# RENT-SEEKING, CRONY CAPITALISM, AND THE CRONY CONSTITUTION

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**Rent-Seeking, Crony Capitalism, and the Crony Constitution**

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**Abstract**
In the United States, the term "crony capitalism" refers to a political-economic system that resembles traditional political "corporatism." As used here, it describes a system in which government, big business, and powerful interest groups (especially labor unions) work together to further their joint interests. Government protects and subsidizes powerful corporations and in (implicit) exchange the government uses those businesses to carry out government policies outside of the ordinary processes of government. Unlike simple models of political rent-seeking, in which businesses use government to advance their own interests in exchange for electoral support, under crony capitalism politicians and regulators use businesses to advance the interests of politicians and interest groups in a symbiotic relationship: government creates rents and then distributes them to itself and favored interests. Many of the relationships that grew up during the financial crisis and its aftermath through legislation such as the Dodd-Frank financial reform legislation illustrate the differences between crony capitalism and mere rent-seeking. Given the mutually reinforcing benefits created by this system, it is argued that prospects for reform are dim unless constitutional structures are built to restrain this system.

## I. Introduction

In 1982 Mancur Olson published his famous book *The Rise and Decline of Nations*, which described how well-organized interest groups had systematically captured the United States government and was strangling the American economy under the aggregate weight of their successful efforts to obtain special-interest favors.[2] Olson contrasted the experience in the United States in the post-War era in which interest groups had become more and more powerful, with that in the defeated countries of Japan and Germany, in which old special-interest coalitions had been destroyed by the War,

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[1] George Mason University Foundation Professor of Law and Executive Director, Law & Economics Center. I would like to thank Bo Palmore for research assistance.

[2] Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagnation, and Social Rigidities* (Yale 1985).

opening up an opportunity for rapid economic growth. In contrast to the dynamic economies of our conquered foes, the American economy during the post-War era increasingly came to be defined by calcification, stagnation, a demise of entrepreneurial activity, and decline.

Olson's description of an economy defined by the relationship between interest groups seeking favors from the government has subsequently come to be known (misleadingly) as "crony capitalism." The term is misleading, of course, because "crony capitalism" has little to do with capitalism, and is actually its opposite. What has come to be known as "crony capitalism" has traditionally and perhaps more accurately been known as "corporatism"—a system where businesses are privately owned, but there is a comprehensive intertangling of government and private industry, such that the success of various firms or industries is closely tied to government and government frequently uses private industry to directly or indirectly accomplished preferred political goals. Regardless of the accuracy of the term, however, Olson's description of an economic system of a symbiotic relationship between big government, big business, and big labor aligned in a cooperative enterprise in which the government picks economic winners and losers and subsidizes and protects particular favored industries, firms, and interest groups, has come to be known as "crony capitalism."

The engine of crony capitalism is the process known as rent-seeking, a term coined by the great economist Gordon Tullock to describe the process by which these well-organized interest groups pursue government favors.[3] Tullock's profound insight was that the economic favors identified by Olson—tariffs, subsidies, preferential regulation—do not simply fall from the sky like manna from Heaven. Instead, they are

[3] Gordon Tullock, *The Welfare Costs of Tariffs, Monopoly, and Theft*, 5 Western Econ J 224 (1967).

usually brought through the concerted effort of interest groups expending real resources to use government power to divert wealth to themselves. So long as the cost of an interest group's investment in political lobbying activity is less than the expected benefit that the interest group can gain by lobbying the government for favorable treatment, the interest group will find it profitable to divert resources from productive uses that have a net benefit to society and the economy to lobbying expenditures aimed at merely redistributing wealth from less-organized interests to that interest group.

Olson's concern that interest groups would try to capture the government and use it as a tool to promote their private interests at the expense of the public was not novel, of course. Indeed, this was the animating concern of the Framers themselves when they established the Constitution, to provide a mechanism for the provision of public goods such as national defense and to promote internal free trade, while at the same time to guard against the capture of the government by special interests, which they referred to as "factions." The Framers' obsession with the concern that factions might divert the government to the advancement of their own interests, rather than the public interest, is reflected in their elaborate system of separation of powers, checks and balances, federalism, enumerated powers, and even the Bill of Rights itself, all of which were designed to raise barriers to commandeering of government power to advance the interests of particular factions. Requiring laws to pass through the gauntlet of bicameralism (with two houses whose membership was originally composed through diverse constituencies), presentment, and judicial review, was designed to raise the level of consensus necessary to make laws and to ensure that those proposals that eventually

did so would tend to reflect broad-based, sober majoritarian support consistent with the principles of republican government.[4]

Notwithstanding the penetrating power of Olson's insights, the timing for the publication of *The Rise and Decline of Nations* in 1982 was ironic: the United States was just beginning to shed exactly those shackles that Olson had pointed to as the causes of economic stagnation and decline in the United States. Beginning with the economic recovery and taming of inflation during the first years of the Reagan administration, the American economy exploded in a burst of creativity and entrepreneurial activity almost unprecedented in human history. From the spontaneous creation and evolution of the Internet to extraordinary breakthroughs in technology, medicine, payment cards, and host of other revolutions that transformed everyday life not only in the U.S. but, led by American dynamism, around the world. Hundreds of millions people in East Asia alone have been lifted out of poverty by the economic dynamism of the past several decades. The threat of crony capitalism seemed to have been tamed—the Framers had won after all.

