. Buchanan, "Public Finance and Public Choice." *National Tax Journal* 28, no. 4 (December 1975), pp. 383–394. A more serious critique of welfare economics is that it ignores the factors that actually increase welfare – the factors that produce economic progress. See Randall G. Holcombe, *Producing Prosperity* (London: Routledge, 2013) for a further development of this idea.

suffer because of the externality; in the second case, the value individuals place on consuming the public good), and there is no mechanism by which policymakers can discover those preferences.[7] Policymakers could not implement the theoretically optimal policies in these cases if they wanted to, because the information required to do so is not available to them, Perhaps more important for the theory of political capitalism, a major part of the subdiscipline of public choice shows that the incentives facing policymakers often lead toward policies that reduce rather than enhance welfare.[8]

The separation of economics from political science has turned economic policy recommendations into wishful thinking. Economists show policymakers the optimal policies, and hope they will implement them, leaving the task of implementation to the sister discipline of political science – an impossible task if the information to implement the optimal policies is unavailable. Even with that information, an understanding of political capitalism shows that not only do policymakers not necessarily have an incentive to implement optimal policies, their incentives are to design policies that benefit themselves and their cronies – the elite – often at the expense of the masses.

The previous chapter explained that different rules will favor some relative to others, which is true whether those rules are government policies or rules in sports. When the three point line was introduced into the National Basketball Association in 1979, the rule change obviously worked to the advantage of shooters who were more accurate shooting from the outside, and to the advantage of teams that had more of those outside shooters. Similarly, in economic policy, the way property is defined, the regulatory environment, and the way rules are enforced affect

[7] Recognizing the issue, economists have looked for mechanisms that can reveal consumer preferences. An interesting example is found in T. Nicolaus Tideman and Gordon Tullock, "A New and Superior Process for Making Social Choices," *Journal of Political Economy* 84, no. 6 (December 1976), pp. 1145–1159.

[8] For example, government production of national defense is often justified because national defense is a public good and individuals have an incentive to free ride, so national defense will be underproduced in the market. Therefore, government steps in to produce the optimal amount. But note the different assumptions this justification makes about public sector versus private sector behavior. It assumes private sector individuals are self-interested so they free ride, while public sector individuals are public spirited so they do what's best for everyone rather than looking at their own interests. Assuming people's motivations are the same in the public and private sectors, it is more likely that governments produce national defense because it benefits those in government, as explained in Randall G. Holcombe, "Why Does Government Produce National Defense?" *Public Choice* 137, nos. 1/2 (October 2008), pp. 11–19.

different people's economic well-being differently. This is true even if there is no bias or favoritism in the creation or enforcement of the rules. There is an important difference, however, between economic policy and rules for sports leagues. With economic policy, those who define and enforce the rules are also "players" who stand to gain if the rules are slanted toward them. The rules are not designed by all of the players, however, but by that elite subset in the low-transaction cost group who can design rules to benefit themselves – perhaps at the expense of those in the high-transaction cost group who have no say in determining the rules but must abide by them nonetheless.

This is why the system works to the advantage of those who hold political power, and this is how capitalism can evolve into political capitalism. Even when good intentions underlie the design of public policy, those with political power have the incentive to conspire with those who have economic power to see that the rules are designed and enforced for their benefit. Giving those with political power the discretion to design rules that might further the public interest gives them the power to design rules that further their own interests. Recognition of this fact underlies the motivation for constitutional limits on government power.

Over time, people's views of government have evolved so they fear the power of government less and are more inclined to view government as benevolent. When government policies turn out to be counterproductive, citizens often ask for more government intervention to rectify the results of counterproductive policies.[9] This gives still more power to the elite, and builds a firmer foundation for political capitalism.

PROGRESSIVE PUBLIC POLICY

Chapter 8 described how the acceptance of Progressivism laid the political foundation for political capitalism. The political ideology upon which the United States was founded viewed the role of government as protecting the rights of individuals. The Progressive ideology that developed in the late 1800s expanded that vision of government not only to protecting people's rights but also to look out for their economic well-being. Progressivism took hold as a political ideology as the economy industrialized and a new economic elite, often labeled Robber Barons, gained more wealth in a generation than was ever possible previously. The good intentions behind

[9] This is the theme of Sanford Ideka, *Dynamics of the Mixed Economy: Toward a Theory of Interventionism* (London: Routledge, 1997).

Progressive Era policies were to control the economic power of concentrated interests so they could not take advantage of those with less economic power.

The working class in the first century of the Industrial Revolution lived a difficult life, as the writings of Malthus, Ricardo, Mill, and Marx showed. Even the proponents of capitalism saw their struggles. Things improved for the working class during the Progressive Era, not necessarily because of Progressive policies, but the lives of the working class improved nonetheless. As national income increased thanks to the productivity of capitalism, the masses wanted protection from the abuses of concentrated economic power, and they wanted government-enforced redistribution to provide economic security for everyone. Those goals seemed reasonable to the masses. People should be protected from the abuse of power, and naturally desire economic security.

Capitalism's apologists[10] will argue that free market competition will control the abuses of economic power, and that the wealth generated by capitalism provides more economic security for everyone than any redistribution program. But significant improvements in the standard of living of the working class and greater economic security for everyone came around the beginning of the Progressive Era, so even capitalism's staunchest supporters cannot argue that the acceptance of the Progressive ideology stopped the advances of capitalism.

The same calls for Progressive policies occur in economies around the world as capitalism's engine moves into high gear. The European welfare states offer examples well-enough known that they do not need an in-depth explanation.[11] In South Korea, which enjoyed phenomenal economic growth beginning in the early 1960s as they implemented an industrial policy that supported certain favored large firms – a good case study for political capitalism – a counter-movement supporting "economic democracy" was launched against industrial policy in the early twenty-first century. The Progressive argument was that Korea's economic policies were slanted to favor the economic elite, and that the economic gains built on the labor of the working class should be shared with them.

[10] For example, Deirdre N. McCloskey, a proponent of capitalism, begins her book *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006), p. 1 by saying "You will find here . . . an 'apology' for capitalism in its American form."

[11] For example, see Richard F. Tomasson, *Sweden: Prototype of Modern Society* (New York: Random House, 1970), who promotes the virtues of Sweden's welfare state at the time when it was beginning to take shape and to grow.

That line of reasoning is not inaccurate. South Korea is probably the country that most closely fits the parameters of political capitalism. Since the 1960s government policy in South Korea has favored a select group of large family-run firms – chaebols – by providing them with favorable financing, by facilitating their importation of inputs for production, by promoting their exports, and by helping them acquire land for their facilities, among other mechanisms. Those chaebols are run by a small group of economic elite with close ties (and accusations of corruption) to those who hold political power. The Korean supporters of economic democracy say that economic policy should shift from favoring the elite to providing a social safety net, educational opportunities, health care, and other benefits for the masses. Economic democracy, in Korea, is a call for Progressive policies to benefit the masses rather than the industrial policy that benefits the elite. Neither side is arguing for limited government, capitalism and free markets. Rather, groups are arguing over which of them should be the beneficiaries of government's economic favoritism.[12] While most of the examples in this book are American, political capitalism is not a uniquely American phenomenon.

The popular response to the institutions of political capitalism, around the world, is the advocacy of Progressive economic policies. The ideology of Progressivism lays the foundation for the growth of political capitalism, something that is rarely recognized by the critics of cronyism. In a pure market economy, interactions among individuals always occur as a result of voluntary exchange. People only engage in economic activities if they agree to them. The Progressive ideology legitimizes the use of force for the economic benefit of some at the expense of others. When the Progressive government can forcibly impose costs on some people for the benefit of others, it is easy to see that those who exercise the power of government are in a position to use that power to benefit themselves. While one would hope that public policies would further the public interest, Progressivism from its beginning has explicitly advocated imposing costs on some for the benefit of others. The challenge for every individual in a Progressive democracy is to participate in the process to design the outcome so that the individual is in the group that receives the benefits, not the group that bears the costs.

[12] I discuss this in Randall G. Holcombe, "South Korea's Economic Future: Industrial Policy or Economic Democracy?" *Journal of Economic Behavior & Organization* 88 (April 2013), pp. 3–13. However, as this book is being written, Koreans on both sides of this debate are recognizing that economic growth is slowing in Korea, and the policy focus has shifted toward creating a more entrepreneurial economy. Even here, however, the debate in Korea is often on how government should intervene to make this happen, rather than on letting the market process play out unencumbered by the visible hand of government.

If members of the political elite want to avoid being in the group that bears the cost, they need to work with others who are in a position to provide them with benefits, and it is easy to see that the economic elite is the group that can produce and share benefits. The poor are not in a good position to provide benefits to the political elite, because they do not have the resources to do so. The economic elite do. Nobody openly says they are redesigning public policy to benefit the rich at the expense of the poor, but many politicians say they are designing economic policies to increase economic growth, or prevent economic calamity. They do not say they are protecting firms from competitors, they claim they are creating jobs. The elite design public policy. High transaction costs prevent the masses from meaningful political participation.

The financial crisis that began in 2008, and that sparked the Occupy Wall Street movement, began when banks were foreclosing on non-performing mortgages, and as a result mortgage-backed securities were losing their value. The government's policy response was to support the Wall Street fat cats who held those securities – the 1 percent – rather than to support the homeowners – the 99 percent – who could no longer pay on their mortgages because the economy had slipped into a recession and they had lost their jobs. They did not say they were protecting the interests of the rich at the expense of the poor; they said they were stabilizing the financial sector to prevent an economic collapse.

While the Occupy protestors objected to policies that bailed out the 1 percent while ignoring the hardships imposed on the 99 percent, the power elite's public interest argument was a variant of the trickle-down argument that everyone would benefit if the government supported the Wall Street elite. Once Progressivism had legitimized the idea that government can further the public interest by benefiting some at the expense of others, the door is opened for government policies that benefit the insiders who design public policy. Regardless of whether the elite's public interest argument on the bailout was true, the direct benefits of the bailout went to the elite, not the masses, as the Occupy protesters noted. Is it realistic to think that policymakers would design policies that would impose costs on themselves? The Progressive ideology legitimizes political capitalism.

THE RELATIONSHIP BETWEEN ECONOMIC GROWTH AND GOVERNMENT GROWTH

If political capitalism is enabled by the ability of the political elite to write the rules in their favor, bigger government should provide the elite with more opportunities to tilt the playing field their way. Many factors cause government to grow as a capitalist economy grows. It bears emphasis that the Progressive ideology legitimizes the actions of people who are involved in the political process to promote policies for their own benefit, and it encourages people to get involved for their own benefit. If one of the roles of government is to look out for people's economic well-being, it is difficult to fault individuals and interest groups getting involved so they can advocate for government policies that would enhance their economic well-being.

A growing economy interacts with the Progressive ideology in two ways. First, a larger economy produces more wealth that can be redistributed. Second, and in line with Progressivism's origins in the late 1800s, it opens up the possibility to argue that those at the top of the income distribution receive their incomes by exploiting those at the bottom, so fairness demands government intervention to rectify an unfair distribution of income. Whether the actual policies achieve their stated goals is an open question. Economic growth combined with a Progressive ideology encourages government to grow as the economy grows.

Mancur Olson offers two distinct reasons why government grows along with economic growth. One, embodied in his *The Rise and Decline of Nations*, is that interest groups become more firmly entrenched over time as the political system matures. The other, found in his *Power and Prosperity*, is that a more complex economy requires increasingly complex government oversight to define institutions, protect people's rights, and provide third party enforcement of contracts. The second argument – the idea of market-augmenting government discussed in the previous chapter – is especially significant to the analysis of political capitalism because while other arguments suggest that government tends to grow over time along with a capitalist economy, the second argument suggests that government must grow to enable a capitalist economy to evolve. A more complex economy requires more government oversight and enforcement.

Growing oversight and enforcement increases the size of the regulatory state, not necessarily the budgetary state. The regulatory state is not costless, but regulatory activities are a small part of most government budgets. The Scandinavian countries provide examples to demonstrate that big government, if interpreted as high levels of government spending as a share of GDP, does not necessarily bring with it a corresponding growth of the regulatory state. While the regulatory state has been growing everywhere, Scandinavian countries have kept their regulatory states in check compared to most other nations, and also are accurately perceived as having less corruption than other nations. This suggests that the regulatory state might be able to controlled even if government grows in other dimensions, and that political capitalism might be kept in check as capitalism evolves.

