The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality

Reviewed by Charles M. North, Baylor University

Economic rents generated by government policies are an important reason why economic growth has slowed and inequality has grown in the US in recent decades. So argue Brink Lindsey and Steven M. Teles in their 2017 book The Captured Economy.

The book’s first chapter presents evidence that the current US economic system is “rigged” in favor of the rich. The authors present their primary argument in general form in Chapter 2; supporting examples from specific industries follow in Chapters 3-6. Defined as “the excess payment made to any factor of production (land, labor, or capital) due to scarcity” (p. 16), economics rents can arise from “artificial scarcity” generated by government policies that give special advantages to favored firms or other actors. Prime examples of regressive rents are subsidies to favored firms and industries and rules imposing added costs on existing or potential competitors. The authors define “rent-seeking” as “business activity that seeks to increase profits without creating anything of value through distortions to market processes, such as constraints on the entry of new firms” (p. 17).

Several factors suggest that there has been a general increase in economic rents. US corporations have become more profitable since the 1980s, and Tobin’s Q has increased over a similar timespan. (The authors define Tobin’s Q as the ratio of a firm’s market value to the value of its tangible assets.) Many US industries have become increasingly concentrated, and new business formation has declined over time. While these developments do not prove that rent-seeking has increased over the past several decades, the authors think there is enough smoke to suggest that the fire is real.

Why does more rent-seeking lead to slower growth and greater inequality? On the growth side, the authors argue that limits on entry and exit slow the process of creative destruction that is at the heart of productivity growth in American businesses. On inequality, the authors describe a shift in regulatory rents from workers to owners. In the 1950s and 1960s, the government created rents for firms through import
tariffs, price regulations in transportation and agriculture, and regulated monopolies in the telephone and broadcasting industries. But other policies forced a downward distribution of these rents to workers; relatively high minimum wages, strong protection of labor unions, and strict limits on immigration are examples. Thus, during this era, there was much rent-seeking behavior, but the overall system reduced inequality by forcing the rents to be shared with the lower and middle classes. Since 1970, the various policies that pushed rents downstream to workers have weakened, while other changes have allowed people at the top to claim more rents. To make their case, Lindsey and Teles provide case studies in the next four chapters: subsidized risk-taking in financial services, intellectual property monopolies, occupational licensing, and zoning regulations.

The primary goal of Chapter 3’s case study is “to demonstrate that government subsidies to the financial sector do exist, that they encourage excessive risk-taking to the detriment of the country’s long-term growth prospects, and that they create large, undeserved gains for financial executives and professionals” (p. 37). The authors describe the historical emergence of mortgage loans and subsequent securitization, sparked by government-created actors – the FHA, VA, Fannie Mae, Ginnie Mae, and Freddie Mac. Savings and loan associations were “a deliberate creature of government policy, designed to convert short-term savings deposits into fixed, 30-year mortgages” (p. 40). All went well until the inflationary 1970s, when the regulatory model of paying low interest on S&L deposits fell apart under pressure from fleeing depositors. Interest rates were deregulated, leading to higher rates paid on deposits than existing mortgages generated. In the end, the S&L crisis of the 1980s was the first collapse of regulatory rent-creation in the mortgage markets. The second wave was the subprime mortgage collapse that led to the 2007-2009 recession. Acknowledging that many private decisions rooted in greed contributed to the crisis, the authors nevertheless remind readers that the entire mortgage crisis was built on a framework of government-created entities and would not have been possible without policies that had enabled mortgage securitization for decades.

Furthermore, banks are much more heavily leveraged than other types of firms, in part because subsidies received through the Federal Reserve’s discount window lending and through underpriced FDIC insurance have substantially reduced banks’ downside risk from financial leverage. As a result, the authors argue that banks have too little
equity, and capitalization requirements have been too little or of the wrong sort to repair the moral hazard problem created by the Fed and FDIC. Thus, the financial sector is over-subsidized and too big, resulting in risky actions that reward the firms and their shareholders and executives in good times, and require expensive government bailouts when the bad times come.