Yet we have learned that the crony capitalists were not exterminated, they were just hibernating. And, indeed, in the wake of the financial and economic crises that began around 2008, crony capitalists have returned with a vengeance. Today the hold of crony capitalists is more powerful than ever before, perhaps even more in the period of the 1970s that caused Olson so much consternation. And like that prior era, many of the costs of crony capitalism are unseen: the dynamism-sapping combination of regulation, political favoritism, and political rent-extraction that diverts so much wealth and energy

[4] James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Liberty Fund 1999).

from the creation of wealth to its mere protection and redistribution through political means. Indeed, many of the industries and companies who overturned the old order have become the crony capitalists of today.

## II. Rent-Seeking and Crony Capitalism

Simply put, wealth can be obtained in two ways: it can be created or taken by force (legally or illegally) from someone else. Rent-seeking in the context can be understood as the process of using legal means to take wealth from someone else and to redistribute it to oneself. But the economic effect of rent-seeking is not merely a zero sum redistribution of wealth from A to B, because the process of conducting rent-seeking uses real resources (measured by opportunity cost) that could otherwise be used for productive purposes.[5] Gordon Tullock illustrates this point through the example of theft: the social cost of theft is not merely the question of whether I or the thief should have my television. Instead, it is the panoply of resources, measured by opportunity cost, that goes into that forced transaction. Consider the thief's perspective. From the perspective of the thief, he considers the highest-valued use of his time and human capital to be to steal wealth rather than create it. But while this decision increases the thief's economic welfare relative to alternative employment, from an economic perspective it actually *reduces* overall social wealth. It is important to recognize that theft is not merely zero-sum for the economy—i.e., the thief is wealthier and I am poorer. It is actually *negative* sum because of the opportunity cost of the resources the thief uses to be a criminal—his investment of time in casing my house waiting for me to go out, the time he invests to become better at crime rather than learning skills for some productive employment (such as driving a taxi,

[5] Maxwell L. Stearns and Todd J. Zywicki, *Public Choice Concepts and Applications in Law* (West 2009).

working at a restaurant, or whatever his best legal employment option is), and the whole network of those involved in the crime industry that make similar choices (such as those who "fence" stolen goods and the like). But there is still more diverted resources, such as the use of steel, factories, and know-how into making better locks, the manufacture and human monitoring of burglar alarm services and anti-theft protections on cars, and the entire fleet of police officers and prisons designed to hold criminals. If the thief had instead chosen to make an honest living doing something productive and wealth-increasing, rather than investing in theft, then all of these resources would have been available to be used to increase social wealth rather than being used to merely redistribute it and protect against redistribution.

Political rent-seeking has essentially the same dynamic, except that it is legal, not illegal. We can understand rent-seeking as the use of real resources to bring about wealth-redistributing rather than wealth-increasing results. Here, again, the full cost must be understood in an opportunity cost manner. The cost of political rent-seeking includes such things as the opportunity cost of the time that a company's CEO spends traveling to and from Washington, meeting with politicians, taking them to dinner, or attending their fund-raisers, rather than running the business and making it more productive—or the time of other CEOs seeking to block adverse government action urged by rivals. It includes the diversion of human capital from lawyers engaging in productive activities such as drafting contracts or helping injured people gain compensation and instead into activities such as lobbying that are designed solely to redistribute rather than increase social wealth. Again, while deploying one's time and talents to lobbying is economically rational for the lawyer who is well-paid for his efforts, it diverts human capital from

productive uses. Indeed, the full social cost of rent-seeking would include all the even more indirect costs, such as the social overinvestment in lawyers, which at the margin diverts some people from activities such as engineering or other professions to those such as law, lobbying, and advertising.

In this light, for current purposes "crony capitalism" can be loosely understood as an economy in which rent-seeking is taken as an ordinary incidence of business operations and a legal and socially legitimized way in which wealth can be acquired and maintained by private industry through the use of political influence rather than through market success. In short, acquiring wealth through the manipulation of government processes is both a lucrative and legitimate way of earning wealth and, quite frequently, government is implicitly seen as a partner to the transaction in that politicians likewise see private industry as a means for advancing their political interests as well.

In many less-developed countries, crony capitalism tends to be highly personal and to turn on idiosyncratic personal relationships between politicians and industry titans. And to be sure, some rent-seeking in the United States has this same flavor. For example, it has been reported that during the early stages of the financial crisis Treasury Secretary Hank Paulson conducted a closed-door meeting with a hand-picked group of hedge fund leaders, including several former colleagues from his prior Goldman Sachs, at which he confided that he was making contingency plans to place home finance GSEs Fannie Mae and Freddie Mac into conservatorship—even as he was telling the public that the two firms were financially stable.[6] According to a news report, several investors at the

[6] Richard Teitelbaum, *How Paulson Gave Hedge Funds Advance Word of Fanny Rescue*, Bloomberg Business (November 2011) online at http://www.bloomberg.com/news/articles/2011-11-29/how-henry-paulson-gave-hedge-funds-advance-word-of-2008-fannie-mae-rescue.

meeting traded on the information that Paulson gave them to short the stock of the GSEs, resulting in huge gains when the two companies eventually were placed into receivership.