Regulation, more than other types of government intervention, invites corruption because regulation is explicitly designed either to force people to do things they would not otherwise choose to do or to prevent them from doing things they otherwise would choose to do. Those being regulated naturally have the incentive to try to offer benefits to regulators to lessen the effects of regulation, or to redesign regulations that harm them and pass regulations that help them. A bribe to a regulator benefits both the regulator and the regulated, opening a natural avenue for exchange. These bribes often are legal, pointing to the fine line between corruption and rent-seeking,[13] but that fine line is perhaps only of academic interest when analyzing political capitalism. Indeed, the elite have every incentive to make such payments legal – a part of the rules under which the economy operates – so they can maintain a barrier to entry to enhance their take. A growing economy leads to a growing demand for regulation, which leads to increased attempts by the well-connected to design regulation for their benefit. The result is regulatory capture by those who are regulated.

This in turn results in a demand by the masses for better oversight of the regulatory process, to limit corruption and to limit the rents that regulation confers on the elite. So, regulation produces effects that lead to the demand for more regulation. Regulatory growth leads to the demand for more regulation, which opens the opportunity for more regulatory capture by those being regulated.

As government policies become more complex, partly in response to a more complex economy and partly because new regulations are designed to counteract the unintended consequences of old ones, the political elite become more firmly entrenched.[14] Those who design the regulations deliberately make them ambiguous and subject to interpretation, at least

[13] Toke S. Aidt, "Rent Seeking and the Economics of Corruption," *Constitutional Political Economy* 27, no. 2 (June 2016), pp. 142–157.

[14] Sanford Ikeda, *Dynamics of the Mixed Economy: Toward a Theory of Interventionism* (London: Routledge, 1997) describes how the unintended consequences of government programs lead to the demand for more government intervention, so government growth feeds upon itself and a mixed economy moves further from a market economy toward a government-planned economy. Ikeda's arguments are solid and persuasive, but he does view economic systems as a continuum from market economies to government-planned economies, leaving out the possibility of another dimension in economic systems leading to, not socialism, but political capitalism.

partly because those designers then have some power to interpret them in ways favorable to themselves.[15] At the same time, because of the complexity of those regulations, those in the ruling class believe (probably correctly) that most people do not have the time or inclination to understand the regulatory state, nor are they in many cases capable of understanding the complexities of modern government.

Just as physicists specialize in understanding physics, doctors specialize in understanding medicine, and automobile mechanics specialize in understanding how automobiles work, politicians, lobbyists and others involved in the political process specialize in understanding the complexities of modern government. Just as most people are not capable of understanding physics as physicists do or medicine doctors do, or automobiles as mechanics do, one should not be surprised that the masses are not as capable of understanding the complexities of modern government as those who specialize in government and politics.

Another factor is that the elite believe they are smarter than the masses, so for the benefit of everyone they should be in charge of designing and implementing public policy. They believe that they can make better choices for the masses than the masses can make for themselves.[16] There is always the tendency, with the elite and everyone else, to identify the public interest closely with one's own private interests.

If one of the roles of government is looking out for people's economic well-being, that would mean that government policymakers should design policies that push people to make what the policymakers believe are good choices. Thus, government runs a compulsory retirement program, not leaving it entirely to individuals to plan for their own retirement saving, in addition to anti-smoking campaigns and restrictions on the sales of sugary soft drinks. This is benevolent government, looking out for the well-being of its citizens; yet despite being designed and administered by the intellectual elite, Social Security, Medicare, and pension programs for government

[15] Excellent arguments to this effect appear in Peter Schweizer, *Extortion. How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets* (Boston: Houghton Mifflin Harcourt, 2013).

[16] This argument is made by Lawrence B. Lindsey, *Conspiracies of the Ruling Class: How to Break Their Grip Forever* (New York: Simon and Schuster, 2016). While Lindsey is critical of the idea, Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (New Haven, CT: Yale University Press, 2008) argue that government should enact paternalistic policies because government experts can make better choices for people than they would make themselves. Thaler and Sunstein do not advocate prohibiting what they see as poor choices, but rather designing policies that make the government-preferred choices look more attractive.

employees are running up massive unfunded liabilities that – those same intellectual elites warn – are not financially viable over the long run.

Despite – or maybe because of – the problems exhibited in many government programs, they tend to build on one another, partly based on the idea that the intellectual elite knows better what is in our interest than we ourselves know. Those who are trying to nudge people to make better decisions make the argument that they would make better decisions for the masses than the masses would make for themselves.[17] Otherwise, they would have no basis for trying to substitute their wisdom for the poor decisions they perceive the masses making.

Ironically, those who are most likely to promote the idea that the government needs to make decisions for the masses because they will not make good decisions on their own are also most likely to promote the idea that the masses should choose the public policies that apply to everyone. They argue that public policy should make it increasingly easy for those same people who do not make good decisions for themselves to vote in democratic elections, and hold the Progressive idea that democratic government carries out the will of the people. The masses who are not competent to make personal decisions for themselves should determine public policy that applies to everyone.

Another hypothesis that connects government growth to economic growth is that economic growth causes the average income to rise faster than the median income. This is the case because there is a lower bound on income but no upper bound, so the tail of the income distribution will expand more in the upper part of the distribution than the lower part. If democratic decision-making represents the preferences of the median voter, and if the median voter has the median income, the benefit to the median voter from voting for redistribution increases as the average income increases relative to the median. Political pressures increase government redistribution which causes government growth.[18]

[17] See Thaler and Sunstein, *Nudge*.

[18] The idea that aggregate voter preferences in democratic decision-making are the preferences of the median voter is explained well by Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957). The hypothesis that economic growth increases the difference between the median and average income, leading voters to favor increased redistribution, is explained by Alan H. Meltzer and Scott F. Richard, "A Rational Theory of the Size of Government," *Journal of Political Economy* 89, no. 5 (October 1981), pp. 914–927.

William Baumol offers yet another argument for bigger government in response to income growth. Government production tends to be more labor-intensive than market production, and because labor productivity grows more slowly than capital productivity, productivity growth is slower in the public sector than in the private sector.[19] Economic growth, which is largely the result of increased private sector productivity, means that consumption increasingly shifts toward private sector consumption, away from government goods and services, unless an increasing share of the monetary value of economic output is devoted toward government. Because citizens have demands for government output, the preferences of citizens and voters are for government's share of the economy to grow, to offset its slower productivity growth. Government should grow because people want it to grow, according to Baumol, and he concludes that government has not grown fast enough. It is too small and has inadequately responded to these citizen preferences.

The ratchets hypothesis offers yet another explanation for government growth, in this case explaining why government tends to grow over time. When crises occur, people demand government action to respond to them and government ratchets up in size. After a crisis passes, government shrinks back down, but not to its former level, so the size and scope of government ratchet up in response to crises, becoming ever larger after crises pass.[20] The ratchets hypothesis, like Olson's interest group hypothesis, implies that government tends to grow over time, independent of economic growth.

There are many theories that try to explain why government grows, and why it has grown so much since the beginning of the twentieth century. As government grows, those who have the power to design public policy accumulate more power to enact policies that apply to everyone. Elite theory concludes that the elite who make public policy will use their power to implement policies that differentially benefit the elite, so the economic and political system shifts toward political capitalism. Those who have political power inevitably use it for their own benefit.

[19] See William J. Baumol, "Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis," *American Economic Review* 57, no. 3 (June 1967), pp. 415–426. He applies the same idea in "Health Care, Education, and the Cost Disease: A Looming Crisis for Public Choice," *Public Choice* 77, no. 1 (September 1993), pp. 17–28.

[20] See Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (Oxford: Oxford University Press, 1987).

EVALUATING THEORIES OF GOVERNMENT GROWTH

Some theories of government growth, like Olson's interest group theory and Higgs' ratchets hypothesis, hypothesize that there is a tendency for government to grow over time. Other theories are more directly linked with advances in capitalism. Olson's market-augmenting government hypothesis, Meltzer and Richard's hypothesis that the growing spread between median and average income leads the median voter to demand bigger government, Baumol's hypothesis about differing productivity growth in the public versus private sectors, and even the Progressive ideology insofar as it has responded to the changes that capitalism has brought to the economy, point toward the idea that capitalist economic development brings with it government growth.

All of these theories could have some explanatory power. Accepting one does not rule out the simultaneous operation of others. Public policy recommendations for limiting political capitalism may differ, however. If certain factors tend to cause government to grow over time, perhaps those factors, once recognized, can be controlled. If economic growth and the maturing of capitalism necessarily brings with it larger government, addressing the problem might be more difficult, especially if capitalist evolution implies growth of the regulatory state. If the increasing complexity of a maturing capitalist economy requires more regulatory oversight, public policy must go beyond just thinking about larger or smaller government and must address specific government activities. The oversight that market-augmenting government provides is a part of the regulatory state, and the regulatory state is the part of government that is most prone to cronyism.

Note also that any ideas about creating policies to limit government growth assume that is a desirable outcome. Many people think that government should be larger, not smaller, and that the regulatory state should exert more oversight over market activities. This means that there will be both political pressures for bigger government from those who believe that way and ideological arguments opposing government retrenchment. Some of the political pressure will come from those who are differentially favored by specific government policies – the bootleggers – but the ideological component from the Baptists may be more significant. If people view the government as a benevolent caretaker that looks out for people's economic well-being, reducing the size of government can easily be viewed as hard-hearted and selfish. It is easy to argue that if government is not acting as people hope it should, the answer is to fix it, not to abolish it. One role of the theory of political capitalism is to show why fixing it is a difficult proposition.

In the twentieth century, economists often differentiated mature economies from developing, economies, or with slightly different terminology, developed economies and less-developed economies. Characterizing economies this way naturally evokes an image of mature or developed economies as in some type of stable situation. Capitalism is depicted as an end state that results when economies mature.[21] The theories of government growth that associate it directly with economic growth paint a different picture, in which capitalism is not a stable outcome, but is an evolving economic system, and this volume explains why there is a tendency for capitalism to evolve into political capitalism. Economic growth leads to government growth, and in particular, growth of the regulatory state, which gives the elite who design public policy more power to design it for their own benefit.

THE WAR OF IDEAS

The manifestations of political capitalism are widely recognized, sometimes under the label of crony capitalism, sometimes under the label of corporatism, but often without any label at all. As Ralph Nader observed, people throughout the political spectrum, from far left to far right, have been critical of the influence of special interests over the political process and the way that the well-connected few are able to steer public policy to their advantage.[22] Nader argues that these critics will join together to form an unstoppable coalition that will oppose the ruling elite, but while Nader's observation that there is widespread opposition from one end of the political spectrum to the other appears correct, there is no similar widespread agreement on what should be done to combat those perceived problems.

At least in part, this is because there is minimal recognition that what those critics are objecting to is a distinct economic system that has emerged from the market capitalism of the nineteenth century. Karl Marx, in *Das Kapital*, was a critic of market capitalism, arguing that capitalism enabled the owners of capital to exploit labor because the capitalists owned the

[21] Francis Fukuyama, *The End of History and the Last Man* (New York: Free Press, 1992) has been mentioned in this regard, though this book is not a part of the development economics that characterized economies as mature or developed.

[22] Ralph Nader, *Unstoppable: The Emerging Left–Right Alliance to Dismantle the Corporate State* (New York: Nation Books, 2014).

means of production.[23] But prior to *Das Kapital*, Marx and Engels argued in *The Communist Manifesto* that the elite – the bourgeoisie – had captured the political system and were designing public policy for their benefit.[24] Without using the name, Marx and Engels were objecting to the system of political capitalism.

Marx presented socialism as the alternative to capitalism, which meant government ownership of the means of production and government direction of economic activity. Into the twentieth century, the debate on economic systems was capitalism versus socialism, with mixed economies lying somewhere in between. Because political capitalism was not recognized as a distinct economic system (except perhaps to the degree that fascism was viewed as a distinct system), the twentieth-century taxonomy examines the problems of political capitalism within the capitalism to socialism continuum, without recognizing political capitalism as a distinct economic system that is not a mixed economy somewhere between capitalism and socialism. Political capitalism is not partly a market economy and partly a government-directed economy, it is a system in which the well-connected are able to design economic policy for their benefit by erecting barriers to those who would compete with the elite.