In Chapter 4, Lindsey and Teles argue that American law provides excessive protection to holders of copyrights and patents. They first acknowledge the general economic argument for protection of intellectual property – that creative works and innovative new products have high up-front development costs and low costs of replication. However, they contend that the fixed cost of developing a new creative work or an innovative product has dropped dramatically in recent decades in most industries other than chemicals and pharmaceuticals. As a result, profits have soared (and executive and shareholder wealth has grown) in entertainment, while older books, journal articles, and other works are not available online due to copyright issues. Similarly, the expansion of patent protection to things like software and business methods has led to ambiguity in what is protected, benefiting “patent trolls” willing to bring claims of ambiguous patent infringement. By limiting competition and entry, and ultimately new innovations, developments in copyright and patent law since the 1970s have inhibited economic growth and concentrated payoffs among the wealthy executives and shareholders most benefited by intellectual property protection.

The case studies in Chapters 3 and 4 focus on rents generated by federal regulation. In Chapters 5 and 6, Lindsey and Teles shift their focus to state-level regulations: occupational licensing and zoning restrictions. Chapter 5 describes the expansion of occupational licensing schemes not only for doctors, dentists, and lawyers but also for cosmetologists, manicurists, barbers, massage therapists, makeup artists, auctioneers, animal trainers, sign-language interpreters, bartenders, interior designers, and more. Occupational licenses are generally adopted for the purpose of protecting consumers from information asymmetries in the quality of the providers, but they also result in barriers to entry that generate rents for those who acquire a license. The authors’ narrative then follows the same pattern of the prior two chapters — showing that occupational licensing provides little actual protection to consumers, and explaining specific ways in which barriers to entry inhibit innovation and dynamism
in the licensed occupations. Moreover, occupational licensing increases income inequality by increasing prices that lower-income consumers have to pay, increasing incomes even more in highly paid professions, and limiting the access of poorer workers to lower-skilled occupations.

Chapter 6 continues the theme through an exploration of zoning rules. The authors state that, by limiting the construction of new, more dense housing, zoning limits the supply of housing and thus drives up the price of existing housing. From an economic growth perspective, there is a handful of cities with the greatest potential agglomeration gains; in such places, zoning enriches existing homeowners and deters lower-income workers from moving in. The effect is to diminish productivity because the cost of migration deters potential workers from moving to newer, more productive jobs. At the same time, it functions as a wealth transfer from renters to homeowners, thus increasing inequality.

In Chapter 7, Lindsey and Teles turn to the underlying politics of regressive rent-seeking. They emphasize several factors that allow such policies to be enacted and to persist. A central piece of their argument is that rent-seeking thrives in situations where the deliberative process of democratic governance has broken down. They attribute the absence of a true deliberative process around regressive rent-seeking policies to four factors: (1) information about policy matters tends to come only from the most interested parties; (2) many rent-seekers play on their positive public image in avoiding too much scrutiny of policies that benefit them; (3) many regressive rent-seeking policies are made in venues far removed from the glare of public and media attention; and (4) politicians prefer to funnel government funds through private sector channels (such as tax cuts) rather than spend money directly. The lack of deliberativeness allows rent-seeking policies to be approved and makes them harder to repeal.

The final chapter presents ways to address the problems described in the preceding chapters of the book. To increase the level of deliberation in government, the authors propose changes in government's decision-making processes. First, they point to a need for more involvement from the parties who do not receive rents, most likely backed by interested philanthropists. Second, the authors suggest an increase in professional legislative staff to allow less reliance on lobbyists as information sources. Third, the authors propose a new or expanded central executive review of regulations propounded by agencies, along with moving
decision-making authority out of low-profile venues (such as the Court of Appeals for the Federal Circuit, which handles patent law appeals). Finally, they argue for more judicial intervention against regulatory rents at both the federal and state levels, using both constitutional and statutory grounds. While some of these ideas are intriguing, many are politically infeasible and might not work even if they could be put into effect.

Throughout this book, the authors rely upon underlying philosophical views (supported by citations to empirical research) that creative destruction is the best path to innovation and growth, and that many regulations do not really achieve their stated policy objectives — e.g., occupational licensing does not really make consumers safer, the level of patent protection in the US does not really increase innovation. Readers sympathetic to these perspectives will find the book a pleasing shot in the arm for the idea that governments harm economies through excessive regulation. On the other hand, many Americans, including younger ones, seem to be embracing the belief that government involvement is essential to generating a stronger and more fair economy. This book’s core assumptions keep it from reaching across that divide, so that it is unlikely to persuade someone who already favors more government intervention. For me, a person more sympathetic than not with the authors’ arguments, the preaching-to-the-choir approach means that Lindsey and Teles are unlikely to change minds with this book. ■