This sort of personal favor-granting based on idiosyncratic personal ties is rare in the United States. Although such situations surely occur, crony capitalism in the United States today, by contrast, tends to be a somewhat more formal and institutionalized affair that provides targeted benefits to organized interest groups in exchange for political support rather than favors based on personal relationships. Crony capitalism today can be seen as the alliance of three powerful interests—big business, big labor, and big government—locked in a symbiotic relationship to create pools of rents for particular industries or firms and to use those pools of rents to pay off powerful political interests, such as labor unions and politicians themselves. Crony capitalism thus rests on an implicit guarantee by the government—it will protect certain politically-connected firms from the rigors of competition, thereby guaranteeing those firms and industries a certain flow of revenues. In (implicit) exchange for this guaranteed flow of revenues, the firm promises to share some of that surplus with politically-favored groups, such as labor unions or favored interest groups (such as environmental groups), and with the politicians themselves through campaign contributions and other means of support. Thus, the firms and their managers and shareholders gain what amounts to a sinecure and protection from the gales of creative destruction, and in exchange politicians can divert some of this flow of resources to their preferred policies and groups.

Rational firms recognize that they can make money two ways, either by earning it or by taking it from others, and at the margin will be expected to invest resources in which ever method is expected to generate the highest return to the firm. Unlike a thief,

however, using the political process to forcibly transfer wealth from others is legal. For many, the highest rate of return will result from lobbying rather than productive activity. More than that, however, in a competitive market for capital acquisition and revenue enhancement, firms will be economically *compelled* to pursue rent-seeking activities if that will enhance the company's bottom line or otherwise it will inevitably go out of business.[7] Thus, so long as wealth acquisition through rent-seeking is a viable business strategy, in a competitive market businesses will be expected to pursue it.

In addition, note that individual firms and interest groups will likely be drawn into rent-seeking activity even if they would prefer not to, and more important, even if the members of the industry as a whole would prefer not to: it only takes one competitor seeking to gain economic advantage through rent-seeking to essentially force other firms to engage in rent-seeking behavior as well, or at the very least, to engage in lobbying to prevent being victimized by more politically-entrepreneurial firms.[8]

The experience of Internet and technology companies is illustrative of an industry transformed from entrepreneurial capitalism to entrepreneurial cronyism. Silicon Valley historically ignored Washington politics—indeed, it largely disdained the political favor-trading inside the Beltway, pouring its energy and talent into product innovation and creation instead. That changed in the late-1990s when the now-defunct Internet browser company Netscape, unable to resist market competition from Microsoft's Internet Explorer, instead turned to Washington to launch a legal assault against the company.

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[7] See Armen A. Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J Pol Econ 211 (1950); see also Geoffrey Manne and Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 J of Law, Policy, and Econ 555 (2014).

[8] See Randall G. Holcombe & Andrea A. Castillo, *Liberalism and Cronyism: Two Rival Political and Economic Systems* at 104 (Mercatus Center 2013). ("Government powers allow some interest groups to impose costs on others, which forces everyone to engage in the political process to compete to be the cronies who benefit from government interference. Big government does not control cronyism; it causes cronyism.").

Millions of dollars of lobbying money later on both sides of the issue eventually resulted in a Department of Justice investigation against Microsoft. Although Netscape won the battle it lost the war—despite its efforts to have Washington bail it out, it soon disappeared from the market and Internet Explorer rapidly gained ascendancy. Explorer's market dominance, however, proved far from permanent. While exact measurements of browser market share vary according to the provider of the information, by at least some measures, by the end of 2009 Internet Explorer held less than half of the market share for web browsers and was surpassed by Chrome by the end of 2012.

Nevertheless, Netscape had cast the first stone that soon became an all-out rent-seeking war. For the first time, competitors in the ferocious and fast-moving world of technology and the Internet discovered that Washington, and later Brussels, could be its most valuable business partner. Microsoft led the way by rapidly building its lobbying operation in Washington and then just a few years after the DOJ's antitrust investigation, Microsoft turned the tables by lobbying the Federal Trade Commission to bring an antitrust action against Google. According to news reports, in the two years that the investigation was open Google spent an estimated $25 million on twelve different lobbying firms to fend off the investigation. And while Google escaped the FTC largely unscathed, its rivals have continued their political efforts in the European Union and in state capitals across the country.

Since that time, government regulators have continued to increase their regulatory oversight—and in turn, Internet and technology companies have emerged as some of the largest political lobbyists in the economy, routinely ranking among the top handful of industries. From questions of antitrust and consumer protection to the relentless lobbying

of the White House and Federal Communication Commission for and against so-called "net neutrality" regulation, these companies have come to recognize that billions of dollars, and sometimes the entire future of their companies, depend on the decisions made in Washington. As a result, expenditures on rent-seeking activities have soared, and the open and innovative nature of the Internet is increasingly under pressure. The foes of crony capitalism in the 1980s—the innovators who broke open AT&T's telephone monopoly and the local cable monopolies—are becoming the crony capitalists of the modern age. In fact, it is reported that Apple—the largest company in the history of the world based on market capitalization—receives a 30% subsidy on the solar panels that it produces.

In fact, even if the members of a particular industry eschew rent-seeking, they may still be drawn into the swamp by entrepreneurial politicians engaged in the practice of rent-extraction or rent-extortion.[9] In a scheme of rent-extraction, a politician threatens to impose a cost on the members of an interest group or to rescind previously-granted benefits with the aim of prompting political action by the affected group to protect the status quo. Consider an anecdote involving the regulation of hedge funds, which historically have been largely unregulated entities. When Congress was writing the Dodd-Frank financial reform legislation, hedge funds came in for special scrutiny and consideration of a new regulatory regime despite scant evidence that they contributed to the crisis. In one famous incident, powerful Democratic Senator Charles Schumer reportedly invited leaders of many hedge funds to dinner where he instructed them that it

[9] Fred S. McChesney, *Money for Nothing: Politicians, Rent Extraction and Political Extortion* (Harvard Press 1997).

was time for them to end their distance from politics and get more involved.[10] And get involved they did, pouring money into the coffers of Schumer and other Democratic politicians, enabling them to not only avoid new severe regulations on their industry but also to push for new regulations on rivals (such as banks) that would benefit hedge funds.