If economic systems are evaluated from within the framework of the capitalism to socialism continuum, and if cronyism, corruption, and favoritism are viewed as characteristics of capitalism, as Marx viewed them, then the natural inclination is to move along that continuum from capitalism toward socialism; that is, to move toward more government control of the economy. He apparently was not concerned that giving the government that acts as an agent for the bourgeoisie more power would further serve the interests of the bourgeoisie. Understanding political capitalism as a separate system that does not lie between capitalism and socialism highlights the dangers of giving the political elite more power over economic activity.

Private ownership of the means of production, a defining feature of capitalism, is also a defining feature of political capitalism. A move from capitalism to socialism would imply a shift from private to government ownership of the means of production. In political capitalism, private ownership of the means of production provides the mechanism through

[23] Karl Marx, *Capital* (Chicago: Charles H. Kerr & Company, 1906).
[24] Karl Marx and Friedrich Engels, *The Communist Manifesto* (New York: International Publishers, 1948 [orig. 1848]).

which the economic elite benefit. Profits flow to the assets they own. They profit as a result of government policies that protect their economic interests. Political capitalism is distinctly different from socialism. A move toward socialism moves away from private ownership of the means of production whereas political capitalism is built on the private ownership of the means of production.

Contemporary economics depicts a mixed economy, somewhere between a market economy and central economic planning, and searches for the optimal point on that continuum. In the twenty-first century, nobody argues for a completely unregulated economy. A minimal state would contain the features of market-augmenting government, to use Mancur Olson's term. This optimistic view of market-augmenting government sees government as a benevolent institution that protects and guides market activity. The concept of market-augmenting government implies that a market economy works best for everyone. Arguments supporting the other end of the spectrum ended after the collapse of the Eastern European communist countries and the breakup of the Soviet Union. Nobody argues for complete government ownership of the means of production and control of economic activity. The framework for the contemporary policy debate is finding the right amount of government control over a primarily market-based economy.

On this issue, those on the political right argue that government is the problem, and the appropriate policy response is less government.[25] But the argument of the right is not that government creates the institutions of political capitalism, but rather that it is an inefficient drag on economic activity. There is little recognition of the gains that accrue to the elite. On the left, critics argue that unfettered capitalism is the problem and that as the economic system – and especially its financial component – grows more complex, more government oversight is needed to control the negative side effects of political capitalism. More government oversight is the Progressive response, dating back to the origins of Progressivism as a means to control the Robber Barons.

The views of Joseph Stiglitz and David Stockman have been drawn on in past chapters to illustrate the general agreement on the problem, and the lack of agreement on how the problem should be addressed. Both see the problem as caused by elites using their influence to design the rules of the game – the economic and political institutions – for their benefit, but

[25] I have made this argument in Randall G. Holcombe, "Crony Capitalism: By-Product of Big Government," *The Independent Review* 17, no. 4 (Spring 2013), pp. 541–559.

neither analyzes the problem within the framework of economic systems. Nobody does in the twenty-first century. The problem is viewed as elite interference with a market economy, or maybe problems inherent with the market economy itself,[26] rather than identifying political capitalism as a distinct economic system that has evolved out of capitalism.

The positive element in this debate is that there is widespread agreement on the problem, or perhaps just widespread recognition of its symptoms, even if there is substantial divergence in the proposed solutions. One way to move ahead to try to achieve some consensus on the solutions is to better identify the nature of the problem. The issue is not that we have a mixed economy and should pursue the optimal mix of market allocation versus government oversight. Political capitalism is a distinct economic system that does not fit on that continuum between capitalism and socialism. A big budgetary state does not necessarily bring with it a big regulatory state, and even this broad distinction illustrates that it is an oversimplification to talk about big government. Political capitalism is more related to what government is doing rather than how big it is.

There is a long-standing debate on the relative influence of ideas versus interests in the determination of public policy. John Maynard Keynes ends his book *The General Theory*, published in 1936, by saying,

> I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, Indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.[27]

Taking Keynes's argument a step further, Dani Rodrik observes that the objectives of political interest groups are subject to change, and subject to the influence of ideas.[28] Their preferences can change, their views on how the world works can change, and their views on what they can do to effect policy changes can also change. Rodrik's main argument is that economists should take the influence of ideas more seriously because they can influence the activities of political interests, but the optimistic corollary is that

[26] In attributing the problems to the nature of capitalism, Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge; Harvard University Press, 2014) is a prime example.

[27] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace and Company, 1936), pp. 383–384.

[28] Dani Rodrik, "When Ideas Trump Interests: Preferences, World Views, and Policy Innovations," *Journal of Economic Perspectives* 28, no. 1 (Winter 2014), pp. 189–208.

good ideas triumph over bad. While one might hope for this to be the case, the conflicting ideas of Adam Smith and Karl Marx have remained influential for centuries. Lawrence White frames the clash of economic ideas as largely a debate between government planning and free markets, and the debate is far from settled.[29]

The theories presented in the previous chapters – theories of rent-seeking, regulatory capture, and most obviously, interest group politics – emphasize the influence of interests over the political process, but those theories do not negate Keynes's view that over the long run, ideas are more influential than interests. Deirdre McCloskey optimistically makes the argument that the remarkable prosperity produced by capitalism was initiated by ideas rather than a host of other factors (investment, inventions, geography, institutions) that are credited by some.[30] Less optimistically, in the 1940s Friedrich Hayek and Joseph Schumpeter lamented that that the ideas of socialism were winning out over the ideas of capitalism, despite capitalism's merits.[31] Schumpeter asks the question "Can capitalism survive?" and answers "No, I do not think it can."[32] Schumpeter argues that despite its merits, those who benefit the most from capitalism will not take a stand to support it.

The failed experiments with Marxism in the twentieth century show that ideas do matter, and in much the manner that Keynes described. By the time they were tried, Marx's ideas were not the newest, but they were persuasive enough that more than a century ago some were willing to try them, and well into the twenty-first century, despite more than a century's worth of evidence that those ideas lead to impoverishment, people are still attracted to them. With such widespread opposition to the manifestations of political capitalism, Nader predicts an unstoppable movement to overturn the system. Ideas do matter, and the first step is to understand that what so many across the political spectrum are opposed to is the distinct political and economic system of political capitalism.

The characteristics and manifestations of political capitalism have been recognized, but political capitalism as a distinct economic system has not.

29 Lawrence H. White, *The Clash of Economic Ideas: The Great Policy Debates and Experiments of the Last Hundred Years* (Cambridge: Cambridge University Press, 2012).

30 Deirdre N. McCloskey, *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (Chicago: University of Chicago Press, 2016).

31 Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), and Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 2nd edn. (London: George Allen & Unwin, 1947).

32 Schumpeter, *Capitalism, Socialism, and Democracy*, p. 61.

The theory of political capitalism does not have to be built from the ground up, because the previous chapters have shown that its components are already well established in the academic literature. What is left to be done is to connect them together to build a coherent theory of political capitalism. Ideally, readers of all persuasions will recognize political capitalism as a distinct and problematic set of institutions and come to a consensus on how political capitalism can be controlled, but the goal of this volume is more modest: just to convince readers that political capitalism is indeed a distinct economic system. It is not capitalism with government oversight, it is not a mixed economy, and it is not a movement toward socialism. If this argument is convincing, the next step is to analyze how it can be controlled.

BUSINESS MUST PARTICIPATE

Schumpeter's lament that those who benefit most from market capitalism will not stand up to defend it identifies one of the characteristics of political capitalism. Businesses must participate. They must cooperate with policy-makers to receive favorable treatment, or they will be run out of business by those who do. Within political capitalism the profitability of business depends on the political advantages they receive from the political elite, so businesses cannot decline to participate in the transactions of political capitalism and hope to survive. Businesses that object to the favoritism and cronyism inherent in political capitalism will be left out of the exchange, and will likely be the target of government policies that would harm them.

John Allison, when he was CEO of BB&T bank during the financial crisis in 2009, recounts that banking regulators threatened his bank with retaliatory regulation if his bank did not agree to participate in the government's bailout program.[33] Regulators noted that when they were talking with Allison, his bank currently met all the regulatory requirements and were adequately capitalized. But, they said, regulations were subject to review, and they told Allison that unless he participated in the bailout program, there was doubt as to whether his bank would be in compliance with the new, and yet-to-be-determined, regulations. The threat was clearly implied that if his bank did not participate, regulations would be designed that would be disadvantageous to his bank. Despite his preference not to, Allison went along with the regulators to prevent harm to his business.

[33] John Allison, *The Financial Crisis and the Free Market Cure* (New York: McGraw-Hill, 2013).

Following Schumpeter's argument, when businesses lobby, they do not lobby for freer markets and greater competition. They lobby for tax and regulatory advantages that will benefit their businesses and hinder their competitors. They have to. The most obvious part of this is that businesses can improve their profitability by using the power of government to protect them from the competition of other firms and solidify their places in their markets. This has been recognized by businesses since the mercantilist policies promoted in capitalism's earliest days.[34] Lobbying for policies that benefit all businesses will cost the lobbying firm but will not give it any competitive advantage. But political capitalism offers a stronger reason not to lobby for freer markets. Such lobbying opposes the cronyist system that benefits both the political and economic elite. Opposing the system that favors the elite not only will not get that firm targeted benefits, it will create opposition by the elite who control policy and is more likely to generate retaliation against any firm that bucks the system.

When the profitability of businesses depends on their participation in the system, firms have to participate or find their profitability dwindling until they are pushed out of business. The firms that survive are those that conspire with the political elite. Political capitalism drives dissenters out of business. The idea that cronyism and corruption are the consequences of bad people misusing the system misrepresents the nature of political capitalism. The system may, indeed, provide incentives for unethical people to use it,[35] but everybody must respond to the incentives inherent in the system, or be eliminated by those who do. The problem is the incentives within the system, not the people who respond to those incentives.

AGREEMENT ON THE PROBLEM, BUT NOT ON THE SOLUTION

Everyone, from the general public to political pundits to academic researchers, sees the symptoms of political capitalism, but there is no agreement on what causes them, partly because the symptoms have been identified as causes. The solution to corruption is to step up enforcement. The solution to cronyism is to throw out the cronies. Attacking the symptoms without having a clear understanding of the cause can result

[34] Robert B. Ekelund and Robert D. Tollison, *Mercantilism as a Rent-Seeking Society* (College Station: Texas A&M Press, 1982) provide an excellent analysis of the political demands for protectionism centuries ago.

[35] Hayek notes reasons why the worst get on top in Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

in a poor diagnosis of the cure. That is why it is important to recognize that when considered as a whole, there is a widespread body of theory in the social sciences that, when connected, identifies political capitalism as the cause.

If one sees a person with a fever and diagnoses the problem as a high temperature, a possible remedy would be to dunk the person in cold water to lower the person's temperature. Meanwhile, if the fever is caused by an infection, the person will continue to suffer from the infection, possibly until the infection results in death. Treatment with antibiotics might be more successful, but that would be the result of looking past the symptom, the fever, to find the infection as the underlying cause.

Those who see corruption, cronyism, and public policies that favor the elite over the masses, and interpret those symptoms as causes, will be tempted to see the solution as passing laws against cronyism and corruption, and redesigning public policies to benefit the general public. Those solutions will not work, because they are addressing the symptoms rather than the causes. Ludwig von Mises was critical of social reformers who did not understand the social laws and interdependencies that created economic and political systems, saying

> They did not search for the laws of social cooperation because they thought that man could organize society as he pleased. If social conditions did not fulfill the wishes of the reformers, if their utopias proved unrealizable, the fault was seen in the moral failure of man. Social problems were considered ethical problems. What was needed in order to construct the ideal society, they thought, was good princes and virtuous citizens. With righteous men any utopia might be realized.[36]

Mises said that the discovery of the laws of economics overthrew that opinion, but his conclusion may have been too optimistic. Critics continue to argue that the system can be reformed with better leaders and more virtuous citizens. Hillary Clinton, running for President of the United States in 2016, referred to the supporters of her opponent Donald Trump as "a basket of deplorables," implying that virtuous citizens would choose her as President. Meanwhile, Trump himself continually referred to his opponent as "lying Hillary," again questioning whether she fit the bill as a good prince, or princess in this case. An understanding of political capitalism shows that the problem is not the lack of virtue of the princes and citizens, but rather the incentives that are inherent in political capitalism as a political and economic system.

[36] Ludwig von Mises, *Human Action: A Treatise on Economics*, Scholar's Edition (Auburn, AL: Ludwig von Mises Institute, 1998), p. 2.

Good intentions are not all that is required to reverse the effects of political capitalism. Indeed, one of the most enduring lessons from Adam Smith's *The Wealth of Nations* is that in a market economy, individuals pursuing their own interests are led by an invisible hand to do what is best for everyone.[37] Capitalism is a system in which people pursuing their own interests further the interests of everyone, but political capitalism is a system in which the visible hand of government leads people to use the powers of government to their own advantage, and to the disadvantage of others. Identifying political capitalism as a distinct system points toward addressing the symptoms that are generally reviled by attacking the underlying causes of those symptoms.

REVERSING THE SYMPTOMS OF POLITICAL CAPITALISM

Political capitalism is a system in which the elite use the power of government to benefit themselves. The idea that more government oversight can reduce the abuses of political capitalism rests on the notion that there is some way to design a political system such that the power of those in government can effectively be checked. The American Founders sought this type of check in two ways. First, they designed a constitutionally limited government with enumerated powers and specified that the federal government has only those powers specifically enumerated in the Constitution. Second, they designed a government with three branches designed to check and balance each other. The idea was that if one branch of government tried to overstep its constitutionally limited boundaries, the other branches would have the power to prevent that overreach, and would have the incentive to do so to protect their own constitutionally granted powers. The Founders envisioned a government run by elites, but by designing three branches, the elites holding government power would check each other.

This system has worked tolerably well for centuries, but it has been continuously eroded because the constraints built into the Constitution have gradually eroded. The executive branch has expanded beyond just executing the laws written by the legislative branch into using its regulatory powers to create its own laws. Agency rule-making and executive orders

37 Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937 [orig. 1776]) uses the "invisible hand" phrase on page 423, but perhaps expresses the idea more clearly on page 14 where he says, "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest."

not only encroach on legislative functions, but go well beyond the powers enumerated in the Constitution. The legislative branch has often been complicit in this expansion, writing vague laws subject to executive agency interpretation to shift public criticism away from the legislature, and often with the intention of having agency rule-making go beyond a literal reading of the legislation that enables it. Meanwhile, the judicial branch has become increasingly willing to render decisions that go beyond just defining the law to mandating public policy. The constitutional constraints that once limited the power of government, and therefore the power of elites to use government to their advantage, have slowly eroded, resulting in political capitalism.

The increasing reach of government has assisted the development of political capitalism, and those who argue that more government is the remedy have not offered any solid reasons to think that additional government powers would not also be channeled to benefit those who wield them. Many suggestions for increasing government oversight to control political capitalism embody increasing discretion for those who exercise the power of government. Additional discretion means additional power to the elite, who can use that power to further their own ends. Consider Stiglitz's observation that the elite are writing and enforcing the rules for their own benefit, at the expense of the masses. If the problem is that the elite are using government power for their own benefit, would a good remedy be to give them more power? Would it be a good remedy to give them more discretion?

Another general approach to controlling the power of government is more democratic oversight. This idea goes back at least to Andrew Jackson, elected to the presidency in 1828. The Democratic Party was created specifically to elect Jackson, and the party's name is very appropriate to Jackson's ideas. He believed the country was being run by elites for their benefit even then, and his remedy was to have the check on government come from its citizens, not from different branches within the government itself.[38] The United States has become much more democratic since Jackson's time, by expanding the franchise and by expanding the role of democratic elections to choose who controls the nation's government, but more democratic oversight has not kept the elite from controlling the system.

As Chapter 8 explained, originally the Constitution specified that Senators were chosen by their state legislatures, and the 17th

[38] Jackson's ideas are discussed in more detail in Randall G. Holcombe, *From Liberty to Democracy: The Transformation of American Government* (Ann Arbor: University of Michigan Press, 2002), Chapter 5.

Amendment, ratified in 1913, changed the method of selection to citizen voting for Senators. Originally, the electoral college was designed to insulate the selection of the president from democratic voting by having electors participate in an electoral college that cast votes for president. While early in the nation's history electors were often chosen by the state legislatures, by the time Andrew Jackson was elected, the current system of popular voting for electors was used in almost every state.[39] Also, over the centuries, the franchise has continually been expanded. The 15th Amendment to the Constitution was designed to prohibit racial discrimination, the 19th Amendment was designed to extend the franchise to women, and the 26th Amendment extended the right to vote to those eighteen years old and older. Constitutional amendments have expanded the right to vote to more people, and people have gained the right to vote directly for Senators and the President.

Giving all citizens an equal right to vote is a good thing. The problem is not an expansion of the franchise itself, but the ideology that went along with it: that democratically electing those who hold political power implies that those who hold that power should therefore carry out the will of the majority. The increase in democratic oversight goes hand-in-hand with the development of the Progressive ideology that views the role of government as carrying out the will of the people, as expressed through democratic decision-making. Over time, the United States has become much more democratic, but that check of the voters on the power of those who run the government has been ineffective. As the right to vote has been expanded for the masses, the power of the elite to create public policy has also grown. As the nation has become more democratic, political capitalism has become more entrenched – because of the widespread view that democratically elected governments embody the views of the voters.

Political capitalism allows the elite to use government power for their benefit, and those who argue for more government – more government oversight, more government programs, more government regulations – have not offered a coherent explanation for how increasing the scope and power of government to constrain the problems of the existing government can succeed. Arguing for more government to control the abuses of government amounts to wishful thinking – the hope for good princes and virtuous citizens – and the analysis of how political capitalism actually

[39] South Carolina, the last state to move to popular voting for presidential electors, did not have popular voting in presidential elections until after the Civil War.

works points away from expanding government as the solution to a system in which the elite control the government for their own benefit.

If the problem is elite abuse of government power, the obvious remedy is to reduce the power of government, which would reduce the power of the elite to use government for their benefit. The constitutionally limited government designed by the American Founders, with elites checking and balancing each other to maintain those constitutional limits, would reduce the opportunity for those who hold that power to use it for their own advantage.

THREE CHALLENGES TO LIMITING THE POLITICAL POWER OF THE ELITE

One challenge to limiting the political power of the elite is that the elite are the policymakers, and therefore they control the mechanisms through which institutional changes can be made. Those who control the power of government, and who use it to their benefit, will not want to give it up. Both sides of the ideological debate – those who see the solution as more government oversight and those who see it as reducing the scope of government – must recognize this as a problem. How can the system be reformed if those who have the power to change it are those who benefit from the status quo?

One answer rests on the power of ideas. If sufficient popular opinion sides against the elite control of the political and economic systems for their own benefit, democratic political institutions will push for change. This is the basis for Ralph Nader's *Unstoppable* hypothesis. But widespread agreement on the problem is not sufficient. Reform will require widespread agreement on the solution, which leads to the second challenge.

A substantial share of the general population supports bigger government to address public policy that is slanted to favor the 1 percent. The analysis in this volume leans the other way, concluding that government is the problem, not the solution. The second challenge, then, lies in forging an agreement on how political capitalism can be controlled and reversed. Again, the answer appears to lie in the power of ideas. The purpose of this volume is to frame the problem in such a way that the solution becomes more apparent to more people.

A third challenge is that the evolution of capitalism may naturally lead to the establishment of the institutions of political capitalism. A more complex economy requires more complex rules and more oversight and third-party enforcement, which means increases in government power. This challenge is not one of ideology or ideas, but one of institutional design.

Can institutions be designed to limit the ability of those who exercise the power of government to do so for their own benefit? If not, it may be inevitable that capitalism evolves into political capitalism.

The policy challenge is perceptively framed in the title of James M. Buchanan's book, *The Limits of Liberty: Between Anarchy and Leviathan*.[40] Without the market-augmenting government discussed in the previous chapter, an economy in anarchy will be necessarily primitive, but a government with sufficient power to define the rules and protect individual rights may also have the power to become a Leviathan government that slants the rules in favor of those who have the power to write them. With governments everywhere growing, anarchy does not seem to pose an immediate threat. The threat of Leviathan is that those who write the rules design them to further their own interests.

This was taken for granted until a few hundred years ago. In monarchies and dictatorships, those who hold the power of government intend to write rules to further their interests, and the masses recognize that they are the subjects of the elite. Political capitalism pushes democracies back in that direction, but without the explicit recognition that the system is being run by the elite for their benefit. The ideology of Progressive democracy is built on the idea that government carries out the will of the people and looks out for their economic well-being. This is the idea that needs to be challenged to limit political capitalism.

CONCLUSION

If the causes of political capitalism lie in the abuses of concentrated economic power in a capitalist economy, then analyzed within the twentieth-century view of economic and political systems that depicts a continuum of policy options between a pure market economy and complete government control of the economy, the appropriate policy response would be to move in the direction of more government control. If political capitalism is a distinct economic system in which the political and economic elite design public policy for their benefit, then the appropriate policy response is to constrain and reduce the power given to the elite rather than increase it. Two different views of the problem give two very different public policy recommendations. Ideas are important because designing an effective public policy to limit political capitalism requires an understanding of its causes.

[40] James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: University of Chicago Press, 1975).

11

Is Political Capitalism Inevitable?

Political capitalism appears to have become more pervasive in the twenty-first century, or at least, more widely recognized. This may be due to the clash of ideas in the twentieth century, between capitalism and socialism, democracy and dictatorship, that depicted political and economic systems as lying somewhere between those extremes. That taxonomy left no room for political capitalism as another possibility.[1] Within that framework, the symptoms of political capitalism were interpreted as the result of corrupt governments, or even as characteristics of capitalism itself.

As this is being written in the second decade of the twenty-first century, the news media frequently reports on cronyism and corruption around the world. In Peru, former president Alejandro Toledo has been accused of accepting bribes in exchange for construction contracts, a decade after former Peruvian President Alberto Fujmori was convicted of abuse of power and corruption. In Brazil, more than 80 members of the economic and political elite have been accused of taking kickbacks paid to politicians in exchange for government contracts. In Japan (rated by Transparency International as one of the least corrupt countries), Prime Minister Shinzo Abe has been accused of cronyism and influence pedaling. In South Korea, President Park Geun-hye was removed from office as a result of a corruption scandal. The Republic of Georgia, once considered among the most corrupt of the former Soviet Republics, elected President Mikheil Saakashvilli in 2004 and the country rapidly eliminated corruption and enjoyed rapid economic growth, but Saakashvilli was voted out of office in 2013, partly because of accusations he and his cronies used the force of government to enact deals favorable to themselves. In the United States,

[1] Lawrence H. White, *The Clash of Economic Ideas: The Great Policy Debates and Experiments of the Last Hundred Years* (Cambridge: Cambridge University Press, 2012).

solar energy company Solyndra, which received $535 million in government loan guarantees before going bankrupt, was run by individuals with connections to the Obama administration. Those loan guarantees were expedited, possibly illegally, which resulted in an investigation by the Department of Justice. The fact that the investigation ultimately ended with no charges filed may itself be evidence of the ability of elites to work the system to their advantage.

Anecdotes like these can be found in just about every country around the world. Commentary on them seems to suggest that these cases of cronyism and corruption are the result of individuals engaging in unethical activities, and that the problems can be cleaned up by replacing those corrupt individuals with good princes and virtuous citizens, to use Ludwig von Mises' phraseology. Perhaps the causes underlying these symptoms of cronyism and corruption have been misdiagnosed, and the problem is not caused so much by specific individuals engaging in some specific misdeeds, but rather is due to the incentive structure within a system of political economy that leads the political elite to cooperate with the economic elite for their mutual benefit. The institutional structure presents people with a set of incentives, and people respond to those incentives. The institutions of political capitalism give the economic and political elite the ability to design public policies for their benefit. Those institutions reward individuals in the low transaction cost group who cooperate for their mutual benefit and penalize individuals who are unable to engage in those bargains, or who choose not to. Perhaps widespread cronyism is not the cause, but a consequence, of the institutional evolution that has resulted in the spread of political capitalism.