## III. Crony Constitutions

While the roots of American crony capitalism date back to the government-mandated cartels of the New Deal and crony capitalism grew gradually over several decades, it appears to have accelerated beginning with the financial crisis and the post-crisis era. If it is true that "War is the health of the state,"[11] then economic crisis is the health of the crony capitalist state.

### A. Progressivism and Crony Capitalism

The purpose of the Constitution was to try to tame the influence of rent-seekers by using various structural institutions such as separation of powers and federalism to fragment power and thereby to reduce the ability of special-interest factions to commandeer the power of the government for their advantage. Meanwhile, to the extent that these structural protections checked the ability of the federal government to act, they pushed power and authority down to state governments. While state governments were by no means immune to rent-seeking pressures, and indeed in many ways were more susceptible to the influence of some types of factions, they faced at least some (albeit imperfect) constraints resulting from the pressures of competitive federalism.

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[10] Timothy P. Carney, *Schumer's Racket: Lobbyists and Hedge Funds*, Washington Examiner (May 26, 2010) online at http://www.washingtonexaminer.com/article/13668.
[11] Randolph Bourne, *The State* (1908).

The Framers famously recognized that they were engaged in a tradeoff—that the structures that they created inevitably would end blocking both good *and* bad legislation—as Hamilton writes in discussing the role of the Presentment requirement in Federalist 73, "It may be that the power of preventing bad laws includes that of preventing good ones; and may be used to the one purpose as well as to the other." But, Hamilton continues, he believed that the operation of the Constitution's structures would *disproportionately* block bad legislation designed to enrich small special-interests relative to good legislation designed to benefit the larger public, as good acts of legislation would be more likely to obtain the higher thresholds of consensus required by the Constitution's structural protections than special interest legislation would. Hamilton continues, "The injury which may possibly be done by defeating a few good laws, will be amply compensated by the advantage of preventing a number of bad ones." Not all government activity is the product of rent-seeking, of course, but the Framers were not so naïve to believe that none of it was either.

In particular, Hamilton observed that the need for checks and balances arose not from "the supposition of superior wisdom or virtue in the Executive, but upon the supposition that the legislature will not be infallible; that the love of power may sometimes betray it into a disposition to encroach upon the rights of other members of the government; that a spirit of faction may sometimes pervert its deliberations; that impressions of the moment may sometimes hurry it into measures which itself, on maturer reflexion, would condemn." The purpose of the Executive veto, therefore, was not merely to enable the President to protect its powers from encroachment but also "to increase the chances in favor of the community against the passing of bad laws, through

haste, inadvertence, or design." Moreover, the Framers opposed the churn of frequent legislating, as more frequent legislating created more opportunities for interest groups to distort legislative outcomes to their will. Similar considerations to protect the new government from corruption by factions also pervade the Framer's justification for a bicameral legislature drawn from distinct constituencies and other structural features.[12] The central purpose of the federal Constitution, therefore, was twofold: first, to protect and promote individual liberty and second, to frustrate the efforts by special interest factions to capture the government for their narrow benefit. Put differently, the goal of the Framers was to avoid institutionalized rent-seeking—although in their case they were more concerned about the effects of majoritarian factions than distortions of Olsonian minoritarian interest-group influence. Still, they recognized the same basic threat—the temptation to try to appropriate wealth through political machinations and interest group pressures instead of creating it through productive activity. The genius of the Constitution, therefore, was to try to direct energy toward the creation of wealth through market activity instead of destroying it through political activity.

All of this changed with the Progressive Era and the New Deal. As is well-known, the architects of the Progressive Era turned the political and constitutional philosophy of the Founding era on its head.[13] Whereas the Framers feared that excessive law-making would give rise to a propensity to enact special interest laws, the Progressives viewed a

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[12] See James Madison, *The Federalist No. 62* ("Another advantage accruing from this ingredient in the constitution of the Senate is, the additional impediment it must prove against improper acts of legislation… It must be acknowledged that this complicated check on legislation may in some instances be injurious as well as beneficial…. But… as the facility and excess of law-making seem to be the diseases to which our governments are most liable, it is not impossible that this part of the Constitution may be more convenient in practice than it appears to many in contemplation."); see also Todd J. Zywicki, *Beyond the Shell and Husk of History: The History of the Seventeenth Amendment and Its Implications for Current Reform Proposals*, 45 Cleveland State L Rev (1997).

[13] See, e.g., Richard Epstein, *How Progressives Rewrote the Constitution* (Cato Institute 2006).

deficit of law-making as reflecting the ability of special interests to block beneficial legislation. In other words, while the Framers recognized that constitutional checks and balances would block both good and bad laws but believed that they would block more bad laws than good, the Progressives looked at the same structures and viewed them as blocking more good laws than bad[14]. As such, an organizing theme of Progressivism and the New Deal—indeed, much of modern Progressivism including the Obama administration as well—was the circumvention of ordinary constitutional processes and legislation in favor of aggressive action by the president. For the Progressives the solution was the vesting of power in independent agencies such as the Interstate Commerce Commission and Federal Trade Commission; during the New Deal the solution was the creation of new agencies and the flexing of the powers of Executive Agencies; for the Obama Administration it is reflected largely in rule by fiat ("phone and pen" lawmaking) by the President directly or the agglomeration of power in super-powerful unaccountable agencies such as the Consumer Financial Protection Bureau or Financial Stability Oversight Council, both created by Dodd-Frank.[15] All of these systems of law-making, however, see the Constitution's structural barriers as magnifying the power of special interests to block useful government programs, and the ability of the Executive to act directly as the solution.