ALL ECONOMIC SYSTEMS ARE MIXED SYSTEMS

Any answer to the question of whether political capitalism is inevitable is obscured by the fact that all economic and political systems never are purely one type or another. The question about the inevitability of political capitalism is better viewed as asking whether market-oriented capitalist economies are inevitably evolving toward political capitalism. Even the most capitalist economy has significant elements of government planning, and even the most socialist economy has a substantial market sector.[2] And,

[2] Citizens of North Korea, probably the most socialist economy in the second decade of the twenty-first century, often rely on extensive underground and illegal markets for their survival. A first-hand description from a North Korean defector appears in Hyeonseo Lee, *The Girl with Seven Names: Escape from North Korea* (London: William Collins, 2015).

all economies exhibit some degree of cronyism. The political capitalism described in this volume does not exist anywhere in a pure form, making it more difficult to recognize political capitalism as a distinct political and economic system. Without an awareness of political capitalism as a distinct economic system, it is easy to see its symptoms as cronyism, corruption, and government interference with a market economy. The closest case of pure political capitalism may have been the fascist economy in Germany between the World Wars.[3]

One difference between political capitalism and the twentieth-century alternatives of capitalism and socialism is that nobody champions political capitalism as a desirable state of affairs. The twentieth century saw the proponents of capitalism debate the proponents of socialism. While political capitalism has no advocates, it also has no explicit opponents, because its symptoms are judged to be flaws in a mixed system that combines markets with government oversight and planning rather than a distinct system of political economy.

All economies have an element of political capitalism. Would anyone doubt that those with political power will be inclined to use it to favor those with whom they have personal connections? Everyone, in business, in government, and in social settings, helps their friends and family. Indeed, it is sensible for people to choose to deal first with those they know and trust. The difference is that in the market, both the costs and benefits of cooperating with friends and family fall on those who cooperate, whereas in government any costs of doing so are shifted to the broader population. The question is whether, as capitalism matures, it brings with it institutional changes that lead to greater cooperation among the political and economic elite, allowing them to use the force of government to their advantage, which then results in an economic system in which the profitability of businesses is increasingly determined by political connections rather than satisfaction of consumer preferences.

If capitalist economies are trending that way, the growing presence of political capitalism could potentially provide a fatal blow, destabilizing both political and economic institutions. Consider the Eastern bloc economies of the 1980s that were nominally designed as centrally planned economies. Yes, they were mixed systems that had elements of markets and elements of cronyism, but the weaknesses of central economic

[3] Details of the fascist German economy are described in Randall G. Holcombe and Andrea M. Castillo, *Liberalism and Cronyism: Two Rival Political and Economic Systems* (Arlington, VA: Mercatus Center, 2013).

planning struck the fatal blow to those systems. In the 1980s few people foresaw how rapidly those systems would collapse. Could the evolution of capitalist economies toward political capitalism cause an equally rapid and equally unforeseen transformation?

The threat of political capitalism is not that it will expand to completely crowd out other elements of a mixed economy, but that it becomes so pervasive that it undermines the productivity that characterizes capitalism. And, because of the intimate connection between the political and economic aspects of political capitalism, just as with the Eastern bloc countries, political capitalism has the potential to destabilize the political system at least as much as it has the potential to destabilize the economic system.

The frequently reported cases of cronyism, corruption, and abuse of power are the symptoms of political capitalism. They are not the market economy at work (capitalism) nor are they government planning of economic activity (socialism), they are examples of political and economic elites conspiring for their mutual benefit, so that the profitability of business increasingly depends on political connections rather than satisfaction of consumer demands. Under pure socialism, the means of production are owned by the state, which blocks the mechanism that allows the economic elite benefit under political capitalism. Private ownership of the means of production allows political capitalism to transfer benefits to the owners of economic assets. That is the capitalism part of political capitalism – private ownership of the means of production.

The symptoms of political capitalism are evident in economies around the world. The question of whether political capitalism is inevitable really means, will capitalist economies inevitably move away from market capitalism, where business profitability depends on satisfying customers, toward political capitalism, where business profitability depends on political connections?

HOW MUCH POLITICAL CAPITALISM?

If all economies contain elements of political capitalism, two issues are how closely an actual economy resembles the pure case of political capitalism, and the degree to which, or even whether, economies are evolving toward political capitalism over time. Economies contain a component of political capitalism to the extent that the profitability of businesses is determined by the political connections of those who run them, One would be hard pressed to find any examples of political and economic systems in which political connections made no difference. In the case of pure political capitalism, those connections would be the primary factor that would determine the profitability of businesses. The economic elite who had connections would be profitable, solely because of those connections. Those who did not have the connections could not start or run a profitable business.

Looking at a continuum from market capitalism to political capitalism, and having described political capitalism, one can see that in the second decade of the twentieth century South Korea is closer to political capitalism than Sweden, even though Sweden is a "big government" country and therefore more likely to be criticized on that ground by supporters of market capitalism. This example illustrates why political capitalism is not the same as government intervention in the economy, and why recognizing political capitalism as a distinct economic system affects the way one views government intervention. While big government facilitates political capitalism, political capitalism is the result of what government does, not how big it is.

Capitalism, as an economic system, has evolved considerably from its beginnings several centuries ago. While market exchange has existed for thousands of years, it is only within a few hundred years that people have come to rely on markets to obtain most of the items they consume. Robert Heilbroner identifies the beginnings of capitalism with the emergence of markets for factors of production.[4] Prior to the Industrial Revolution, land tended to stay with families and complex land rights made ownership transfer problematic in any event. Labor was organized by feudal relationships, guild apprenticeships, slavery, and other arrangements rather than a straightforward exchange of hours of labor for money. Most significantly, capital markets emerged in which people with excess wealth could transact with those who wanted resources to engage in business activities, laying the foundation for increasingly sophisticated capital markets that facilitated the investments that led to unprecedented increases in industrial productivity. While the term capitalism is used to refer to the economic systems in both Britain in 1800 and the twenty-first-century US economy, it is very obvious that the economic system that goes by the name of capitalism is very different in the twenty-first century than it was in 1800.

Joseph Schumpeter observes, "The essential point to grasp is that in dealing with capitalism, we are dealing with an evolutionary process. It may seem strange that anyone can fail to see so obvious a fact which

[4] Robert L. Heilbroner, *The Making of Economic Society* (Englewood Cliff, NJ: Prentice-Hall, 1962).

moreover was long ago emphasized by Karl Marx . . . Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary."[5] Perhaps the inevitable and obvious changes within capitalism lead capitalism to evolve into political capitalism.

Political capitalism is inextricably tied to the ability of the elite to design the institutions of the political and economic system for their benefit. The profitability of business becomes dependent on the rules the state establishes, so those with political power have the leverage to demand the support of those with economic power, leading the political and economic elite to cooperate for their mutual benefit. Big, powerful government is the engine of political capitalism, but political capitalism is not just big government, or government intervention in a market economy. It is a regulatory state that is able to design the rules such that business profitability rests on political connections. Does the evolution of capitalism naturally enhance the discretionary power of the elite in this way?

GOVERNMENT GROWTH UNDER CAPITALISM

The previous chapter offered a variety of explanations for the government growth that has accompanied the evolution of capitalism. Most of those theories do not necessarily point toward the evolution of capitalism into political capitalism, and some even depict government growth as a response to citizen preferences. Perhaps government growth is a way for self-interested individuals to use the democratic process to vote themselves benefits,[6] or to provide a social safety net for everyone as a nation's wealth increases,[7] or even to provide collectively provided goods and services that citizens want to consume.[8] Even if one views government as a predatory Leviathan that tries to maximize the resources it can extract from the population it rules, that revenue-maximizing state has the incentive to rule over as productive an economy as possible, to maximize the amount it can take.[9]

[5] Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 3rd edn. (London: George Allen & Unwin, 1950), p. 82.
[6] Alan H. Meltzer and Scott F. Richard, "A Rational Theory of the Size of Government," *Journal of Political Economy* 89, no. 5 (October 1981), pp. 914–927.
[7] John R. Lott, Jr. and Lawrence W. Kenny, "Did Women's Suffrage Change the Size and Scope of Government?" *Journal of Political Economy* 107, no. 6 (December 1999), pp. 1163–1198.
[8] William J. Baumol, "Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis," *American Economic Review* 57, no. 3 (June 1967), pp. 415–426.
[9] Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988).

Even if government has a tendency to grow as capitalism evolves, that does not necessarily imply a movement toward political capitalism. None of the explanations for government growth listed in the previous paragraph implies that government growth inevitably leads to the cronyism that makes business profitability dependent on political connections.

There is sometimes the tendency to anthropomorphize the state. Government looks out for people's well-being. Or, government is a revenue-maximizing Leviathan. The state has no motives and makes no decisions. Individuals who wield the power of the state make decisions, but exercising the power of the state always requires the cooperation of others. This is obvious in a representative democracy. Even in a dictatorship, the dictator requires the support of many individuals, including at least the nation's military establishment, to remain in power.[10] The state will endure, history shows, even though those who hold state power may change along with the system under which state power is exercised. One goal of the elite is to maintain their own positions in the face of others who would like to displace them. That applies to the political elite, who can be displaced through elections (or coups or revolutions) and the economic elite, who can be replaced by rising entrepreneurs.

Political capitalism is a mechanism by which the political and economic elite can retain their elite positions by using their power for their mutual advantage. They are members of the low-transaction cost group who can negotiate for their mutual benefit. Any challengers first must work their way into the low-transaction cost group As capitalism evolves, those who were the elite decades ago risk being displaced by a new elite. Political capitalism writes the rules so that the elite can maintain their elite positions, because under political capitalism, connections, not productivity, determines who remains on top.

Productivity represents an obvious threat to the elite under market capitalism. Entrepreneurs can start new firms and bring new and improved products to market, producing a creative destruction that replaces the old elite with a new one. This is why the economic elite lean on a regulatory state to create barriers to entry to prevent them being displaced from their elite positions. In exchange, the economic elite support the political elite who write the rules and manage the regulatory state.

[10] See Quoc-Anh Do, Kieu-Trang Nguen, and Anh N. Tran, "One Mandarin Benefits the Whole Clan: Hometown Favoritism in an Authoritarian Regime, *American Economic Journal: Applied Economics* 9, no. 4 (October 2017), pp. 1–29, for empirical evidence of cronyism in an authoritarian regime.

Why should this cronyism increase as capitalism matures? Mancur Olson offers two distinct reasons. One is that, over time, interest groups become more strongly connected to the political elite.[11] The other is that more government oversight is necessary in an evolving capitalist economy where ownership increasingly shifts to intangible assets – financial assets and intellectual property.[12] The first reason suggests increasing cronyism as the political system matures; the second reason suggests an inevitable connection between economic growth and the growth of the regulatory state. An increasingly complex economy requires increasingly complex oversight mechanisms to define and enforce the property rights that underlie a capitalist economy.

While market arrangements might be envisioned that would work to provide the rules and enforcement mechanisms, the fact is that government always has the final say, because it imposes its rules by force. This suggests that government growth is an inevitable, if not necessary, by-product of capitalist advancement. It does not matter whether market institutions could have evolved to manage an increasingly complex capitalist economy, because those who hold political power will use the state to impose institutions that benefit those in the low transaction cost group.[13] Profit is an indicator of success in a capitalist economy, perhaps giving the economic elite some claim that the rules should be designed to reward success as measured by profitability, and certainly giving the economic elite the means by which they can compensate the political elite to tilt the rules in their favor. This points toward an increase in the scope of the regulatory state as a by-product of capitalist development.

Is there any way to decouple the growth of cronyism from the government growth that accompanies the economic growth produced by market capitalism? While there is a close relationship between government growth – especially growth in the regulatory state – and political capitalism, many theories of government growth do not draw a close connection

[11] Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

[12] Mancur Olson, Jr., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

[13] Bruce L. Benson, *The Enterprise of Law: Justice Without the State* (Oakland, CA; Pacific Research Institute for Public Policy, 1990) discusses the private origins of British common law, and argues that these institutions were taken over by the state. By extension, even if the private sector could develop institutions to cope with the growing complexities of a maturing capitalism, those with government power have the incentive to take over those institutions to better shape them for the benefit of the elite.

between government growth and the growth of political capitalism. If proponents of market capitalism are concerned about the growth of political capitalism, they should focus their attention less on big government itself and more on the factors that enable elite control of the levers of public policy.

THE CAUSES OF POLITICAL CAPITALISM

In the context of political capitalism, the hostility that capitalism's supporters show toward big government fails to focus on the problem of cronyism. Critics of big government argue that government interference with the economy lowers productivity and slows economic growth, ultimately lowering the standard of living for everyone. While this is often true,[14] it makes government interference in the economy look like a drag on the economy, similar to the excess burden of taxation or the welfare loss from monopoly. Political capitalism is not just government interference with the economy, and it does not just act as a "tax" on productive economic activity. It is an institutional framework that provides the elite with the ability to design the system for their benefit, decoupling productivity from profit. In capitalism, even if government intervention imposes a cost on productive activity, there is still a direct relationship between productivity and profit. In political capitalism, that relationship is severed. Although government intervention may be inefficient, the problem political capitalism identifies is not inefficiency per se but the ability to design public policy to create advantages for a few while imposing costs on the many. Connections replace productivity as the primary source of profitability.

In this sense, both the political left and right often miss the key feature of political capitalism. It is not unconstrained capitalism run wild, which needs more government oversight, nor is it excessively big government which needs to be reduced. It is not the size of government, but the fact that those who hold the power of government are unconstrained, which is why they can design the system to maintain their elite status. The problem is not unconstrained capitalism but unconstrained government.

[14] Some evidence is provided by Niclas Berggren, "The Benefits of Economic Freedom: A Survey," *Independent Review* 8, no. 2 (Fall 2003), pp. 193–211, and Jakob de Haan, Susanna Lundstrom, and Jan-Egbert Sturm, "Market-Oriented Institutions and Policies and Economic Growth: A Critical Survey," *Journal of Economic Surveys* 20, no. 2 (April 2006), pp. 157–191.

POLITICAL AND ACADEMIC IDEOLOGICAL OPPOSITION

While political capitalism has been recognized as a problem, under names like cronyism and corporatism, controlling it is not high on the agenda of many policymakers. Some want a more equal society and promote redistribution and human resource programs. Others want to promote business and advocate subsidies, tax breaks, and protection of domestic business from foreign competition. Most people who promote public policies do not perceive the potential relationship between what they are proposing and the potential of their proposals to foster political capitalism. Everyone will speak out against cronyism (even the cronies), but it is viewed as a separate issue – unethical behavior rather than an endemic response to political and economic incentives. Politicians as well as academics take a "mixed economy" view of the economic system. It is government interference (seen from the right), or government oversight (seen from the left), within a market economy. They do not see the elite control of public policy as the foundation of the distinct economic system of political capitalism. This is especially true of those who design public policy – the elite.

For similar reasons, there will be academic resistance to the theory of political capitalism because of the sources of its building blocks. The theory of political capitalism rests partly on the elite theory that was developed by political scientists and sociologists, and this will meet with resistance from economists, who tend to view all behavior as individual behavior and minimize the impact of group behavior. Individuals act, and group behavior is simply the aggregated behavior of a group's members. Economists may have reservations because political capitalism emphasizes the distinction between elites and masses. Meanwhile, other social scientists are often suspicious of public choice theories like regulatory capture and rent-seeking, seeing government regulation and government spending programs as necessary to control the errant forces and undesirable effects of capitalism and markets. While less prevalent than decades ago, there is an attitude among many social scientists that those in the private sector act in their own interests while those in the public sector are public-spirited and act in the public interest.[15]

Economists may be suspicious of elite theory because it leans against the individualist approach they take to human behavior. Other social scientists

[15] See, for example, Steven Kelman, "Public Choice and the Public Spirit," *Public Interest* 87 (Spring 1987), pp. 80–94, who argues that public choice theories should not be taught because they undermine the public spiritedness of citizens and make their political actions more selfish.

question the self-interest motivations that underlie public choice theory. There may be academic resistance to the theory of political capitalism partly because different segments of the academic community will find objections to different building blocks of the theory.

Another point of academic resistance to recognizing political capitalism as a distinct system of political economy might lie in the fact that the building blocks of the theory of political capitalism already enjoy widespread acceptance. Because the building blocks are familiar, it might be easy to dismiss this theory of political capitalism because it has nothing new to offer. Regardless of whether they buy into the theories, rent-seeking, regulatory capture, interest group politics, and elite theory are well-established in the academic literature. But the widespread recognition of the threat of corporatism, cronyism, and favoritism ought to overrule resisting the theory of political capitalism because it offers nothing new.

CONTROLLING POLITICAL CAPITALISM

What mechanisms can be used to limit and reverse political capitalism? The following sections evaluate three: democratic government, constitutional constraints, and checks and balances. All are imperfect ways to control the power of elites to write the rules in their own favor, but perhaps working together they can have an effect. Mechanisms are important, but ultimately ideas and ideology are necessary to enable those mechanisms to work. Chapter 8 emphasized the role that the ideology of democratic Progressivism has played in enabling political capitalism. One can expect, if citizens are eager to delegate to government the discretionary power to look out for their economic interests, that those who have that power will continue to use it to further their own interests.

This is why mechanisms alone cannot control political capitalism. There must be a general understanding about the way that power corrupts for citizens to support institutions that limit political capitalism.[16] Otherwise, institutions will be bent to the shape that favors those who have the power to design and interpret them. While recognizing the essential importance of ideas, what mechanisms can be designed to control political capitalism?

16 Lord Acton wrote in correspondence to Bishop Creighton, “Power tends to corrupt, and absolute power corrupts absolutely.” See John Emerich Edward Dalberg and Lord Acton, Acton-Creighton Correspondence [1887], www.oll.libertyfund.org/titles/acton-acton-creighton-correspondence.

DEMOCRATIC CONTROL

The idealized version of democracy depicts it as government that carries out the will of its citizens, as revealed through democratic decision-making processes. Commentators at least since Alexis de Tocqueville have observed that a majority can be just as tyrannical as a despot.[17] A government that furthers the will of the majority will always be in a position to exploit a minority. Political capitalism depicts a system in which well-connected minorities are able to use the political system to exploit the majority for their own benefit. Unconstrained democratic government is unlikely to limit political capitalism. Quite the opposite. A lack of constraints on democratic government has been a contributing factor to the emergence of political capitalism.

It may be that a society with no clear majority group will find itself with rotating majorities, so that those who hold political power at any moment will be reluctant to expand the power of government for fear that another group will be able to use that power against them at a later date. Kenneth Arrow began his well-known book, *Social Choice and Individual Values*, with an explanation of the (already well-known) paradox of the cyclical majority, in which no one outcome of an election could beat all others in a simple pairwise election among alternatives.[18] With no stable majority rule outcome, election outcomes would cycle among many alternatives. While Arrow's depiction of the cyclical majority has typically been viewed as a problem inherent in democratic decision-making, James Buchanan has explained that it is often a virtue.[19] If majorities are unstable, that means that no one majority can maintain control of the government. Political power will rotate among groups.[20]

If those who control the power of government recognize that their time in power will be limited, they may be more inclined to constrain the powers of government than to expand them, seeing that in the future they will be subject to the rule of another group. There is an argument that goes the other way, however, and suggests that rulers with short time horizons have

[17] Alexis de Tocqueville, *Democracy in America* (New York: W. W. Norton, 2007 [orig. 1838]).

[18] Kenneth J. Arrow, *Social Choice and Individual Values*, 2nd edn. (New Haven: Yale University Press, 1963).

[19] James M. Buchanan, "Social Choice, Democracy, and Free Markets," *Journal of Political Economy* 62, no. 2 (April 1954), pp. 114–123.

[20] On this point, see also Leonid Polishchuk and Georgiy Syunaev, "Ruling Elites' Rotation and Asset Ownership: Implications for Property Rights," *Public Choice* 162, nos. 1/2 (January 2015), pp. 159–182.

an incentive to use their power to plunder as much as they can while they have power, and that rulers who anticipate holding power longer have more of an incentive to create a productive society, which affords them a greater share of future output.[21] This argument runs along the same lines as Mancur Olson's argument that roving bandits who plunder and move on have an incentive to be more destructive than stationary bandits who continue plundering and therefore have an incentive to maintain the productivity of those from whom they are plundering.[22]

Even if the argument that a rotation of elites can control political capitalism has merit, there is no assurance that elites actually would rotate under any circumstances. If there are different groups vying for power so that democratic elections result in a rotation of power, those in power at any point in time have an incentive to conspire with those temporarily out of power to incorporate them into the current elite. If the symptoms of political capitalism seem descriptive of the political economy of the United States, consider that Democrats and Republicans have rotated in and out of power since those parties came into existence.

That rotation of party control has not stopped the advance of political capitalism, because the Republican and Democratic elite share more in common with each other than they do with the masses in their own parties. In the United States two parties dominate the political process, and while power appears split between them, the high reelection rate of incumbents means that there really is not a rotation of power. Incumbents are the political elite who have solidified their power and enabled the advancement of political capitalism.

Democracy, in the sense of a government that responds to the will of the people, does not appear to be a good mechanism for controlling political capitalism. Problems are apparent from a theoretical perspective, and in fact, political capitalism has thrived under democratically elected governments. Democracy is a good mechanism for peacefully replacing those who hold political power. It is not a good mechanism for determining public policy. And, because the elite design the rules under which democratic elections occur, democracy even loses its ability to replace those who hold political power, because the elite design the rules to favor incumbents.

[21] Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988).
[22] Mancur Olson, Jr., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

CONSTITUTIONAL CONSTRAINTS

The American Founders were well aware of the limitations of democracy, and deliberately designed their government to be a constitutionally constrained republic, not a democracy. The key feature in a constitutionally limited government is that the government has enumerated powers and is constrained to exercise only those powers constitutionally given to it. This presents two challenges. One is the design of the list of enumerated powers. The other is designing constraints that can actually limit the government to exercising only those powers.

Within academics, the subfield of constitutional economics deals with these challenges, but not completely successfully.[23] James Buchanan, whose work lays the foundation for this subfield, summarizes the challenges well in the title of his book *The Limits of Liberty: Between Anarchy and Leviathan*.[24] The constitutional challenge is to design a government that has sufficient power to protect people's rights – to protect them from the "war of all against all" that would exist in anarchy – but is constrained from using its power to violate people's rights – to protect people against Leviathan government. While constitutional constraints play a major role in Buchanan's constitutional research program, the research program has not come up with a list of enumerated powers to constrain government. Rather, Buchanan suggests the norm of consensus as a guide to constitutional constraints. The constitution should contain that set of constraints to which people agree. The problem is that people might agree to constitutional provisions that would lay the foundation for political capitalism.[25]

Despite elements of political capitalism that are undermining American capitalism and democracy, the American Founders seemed to do a good job of designing appropriate constraints on the new government they formed. The system has held up tolerably well for more than two centuries, and if the government were run according to the literal words in that Constitution, political capitalism would be much more limited. While there is a challenge in listing the appropriate enumerated constitutional constraints on government, it appears that the larger challenge is enforcing those constraints rather than listing them.

[23] James M. Buchanan, "The Domain of Constitutional Economics," *Constitutional Political Economy* 1, no. 1 (December 1990), pp. 1–18.

[24] James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: University of Chicago Press, 1975).

[25] I have discussed this in Randall G. Holcombe, "Consent or Coercion? A Critical Analysis of the Constitutional Contract," in Alain Marciano, ed., *Constitutional Mythologies* (New York: Springer, 2011), pp. 9–23.

CHECKS AND BALANCES

The design of checks and balances was discussed in the previous chapter, and the idea of one branch of government checking the power of others was the Founders' approach to enforcing constitutional constraints. Recognizing that the government would be run by elites, the idea was to have one set of elites check the power of others. This is different in a significant way from the idea that democracy can control the power of government. If the elite are identified as those in the low transaction cost group who can bargain to use the power of government to their advantage, then those who hold the reins of power are by definition members of the elite. The theory of political capitalism explains why the prospect of the masses controlling the elite through democratic government is unlikely. This points to the Founders' logic in designing a system in which members of the elite would check and balance the power of each other.

This system of checks and balances has eroded because the powers of government have expanded. The checks might work if government was limited to those initial enumerated powers, but twenty-first-century government steps well beyond the bounds of the powers listed in the Constitution. Where in the Constitution has government been given the power to compel people to participate in a government-run retirement program? Yet the Supreme Court ruled Social Security to be constitutional in 1937. Where does the Constitution give the government the power to compel people to purchase health insurance? Elites in the various branches of government, all in the low-transaction cost group, have been too willing to cooperate with each other for their mutual benefit, expanding discretionary powers for them all, rather than jealously guarding their limited and enumerated powers by checking and balancing each other.

Rather than going back to the Constitution to evaluate the powers of government, courts are too willing to determine what powers the government should have on the basis of some notion of the public interest. If it is in the public interest for the federal government to run a compulsory retirement system, the Constitution was designed so it could be amended to add this power, yet that did not happen when Social Security was established. Effectively, the Supreme Court has increasingly sidelined rule of law and replaced it with the Progressive idea that it should look out for people's economic well-being when rendering decisions, regardless of what the law actually says. Each branch of the government, being run by elites, has allowed the powers of the other branches to expand. This, coupled with the Progressive idea that one role of government is to look out for the economic well-being of some, even at a cost to others, lays the foundations for political capitalism.