These two competing visions of politics and politicians, therefore, suggest a testable hypothesis: if the Progressive view of politics and politicians is correct then

[14] Consider, for example, the criticisms of the pre-17th Amendment Senate, which blocked numerous acts of Progressive legislation and was supposedly a tool of money interests. See Zywicki (cited in note 12). Casual empiricism suggests that the American public today is not convinced that direct election of Senators has reduced the importance of moneyed interests in politics, which, of course, was an entirely predictable consequence of the reform. See id.

[15] See Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 George Washington L Rev 856 (2013).

removing or circumventing constitutional constraints should weaken the power of special interest groups over the government. If, however, the Framers were correct, then the erosion of the Constitution's safeguards in recent decades should increase the power of special interest groups over politics.

While the final section of this paper examines law-making in a variety of areas since the financial crisis, it hardly seems contested on either the left or right that the influence of special interests is larger today than ever before. Before turning to several examples that illustrate the point, it is first worthwhile to understand how this state of affairs came about.

The engine of rent-seeking, and hence crony capitalism, is discretion: the power of politicians to draw arbitrary and unprincipled distinctions between similarly-situated parties; for example, to provide subsidies or tax breaks to one industry but not another (such as corn farmers but not apple farmers or retailers over banks as with the Durbin Amendment to Dodd-Frank[16]) or to benefit some workers (such as unionized workers) over others (non-unionized). This power to single out certain parties for particular positive or negative treatment based on idiosyncratic political influence rather than principled distinctions is a necessary condition for rent-seeking to occur, as the favored group must have some disadvantaged group that provides the gains.

### B. Rent-Seeking and Crony Capitalism Compared

Rent-seeking can occur in three basic fashions: direct, indirect, or rent-extraction.

[16] Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, ICLE Financial Regulatory Program White Paper Series at 53-54 (June 2, 2010).

Direct rent-seeking occurs when an interest group is provided with a benefit that directly benefits it, such as a tariff, regulated monopoly (such as a licensed profession), or subsidy, such as subsidies for particular agricultural commodities. These regulatory schemes typically also erect barriers to entry to prevent other parties from entering and dissipating the rents generated by the regulatory scheme.

Indirect rent-seeking occurs when a seemingly neutral regulation or law is enacted which actually implicitly favors some people over others. For example, it is understood that the cost of complying with many regulations are not directly proportional to size. Many paperwork obligations, such as filling out and filing forms, have a large fixed-cost component to them, which means that larger firms can bear those costs relatively easier than smaller firms.

Both direct and indirect rent-seeking have a corollary effect, called rent-sharing. When economic rents are created for an industry through government action, those rents are distributed among shareholders, managers, and workers, through an explicit or implicit bargain. Thus, industries subject to regulation tend to pay above-market wages to their employees and those wage premiums disappear following deregulation.[17] The reality that some of the economic rents generated from protectionist legislation is shared with workers leads the workers to favor the regulations. How the rents are shared is a matter of bargaining between labor, management, and shareholders; one constant, however, is that workers in unionized industries tend to receive a larger share than workers in non-unionized industries.[18]

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[17] See Sandra E. Black and Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 American Econ Rev 814 (2001).
[18] See Nancy L. Rose, *Labor Rent Sharing and Regulation: Evidence from the Trucking Industry*, 95 J of Political Econ 1146 (1987).

Finally, crony capitalism can also occur through rent-extraction by politicians: in this scheme, politicians threaten to impose harm or take away benefits currently held by various firms or industries, which those firms can avoid by paying tribute to the politician. In this situation, the firms lobby not for gain, but to avoid losses that are larger than their rivals.

It sometimes can be difficult to determine whether a particular action constitutes rent-seeking or rent-extraction. For example, as discussed below, while it has been argued that the vocal support of pharmaceutical companies for the Affordable Care Act was rent seeking in support of a law that would increase demand for pharmaceuticals, as an a priori matter the political activity of pharmaceutical companies could be explained equally well as a response to rent-extraction by politicians. As was explained to me by one industry insider with knowledge of the political negotiations, the Obama administration informed the members of the industry that they had "two choices: they could oppose the law and receive price controls that would impose $40 billion in annual losses on the company or they support the law and suffer only $20 billion per year in losses."

For purposes of understanding the dynamics of crony capitalism, however, it matters little whether a particular action is best understood as rent seeking, rent extraction, or some combination thereof. What matters most fundamentally is that private industry and the government become so intertwined that the economic success of firms or industries—indeed, their very survival—depends on remaining in the good graces of political actors and, quite frequently, that political grace can be given or withheld in a largely arbitrary fashion.

Banking, of course, is the prototype example, as the need for regulated banks to remain in good standing provides their regulators with the power of life and death, especially after many of the largest banks were bailed-out during the financial crisis as a result of their reckless lending practices. In turn, this provides the government with the power to use banks as a de facto arm of the federal government to carry out regulatory purposes that regulators could not accomplish directly and to do so without due process and other procedural protections, such as administrative rulemaking procedures. Consider two examples that illustrate the point.

The first is the shadowy initiative known as Operation Choke Point, which seems to have been spearheaded by the Obama Administration's Department of Justice and the Federal Deposit Insurance Corporation (FDIC). Under Operation Choke Point, government regulators targeted myriad legal, but politically unpopular industries, such as firearms dealers, coin dealers, pornography, sellers of "racist materials," home-based charities, and most intensely, payday lending.[19] The FDIC, of course, had no jurisdiction over these industries and absent any wrongdoing, the DOJ could not outlaw them either. Yet these limitations did not stop them.