Still, a system of checks and balances may be the best hope for limiting political capitalism, based on the theory of political capitalism itself. A theory based on the idea that elites will write the rules and use the system for their benefit suggests that ultimately, constitutional limits and democratic elections will be inadequate. The elite will still be designing public policy. Without a system in which some elites check the power of others, one would expect the system to evolve so that it increasingly favors those in power.

Democratic elections have a role to play, in that they enable citizens to peacefully replace those who hold political power. The power of elections has been eroded by increasing advantages going to incumbents, designed by the elite. Constitutional constraints and enumerated powers have a role to play, in that they provide the institutional parameters that give one set of elites the power to check the power of others. The power of constitutional constraints has been eroded by an increasing cooperation among those elites that are supposed to check each other. If elites really write the rules and control the system, it would appear that the best route for limiting political capitalism is to reinforce a system of checks and balances within which one set of elites really can check and balance the power of others.

THE REGULATORY STATE

One way to categorize the activities of government is to divide them into budgetary and regulatory activities. The budgetary state acts through taxing, borrowing, and spending. The regulatory state acts through requiring that individuals do certain things and prohibiting them from doing other things.[26] The analysis of political capitalism has continually pointed back to the activities of the regulatory state. The elite can abuse their power through both budgetary and regulatory activities, but there are more checks on abuses in the budgetary state partly because abuses are more

[26] James M. Buchanan has made the distinction between the productive state and the protective state in *The Limits of Liberty* (Chicago: University of Chicago Press, 1975), pp. 68–70, and elsewhere, showing that state activities can be divided into categories in different ways. For present purposes the budgetary state and regulatory state provide a more appropriate division of the activities of government. There is a close relationship between the effects of the budgetary and regulatory components of the state, as described by Richard A. Posner, "Taxation by Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971), pp. 22–50.

visible, and often allow for less discretion. Political capitalism is characterized by tax laws that favor the elite and expenditures that favor the elite, perhaps directly through subsidies and perhaps indirectly through government purchases. President Eisenhower's warning about the military–industrial complex as a threat to democratic government in 1961 shows that the dangers of political capitalism through the budgetary state were apparent then, at a time when military spending was half of the federal budget. As the scope of government has expanded vastly since then, the threat has expanded beyond the military to health care, energy, education and all other areas of the budget.

Still, taxes and expenditures are more visible and therefore more subject to scrutiny than regulations. George Stigler notes that firms are more likely to seek regulatory benefits than direct subsidies, because when competitors spot budgetary benefits, that can tend to instigate a rent-seeking competition that can dissipate those benefits in rent-seeking costs.[27] Regulations are often written in obscure language, making interpretation difficult and subject to the discretion of those in government who apply the regulations. This opens a clear advantage to the well-connected, because regulations can be interpreted to benefit cronies and harm the cronies' competitors.

While one would hesitate to rest academic conclusions too heavily on a passage from a novel, Ayn Rand's 1957 novel, *Atlas Shrugged*, has a government official explaining to a businessman,

> Did you really think we wanted those laws to be observed? We want them broken ... We're after power and we mean it ... There's no way to rule innocent men. The only power government has is the power to crack down on criminals. Well, when there aren't enough criminals, one *makes* them. One declares so many things to be a crime that it becomes impossible for men to live without breaking laws.[28]

The point is that when regulations are vague and arbitrarily enforced, a substantial amount of discretionary power is vested in the enforcers. They can use the regulations to shackle outsiders and to benefit cronies and insiders. And, they can use government's regulatory power as a threat. People who are unwilling to cooperate with the political elite will bear the costs of an arbitrary regulatory state.

The regulatory state is also much more susceptible to corruption, because exchanges between regulators and the regulated can go unnoticed

[27] George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971), pp. 3–21.

[28] Ayn Rand, *Atlas Shrugged* (New York: Signet Classics, 1957), p. 404.

much more readily than with the budgetary state. Even when they are noticed, wrongdoing may be difficult to prove. When regulations are enforced on one company but not on another, that is easy to justify by saying that the two cases were different. When someone in the private sector offers a payment to a regulator, and subsequently a regulatory enforcement is resolved in favor of the private sector payer, there is a very fuzzy line between lobbying and corruption.[29]

In a pair of books, Peter Schweizer leans toward viewing such payments as corruption. In his 2013 book *Extortion*, he gives examples of the payments legislators extort from business interests in exchange for favorable legislation.[30] In his 2015 book *Clinton Cash*, he describes how foreign governments and businesses made contributions to the Clinton Foundation when Hillary Clinton was Secretary of State from 2009 to 2013, rapidly followed by State Department policies and decisions that benefitted those donors.[31] Did foreign governments and businesses receive favorable treatment from the State Department in exchange for their contributions to the Clinton Foundation? Schweizer presents evidence that they did, but Clinton says they did not.

The point is not to condemn Clinton or anyone else, but to point out how the ambiguities inherent in regulation – and often deliberately written into regulations – can lead to arbitrary enforcement, can encourage rent-seeking, and can blur the lines between rent-seeking and corruption. When connections count and contributions often have to be made for lobbying access, the regulatory state encourages cronyism and lays a foundation for political capitalism.

The connection between big government and corrupt government has often been drawn, but the Scandinavian countries have a justly deserved reputation for big government, yet are perceived to have relatively uncorrupt governments. While Scandinavian governments tend to be big spenders, they have relatively little regulation by world standards. They have large budgetary states but small regulatory states. If the regulatory state lays the foundation for political capitalism, one way to limit the expansion of political capitalism is to deregulate.

[29] For an academic discussion, see Toke S. Aidt, "Rent Seeking and the Economics of Corruption," *Constitutional Political Economy* 27, no. 2 (June 2016), pp. 142–157.

[30] Peter Schweizer, *Extortion: How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets* (Boston: Houghton Mifflin, 2013).

[31] Peter Schweizer, *Clinton Cash: The Untold Story of How and Why Foreign Governments and Businesses Helped Make Bill and Hillary Rich* (New York: Harper, Broadside Books, 2015).

Advocates of smaller government often focus on government spending because it is more visible and more measurable. The regulatory state is a more significant building block for political capitalism than the budgetary state. Supporters of capitalism often criticize big government, arguing that government spending should be reduced, but at the same time favor "pro-business" regulation that enables political capitalism. Policies claimed to be pro-business often are anti-capitalism, in that the undermine the market mechanism and encourage cronyism. This is why it is important to recognize political capitalism as a distinct economic system, and to recognize the central role of the regulatory state that enables political capitalism.

IDEAS AND INTERESTS

A major theme of this volume is that political capitalism has a well-established foundation in the academic literature in economics and the other social sciences. Is the power of these ideas sufficient to push back against the elite interests that use their political and economic power to further their own ends? While there is widespread opposition to the cronyism, corporatism, and clientelism that defines political capitalism, nobody is an advocate for political capitalism. The elite use the system to their advantage not because they support the system, but because they are able to use the institutions of political capitalism that are already in place for their benefit. Political capitalism was not designed by the elite, it evolved as a result of human action but not of human design.[32]

Political capitalism is a product of Progressive democracy. Progressivism embodies the idea that one role of government is to look out for people's economic interests, and that government is justified in imposing costs on some for the benefit of others. Democracy, as it is seen in the twenty-first century, embodies the idea that the actions of a democratically elected government carry out the will of the people. The idea of Progressive democracy implies that democratic government may legitimately impose costs on some for the benefit of others, because democratic elections legitimize the discretionary use of political power.

When governments are given more discretion, this opens the door for those who hold government power to use it for their own interests. This is

[32] This phrase, the result of human action but not of human design, goes back to nineteenth-century Scottish philosopher Adam Ferguson, has been more recently popularized by Friedrich Hayek. See for example, his *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1944) which has an essay with that title.

true whether power is seized by force and the population is held down by fear or whether power is purposefully given to government by a citizenry who believes it will be used to further the public interest. The elite did not plan to design a system in which they benefit at the expense of the masses, and would speak out against such a system. Rather, the Progressive ideology, which granted the government more power and more discretion with the idea that government could be a benevolent force for furthering the public interest, gave the elite more power to design public policy for their benefit. The elite are looking out for their own interests, as is everyone, and the expanding size and scope of government provides them with a mechanism to further their interests.

To hear what the elite say – which could be what they actually think – the policies they advocate further the public interest. By protecting their business interests, they are protecting and creating jobs, and by solidifying the hold that incumbents have on political power, they are keeping experienced people in office who are better able to use the powers of government for the public interest. They are maintaining governmental competence and professionalism.[33] Institutions that convey advantages to political incumbents increase legislative professionalism. Institutions that weaken the hold incumbents have on political power threaten professionalism. Nobody is arguing for cronyism. The arguments that support political capitalism are arguments that are built on the hope of benevolent government and governmental professionalism. And, they are arguing for policies that support domestic businesses and that create jobs.

The policy arguments are the same mercantilist arguments that were criticized by Adam Smith and David Ricardo.[34] Free trade and free markets pave the road to higher standards of living, Smith and Ricardo argued, and those arguments are almost universally supported by twenty-first century

[33] See, for example, Morris P. Fiorina, "Further Evidence on the Partisan Consequences of Legislative Professionalism," *American Journal of Political Science* 43, no. 3 (1989), pp. 974–977, and Scott R. Meinke and Edward B. Hasecke, "Term Limits, Professionalism, and Partisan Control in US State Legislatures," *Journal of Politics* 65, no. 3 (August 2003), pp. 898–908, for arguments that longer-serving legislators benefit public policy. The argument extends, as the second article suggests, to opposing term limits because it reduces legislative professionalism.

[34] Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937 [orig. 1776]) and David Ricardo, *Principles of Political Economy and Taxation*, 3rd edn. (London: John Murray, 1821). See Robert B. Ekelund and Robert D. Tollison, *Mercantilism as a Rent-Seeking Society* (College Station: Texas A&M Press, 1982) for an excellent analysis of the way that mercantilists were rent-seekers as the contemporary theory of rent-seeking describes.

economists. Setting aside the degree to which the elite understand these policy arguments, their arguments for policies that give them advantages always say the policies they promote further the public interest, and never support the quid pro quo cronyism that underlies political capitalism.

The elite are driven by their interests, not by ideas, and the ideas that support political capitalism are ideas held by political capitalism's critics. Progressives, who see government as a force for good, advocate a system that gives the elite the power they can use for their own benefit. Without effective checks on the use of power, one should naturally expect that it will be used for the benefit of those who exercise it, with the public interest being a secondary concern.

Arguing against political capitalism is difficult because nobody is in favor of it, so there is nobody to argue with. The debate is only on what the best ways are to reverse it, which is why it is important to understand how it works. The arguments against political capitalism must move beyond whether it is undesirable, because everyone agrees it is. The challenge is to find ways to control the rent-seeking, the regulatory capture, and the power of concentrated interests which underlie political capitalism.

Can ideas overpower the interests that perpetuate and expand political capitalism? The arguments presented here have often been depicted as cynical views about government. Critics of the arguments put forward here argue that even making them reduces public spiritedness and works against the public interest.[35] But government will not be benevolent simply because people wish it were so. Political capitalism cannot be controlled without understanding how it works.

If ideas really do matter, what are the ideas that should be developed to counteract political capitalism? Because there is no consensus, the best place to start is with an analysis of the underlying nature of political capitalism as a political and economic system. If people can agree on the causes of the problem, there is a better chance that they will agree on the solution.

CAPITALISM VERSUS POLITICAL CAPITALISM

Capitalism has led to the greatest improvement in the standards of living for humankind, and has been the biggest force for eliminating poverty in

[35] Steven Kelman, "Public Choice and the Public Spirit," *Public Interest* 87 (Spring 1987), pp. 80–94.

human history. Political capitalism is a threat to capitalism. Proponents of capitalism do not like to refer to the cronyism, corporatism, and clientelism as political capitalism because they think that name misrepresents capitalism and gives capitalism a bad name. If political capitalism is an economic system distinct from capitalism, they can use the arguments in this book to support that view. However, there are three reasons why the name might be appropriate.

First, political capitalism is an economic system that is characterized by private ownership of the means of production and the transfer of resources through voluntary market exchange, the two fundamental characteristics of capitalism. Political capitalism is closely connected to market capitalism, because private ownership of the means of production lies at the foundation of both. The difference is the source of profits that accrue to those who own the means of production. In political capitalism, government mandates restrictions on the terms of some exchanges, limits how people can use their property, and engages in favoritism through its regulations, favorable tax treatment for some, and subsidies and government contracts for the well-connected. The two systems, while different, share many characteristics.

Second, political capitalism has evolved from capitalism as government became more involved in micromanaging the economy. Political capitalism is more than just government oversight or interference in a capitalist economy, and micromanagement is descriptive because government policy selectively benefits some and imposes costs on others depending on their connections.[36] If capitalism is always evolving, there is the threat that it is evolving toward political capitalism.

Third, and perhaps most significant, the strongest proponents of the activities of political capitalism claim to be supporters of capitalism. They do not say they support political capitalism – nobody does – they say they are pro-business. Pro-business supporters advocate the tax breaks, subsidies, and regulatory protections that are the components of political capitalism. Nobody claims to favor cronyism, but policies that claim to be pro-business lay at the foundation of political capitalism. Political capitalism is the product of the combination of public policies advocated by those who claim to be pro-business and a Progressive government that

[36] This is consistent with Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982). For evidence on this evolution from capitalism, see Bos van Bavel, *The Invisible Hand? How Market Economies Have Emerged and Declined Since AD 500* (Oxford: Oxford University Press, 2016).

has the discretion to design public policy to look out for people's economic well-being. Political capitalism is a fitting term because many of the supporters of its policies claim to be supporters of capitalism.

Those who support the features of political capitalism by claiming they are supporting capitalism are a threat to capitalism. While there are those on the left, from Marx through Piketty, who see capitalism as a flawed system that should be, at a minimum, highly regulated and taxed, and perhaps replaced,. there are also those who are pro-business, who advocate the subsidies, tax breaks, and regulatory protections as pro-capitalist. This second group may represent more of a threat to capitalism than capitalism's critics because unlike the critics, they claim to be champions of capitalism even as they advocate policies to undermine it. Pro-business polices are different from pro-free market policies.

Those who want to reverse the march of political capitalism and reestablish a market economy based on voluntary exchange under an unbiased set of rules must recognize that political capitalism is not just excessive government intervention in the economy. Political capitalism is not the welfare state. It is a system in which those who have the power to direct public policy use that power to provide advantages to themselves over others. This features of political capitalism are difficult to reverse because those who hold the power to do so are those who benefit from the status quo.

The problem is not big government, per se, but the discriminatory exercise of political and economic power of the elite for their benefit. In this regard, one challenge is designing constraints on the power of the elite so that economic rewards are assigned based on the value people create for others rather than on the connections they have.[37] But the first challenge is convincing many critics of political capitalism that the problem is not inherent in capitalism itself.[38] This challenge is made more difficult because the pro-business advocates claim to be advocating for capitalism.

[37] This is the challenge James M. Buchanan sees in, for example, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: University of Chicago Press, 1975).

[38] Consider Thomas Piketty, *Capitalism in the Twenty-First Century* (Cambridge, MA: Harvard University Press, 2014), a rare case of an economics book that rose to the top of the *New York Times* bestseller list. The popularity of Piketty's book should convince readers that the idea that capitalism inherently generates inequality and that the owners of the means of production, who have the highest incomes, do not deserve them is not a fringe idea; it is widely held. There are many dissenters, however. See, for example, the 24 chapters by different economists in Jean-Philippe Delsol, Nicolas Lecaussin, and Emmanuel Martin, eds. *Anti-Piketty: Capital for the 21st Century* (Washington, DC: Cato Institute, 2017).

Proponents of capitalism and free markets sometimes object to terms like political capitalism or crony capitalism because it sheds an unfavorable light on capitalism, but when those who advocate protectionism, subsidies, tax incentives and other policies that favor some businesses over others claim to be proponents of capitalism, the term political capitalism seems very descriptive. Political capitalism is not market capitalism, but those who support free markets and voluntary exchange should acknowledge and address the close relationship between the two.

POLITICAL CAPITALISM AND DEMOCRACY

Political capitalism is not only a threat to capitalism, it is also a threat to democratic government. The Progressive movement, now more than a century old, has altered the way that citizens view democratic government. As the American Founders viewed it, democracy was a method of selecting and peacefully replacing those who exercised the power of government. They deliberately designed a government with constitutionally limited powers with the hope that those constitutional limits, coupled with a system of checks and balances, would define the scope of government action. They did not envision democracy as a system in which government carried out the will of the people, as revealed through a democratic decision-making process. Similarly, in Britain, democracy evolved as a method of checking the power of the king, not as a method for enabling a collectivity of citizens to determine public policy.[39]

The Progressive idea that government should look out for the economic well-being of its citizens in addition to protecting their rights has both enabled political capitalism and threatened the democratic ideals on which it is founded. The backlash against political capitalism across the political spectrum is aimed primarily at political actors and political institutions. While there is a tendency to think that democratic government carries out the will of the people, critics increasingly perceive that government actually carries out the will of the low-transaction cost group of people who have the power to design public policy – the elite, the bourgeoisie, the 1 percent. This is especially clear to the 99 percent, who on the one hand realize they have no power to make public policy, and on the other hand have most of the voting power in democratic elections. One way to address this elite

[39] For an excellent discussion of the evolution of British democracy, see Roger D. Congleton, *Perfecting Parliament: Constitutional Reform, Liberalism, and the Rise of Western Democracy* (Cambridge: Cambridge University Press, 2011).

capture of the public policy process is to turn government power over to a strong leader who can overpower the well-connected special interests.

The sacrifice of democracy to promote general economic interests has worked at least to some extent in several cases. General Park Chung-hee oversaw South Korea's remarkable economic development as a military dictator from 1961 until 1979. Similarly, General Augusto Pinochet ruled Chile from 1973 through 1990, overseeing rapid economic development. Both assumed power through military coups rather than democratic elections, but both also oversaw rapid economic development in formerly poor countries. Similarly, Singapore has been ruled by the People's Action Party since 1959. Though democratically elected, the Party has been accused of unfair election tactics and has greatly limited political freedom and political speech, while overseeing rapid economic development.[40]

Meanwhile, the twenty-first century has seen strong-willed populist political candidates in Western democracies become increasingly popular and increasingly electable. Donald Trump ran a populist political campaign accusing the political system of favoring the elite and promising to push policies that would benefit working class Americans – the 99 percent – and attacking the 1 percent who designed public policy for their benefit. The point is, many voters perceive that democratic government, as it has been operating, has not been working for them, and politicians consistently belong to the least respected occupation, when people are surveyed.[41]

This is another area in which the role of ideas is crucial. The notion that democratic government should carry out the will of the people, as revealed through democratic elections, gives those who hold political power the discretion to design public policy as they see fit under the argument that they have a mandate – a term commonly used by elected officials – because of their electoral victories. The analysis of the preceding ten chapters has shown that when given this discretion, they carry out policies that benefit themselves and their cronies. The successes of Western constitutional democracies has come not so much because they are democracies, but

[40] For an analysis of Singapore's economic and political development, see Christopher Lingle, *Singapore's Authoritarian Capitalism: Asian Values, Free Market Illusions, and Political Dependency* (Fairfax, VA: Locke Institute, 1996) and Christopher Lingle, *The Rise and Decline of the Asian Century: False Starts on the Path to the Global Millennium* (Barcelona: Editions Sirocco, 1997).

[41] A Gallup poll done in November 2012 rated members of Congress as the lowest profession on honesty and ethical standards, with 54 percent of respondents ranking them low or very low. The second-lowest profession was car salespeople, with a low or very low rating of 47 percent. See www.gallup.com/poll/159035/congress-retains-low-honesty-rating.aspx, accessed June 8, 2017.

because constitutional constraints have limited how elected officials can exercise their powers.

Democracy is important, because it provides a mechanism for peacefully replacing those who hold political power. In this way democracy provides a check on the amount of power they can exercise. When people become disenchanted with the direction in which democratic government is headed, they are more willing to tolerate autocratic government. Adolf Hitler was democratically elected. Vladimir Putin was democratically elected. Both were able to solidify their power because of disenchantment among citizens, in Hitler's Germany because of oppressive conditions following World War I and in Putin's Russia because of the corruption and cronyism in the democratic governments that followed the Soviet Union's breakup in 1991.

Western democracies have thrived because of constitutional limits on the powers those governments have been able to exercise, not only because they hold democratic elections. The important idea here is that if democratic government is given the unconstrained power to design public policy because of an electoral mandate, the policies they design will be for their own benefit – for the benefit of the elite members of the low-transaction cost group – so to control political capitalism the masses need to understand the importance of constraints and constitutional rules.

The first seven chapters of this book recounted a substantial body of academic analysis in the social sciences which explains how elites are able to use the political process to favor their interests over the masses. The last four have explained how political and economic institutions have evolved to allow the evolution of capitalism toward political capitalism. If these ideas spread to the masses, they will be less inclined to cede discretionary power to their governments with the hope that it will be used benevolently.

The idea that constitutionally constrained government is necessary for both freedom and prosperity is a hard sell, because voters are rationally ignorant. They know they have no influence over public policy so they have little incentive to become informed, and they tend to vote more on emotion than on any rational analysis of public policy. This opens the door for charismatic candidates to win elections, and those who can most effectively exercise political power are those who care the least about how their exercise of power might negatively affect the general public.[42]

[42] Thus, Friedrich Hayek notes the tendency for the worst to get on top in *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

Progressivism, nominally based on the idea of democracy, ultimately undermines it.

CONCLUDING REMARKS

One of the remarkable things about the American Revolution was its explicit recognition that the role of the new American government was to protect the rights of its citizens rather than further the interests of the elite. The European nations from which the colonists emigrated were monarchies where, nominally, citizens were subjects of the crown and their interests were subservient to those of their rulers. While it is true that the citizenry of those European nations had been gaining more power and more political representation at the time of the American Revolution, a major reason was the spread of the enlightenment-era ideas that also inspired the colonists. In the centuries that have passed since then, democracies have displaced monarchies and dictatorships, but one would be hard pressed to claim that democracy was inevitable, and many places remain undemocratic in the twenty-first century.

Political capitalism is not inevitable just as democracy is not inevitable. Democracy has spread because of the idea that citizens have the right to control their governments. Ideas have triumphed over interests to allow the spread of democracy. The ideas behind political capitalism are not so direct, and the ideology of democracy has been a contributory factor to the spread of political capitalism. The idea that democratic governments should carry out the will of their citizens has expanded the power of government, and those who hold government power tend to use it for their own interests. The theory of political capitalism explains why elites control public policy, and how they use that control for their benefit.

Capitalism has given humankind an unprecedented increase in the global standard of living and an unprecedented decline in global poverty. Despite the benefits capitalism has delivered to humankind, its proponents must recognize the threat that political capitalism represents to the capitalist economic system. Because political capitalism is characterized by private ownership of the means of production and resource allocation through voluntary exchange, capitalism itself is under attack because it shares these features with political capitalism. Capitalism's proponents must recognize the threat that political capitalism represents to market capitalism, and combatting political capitalism requires an understanding of its components. The problem is not just big government, and the solution is not just shrinking government. The problem is the unconstrained ability of the elite to design public policies that apply to everyone, and the solution is constraining the scope and power of government, not just its size, somehow measured.

This volume goes only partway toward a solution to the problem of political capitalism. Because it is widely recognized as a problem, there is no need to convince readers of that. There are three steps to identifying and solving it, much as if one were trying to cure a disease. The first step is to recognize the symptoms. The second step is to identify the causes of those symptoms. The third step is to identify how those causes can be reversed. The first step precedes this volume, because there is widespread recognition and agreement on the symptoms. This volume addresses the second step, which is identifying the causes of political capitalism. While some suggestions about how those causes can be reversed have been offered, that third step remains incomplete.

Understanding what enables political capitalism points toward reining in the regulatory state and reinforcing the checks and balances that enable elites to control the power of each other. Having identified the causes of political capitalism, some still may not agree that these steps work to constrain political capitalism. Even for those who do agree, there is not an obvious way to actually constrain the regulatory state and reinforce checks and balances within a system that is controlled by an elite who would view these steps as threats to their power. One can hope that a better understanding of how the system works moves us one step closer to addressing its widely recognized problems.

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