Instead, the FDIC instructed regulated banks to cease providing banking services to these particular industries, with special attention paid to payday lenders.[20] Banks were instructed not to accept bank accounts from or provide payment services for those

[19] The entire list of targeted industries was promulgated informally by the FDIC in U.S. House, Committee on Oversight and Government Reform, *The Department of Justice's "Operation Chokepoint": Illegally Choking Off Legitimate Businesses?* Staff Report 113th Congress at 11 (May 29, 2014) online at http://oversight.house.gov/wp-content/uploads/2014/05/Staff-Report-Operation-Choke-Point1.pdf.

[20] See, e.g., Letter from M. Anthony Lowe, Director, FDIC Chicago Regional Office to Board of Directors of [Redacted] Bank (Feb. 15, 2013), *available at* http://oversight.house.gov/wp-content/uploads/2014/10/Regional-Director-Letter.pdf (stating that providing banking services to payday lending companies "carries a high degree of risk to the institution, including third-party, reputational, compliance, and legal risk" and that as a result "activities related to payday lending are unacceptable for an insured depository institution").

industries listed on the FDIC's hit list. As described in internal government deliberations regarding the program, the objective was to "choke off the air" that these industries needed to breathe and that the banks themselves provided the "choke point" of payment processing that these businesses needed to survive. Without the ability to clear checks and process electronic payments, payday lenders and other targeted firms simply could not exist and conduct business. Notably, the government's instructions were issued without any evidence that of the industries on the affected list had done anything illegal, no due process to the adversely affected firms, and, indeed, a complete lack of transparency, including a reluctance to even admit the existence of the initiative and its reach. The FDIC's instructions were based on the vague and undefined claim that even though the subject industries were legal, dealing with them raised issues of "reputational risk" for banks and that based on this vague and undefined concept, the banks should eschew provision of banks services to them.[21]

Despite the lawless and secretive manner in which Operation Choke Point operated, banks got the message. Payday lenders, firearms dealers, adult performers and others suddenly found bank services—sometimes decades-long relationships—terminated summarily and without explanation. Unstated was that the reason that the targeted industries provided "reputational risk" was the circular reasoning that FDIC subjectively considered them to have a bad reputation. Noticeably absent was any rhyme or reason for why some controversial industries, such as firearms dealers, raised reputational risk, but

[21] The arbitrary and political nature of the program is illustrated by the irony that at the same time that the FDIC and DOJ were strong-arming banks into dropping payment-processing services to members of these legal industries they were also urging those same banks to begin providing bank accounts and payment processing services to sellers of recreation marijuana in states such as Colorado, even though their operations were illegal under federal law that continues to prohibit the sale of marijuana. See David Migoya and Allison Sherry, *Banks Given the Go-Ahead On Working with Marijuana Businesses*, Denver Post (Feb. 14, 2014), *available in* http://www.denverpost.com/business/ci_25143792/feds-give-historic-green-light-banks-working-marijuana.

other controversial industries, such as abortion clinics, did not. In one particularly colorful example of the result-oriented approach toward attacking payday loans, a senior official in the Division of Depositor and Consumer Protection instructed that any letters by FDIC Chairman Martin Gruenberg to Congress and talking points "always mention pornography when discussing payday lenders and other industries, in an effort to convey a 'good picture regarding the unsavory nature of the businesses at issue.'"[22] Aggressive oversight by Congress eventually persuaded FDIC to withdraw its list of target industries and to formally claim that it was terminating Operation Choke Point,[23] but news reports indicate that it might still be continuing and that its implementation has simply shifted to the CFPB[24].

A second example is the effort of the Consumer Financial Protection Bureau to impose fair lending laws on auto dealers for the loans that they issue. It is clear, that fair lending laws that prohibit discrimination in making loans apply to auto dealers. It is equally clear, however, that Dodd-Frank prohibits the CFPB from exercising jurisdiction over loans made by auto dealers, leaving that responsibility by implication to other federal agencies such as the Federal Trade Commission and DOJ.[25] To be sure, it appears that this carve-out from the CFPB's vast powers was most likely a special interest provision provided to the auto dealer industry; nevertheless, the fact that is was a special

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[22] U.S. House, Committee on Oversight and Government Reform, *Federal Deposit Insurance Corporation's Involvement in "Operation Choke Point,"* Staff Report 113th Congress at 1 (December 8, 2014) online at http://oversight.house.gov/wp-content/uploads/2014/12/Staff-Report-FDIC-and-Operation-Choke-Point-12-8-2014.pdf.

[23] See Kent Hoover, *FDIC removes Operation Choke Point's 'hit list,' clarifies guidance to Banks*, The Business Journals (July 29, 2014) online at http://www.bizjournals.com/bizjournals/washingtonbureau/2014/07/fdic-removes-operation-choke-points-hit-list.html.

[24] See Rachel Witkowski, *CFPB Launches Its Own Choke Point-Style Operation*, American Banker (April 8, 2015) online at http://www.americanbanker.com/news/law-regulation/cfpb-launches-its-own-choke-point-style-operation-1073659-1.html.

[25] Dodd-Frank Wall Street Reform and Consumer Protection Act § 1029(a), Pub.L 111-203, H.R. 4173 (2010).

interest provision makes the provision no less clear in its language or intent that the CFPB is not to regulate the lending practices of auto dealers.

Auto dealers engage in what is referred to as “indirect” auto lending, essentially providing broker services for banks and auto finance companies. For example, when an auto dealer offers to finance a car purchase, the dealer itself does not actually provide the money to purchase the car. Instead, the dealer essentially solicits bids from banks and non-bank lending companies such as Bank of America, Honda Motor Finance, Ally (formerly GMAC), or BB&T. Those financial institutions provide the money to the dealer and the dealer negotiates with the car buyer for final purchase terms. Although the story is more complex, the dealer essentially makes its money off the spread between the wholesale price of the money provided to the dealer by the financial institution and the final terms of the loan to the consumer along with some other elements, such as fee for placing the loan with one company rather than another. Thus, the final pricing of the loan is set by the dealer according to the terms that the dealer negotiates with the consumer. Moreover, in many instances the final terms on the loan are interwoven with the vehicle itself—for example, Toyota may run a financing special (i.e., 1.9% financing) in order to move certain types of inventory (say pick-up trucks) in some markets that aren’t available for other types of vehicles or in other areas of the country. The indirect lending financial institution never has any interaction with the consumer—indeed, the consumer may not even know who the actual lender is that is providing the loan until after the deal is struck with the dealer.

Lacking the authority to reach the auto dealers, the CFPB came up with a creative solution—they decided to hold the financial institutions (the indirect lenders) responsible

for any alleged discriminatory lending patterns by the auto dealers themselves. Moreover, the indirect lenders would be held responsible according to the theory of "disparate impact," making the indirect lenders responsible for any statistical anomalies that seemed to exist, regardless of the lack of any evidence of intentional discrimination.[26] The reach of this theory is especially questionable in that in offering to extend the loan, when the applicant's file is forwarded to the financial institution it contains no evidence of the applicant's race.[27] Despite all of this, the banks and financial institutions—over which the CFPB do have jurisdiction—have been held responsible for any statistical anomalies in lending terms by the auto dealers. In short, the CFPB has deputized the financial institutions as arms of the agency to regulate parties whom Congress specifically instructed them that they could not reach under Dodd-Frank. Needless to say, the CFPB announced this policy through no formal rulemaking or anything else—it simply issued an informal guidance to financial institutions. It provided no cost-benefit analysis to determine what the impact of its policy would be on the cost and availability of credit for consumers. Indeed, the CFPB did not even provide any evidence that auto dealers were

[26] The CFPB has successfully extracted tens of millions of dollars in settlements from indirect auto lenders under this theory. In the case of Ally Financial, however, the CFPB collected some $80 million from the company under the theory of disparate impact but some 18 months after the case still had not distributed any of the recovery to "victims" of Ally's allegedly discriminatory behavior. The difficulty, of course, was that the CFPB had identified no actual victims of bias, leading to the challenge of identifying beneficiaries of the recovery despite having no identifiable victims. See *Do Two Half Victims Make a Whole Case?*, Wall Street Journal (Apr. 13, 2015) online at http://www.wsj.com/articles/do-two-half-victims-make-a-whole-case-1428966741.

[27] Needless to say, this reality hasn't slowed down the CFPB either—they have instructed financial institutions to use a technique called "Bayesian Improved Surname Geocoding," which requires them to guess at the race of a particular borrower based on the statistical frequency of certain surnames being associated with certain races in particular zip codes. A recent assessment of the CFPB's proffered geocoding methodology found the CFPB's recommended procedures to have no statistical validity in accurately identifying the race of particular applicants. See Arthur P. Baines and Marsha J. Courchane, *Fair Lending: Implications for the Indirect Auto Finance Market*, American Financial Services Association (November 19, 2014) online at http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf.

even engaged in discrimination, it simply asserted it based on questionable statistical analysis.

Both of these examples demonstrate the double-edged sword of crony capitalism. While the federal government now protects banks from competition and even bails them out when they make foolish choices, this corporate dependency comes at a high price—the banks now are essentially obliged to do the government's bidding when it comes to promoting specific political agendas. Moreover, much of the policymaking is done in back rooms with no other formal protections. For example, Operation Choke Point was a secretive government program whose very existence proved difficult to confirm, much less its details and implementation. The CFPB's attack on indirect auto lenders was issued through a five page "Guidance" document that provided no information about the basis for the CFPB's charge of discrimination or, originally, any methodology for determining liability, or any opportunity for public comment or other due process protections.[28] Meanwhile, those entities that are politically disfavored, such as payday lenders and firearms dealers, are to be crushed with no due process and no opportunity to defend themselves in any transparent regulatory proceeding.

This tradeoff is characteristic of crony capitalist systems—in exchange for preferential governmental treatment favored firms implicitly agree to become agents and private accomplices of governmental policy. While the use of banks to strong-arm auto dealers and payday lenders is one of the more egregious examples to date, they are merely different in degree, not kind, from what has come before. For example, the legal authority claimed by the FDIC and DOJ as justifying Operation Choke Point is the

[28] Consumer Financial Protection Bureau, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act*, CFPB Bulletin 2013-02 (March 21, 2013) online at http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.

expansive web of anti-money laundering rules that have long been a feature of the banking system and its regulation and the general practice of using banks as an indirect means to further political priorities and enrich favored interest groups has been the defining characteristic of the government's housing policies for decades.[29] The further entanglement of the government with the banking system and the use of the banking system to further political ends is likely to prove permanent—for example, it is easy to imagine a future conservative administration potentially using the same techniques against abortion providers, environmental groups, or other left-wing causes.

## IV. Financial Crisis and the Health of Rent-Seeking State

The financial crisis and the government's response to it has entrenched crony capitalism to an unprecedented extent. Moreover, while the roots of the older less-developed form of crony capitalism of the 1960s and 1970s were shallower and were able to be supplanted by the Reagan administration in the 1980s, the new more developed form of crony capitalism is more deeply rooted and may prove more difficult to unwind than that of an earlier era because it has broadened the net of powerful interests that share the fruits of crony capitalism. Indeed, the defining difference between the era of the 1970s and today is that the 1970s version was, in fact, a series of little more than transactional rent-seeking exchanges between particular industries and their regulators. Today, however, crony capitalism has become a full-blown system of intertwined benefits to big business, big labor, and big government in which all three have a stake in the maintenance of the system.

[29] See Department of Justice Civil Division Consumer Protection Branch, *Holding Financial Institutions Accountable for Fraud* (March 27, 2015), *available in* http://www.justice.gov/opa/blog/holding-financial-institutions-accountable-fraud.

Modern crony capitalism is best exemplified by the example of the government bailouts of General Motors and Chrysler beginning at the end of the Bush administration and growing in size and scope during the Obama administration. There was, in fact, an arguable, albeit contestable, role for a very modest and circumscribed role for the government to aid the bankruptcies of the two companies based on the fact that credit markets were still somewhat dysfunctional and a government guarantee of debtor in possession financing may have been appropriate to overcome temporary liquidity problems. Yet that slight and narrow rationale for intervention hardly captures what the government actually did in those cases. Instead, the government intervened to run the cases entirely and used them as a vehicle to line the pockets of the United Auto Workers (UAW), a very powerful interest group.[30] In Chrysler, the government-imposed plan plundered secured creditors in order to increase the payout to the UAW's underfunded health benefits plan. Surprisingly, many large banks who held Chrysler's secured debt did not object to the plan—one suspects that the reason was that most of these same banks were at the same time beneficiaries of the TARP bailouts of their banks and so were in no position to cross the Obama Administration on this politically sensitive topic.[31]

The auto bailouts show the flower of crony capitalism in full bloom. Obviously, the government bailed out the companies and engineered their reorganization. At the same time, the primary beneficiaries were the members of the UAW—according to calculations by James Sherk and myself, the entire loss to the taxpayers on the auto

[30] Todd J. Zywicki, *The Corporatist Legacy of the Auto Bailouts*, Library of Law and Liberty (January 13, 2014) online at http://www.libertylawsite.org/2014/01/13/the-corporatist-legacy-of-the-auto-bailouts/.
[31] Indeed, according to the bankruptcy court that upheld the Chrysler bankruptcy plan, the real reason why creditors had no basis to object to their treatment in the Chrysler case is that the government's bailout money was not actually Chrysler's money because the government had no intention to benefit Chrysler. Instead, Chrysler was just a pass-through conduit for the government to launder what was actually just a payment to the UAW. *In re Chrysler, LLC*, 405 BR 84, 99-100 (Bankr. S.D.N.Y 2009)

bailouts (approximately $10 billion[32]) was a result of the disparately beneficial treatment given to the UAW in the cases relative to what labor would receive in the typical bankruptcy case.[33] The Obama Administration benefited as well: not only were the auto bailouts credited as providing pivotal votes in several states that helped President Obama to be reelected in 2012, the Administration used the bailouts to further its own policies. For example, buried in the midst of the "sale" of Chrysler to Italian carmaker Fiat (although the term "sale" is a misnomer because Fiat essentially paid nothing for the company[34]) were provisions that provided Fiat with still further windfalls if the company met certain environmental goals in the post-bankruptcy period.[35] Finally, the auto bailouts provided a host of opportunities for members of Congress to intervene in discrete decisions by the car-makers, such as which dealerships to close, which factories to shutter, and which suppliers of raw materials to use.[36] In addition, the taxpayer-funded "cash for clunkers" program to subsidize new auto sales amounted to an off-the-books bailout as well.

The cronyist nature of the auto bailouts was not unique to that industry, however. For example, multiple studies have been conducted of the relationship between the bank bailouts (in the form of the TARP) and various political factors. Various studies have identified the following characteristics related to the bank bailouts: the propensity of

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[32] Bill Vlasic and Annie Lowrey, *U.S. Ends Bailout of G.M., Selling Last Shares of Stock*, Deal Book-The New York Times (December 9, 2013) online at http://dealbook.nytimes.com/2013/12/09/u-s-sells-remaining-stake-in-gm/?ref=autoindustry&_r=1.

[33] James Sherk and Todd J. Zywicki, *Auto Bailout or UAW Bailout? Taxpayer Losses Came from Subsidizing Union Compensation*, The Heritage Foundation (June 13, 2012) online at http://www.heritage.org/research/reports/2012/06/auto-bailout-or-uaw-bailout-taxpayer-losses-came-from-subsidizing-union-compensation.

[34] John Berlau and Mark Beatty, *The Real Fiat Scandal*, Daily Caller (November 1, 2012) online at http://dailycaller.com/2012/11/01/the-real-fiat-scandal/.

[35] David A. Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (John Wiley & Sons, Inc 2011).

[36] Todd J. Zywicki, *The Auto Bailouts and the Rule of Law*, 7 National Affairs 66 (Spring 2011) online at http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law.

politicians to vote for a bailout were positively correlated with the campaign contributions that they received from the banking industry and that bailout funds were directed to banks with "political clout, not those most in need of liquidity[37]; that contributions from the financial services sector had a significant impact on the probability that a legislator would support the bailout[38]; that banks with an executive on the board of the Federal Reserve bank were 31 percent more likely to receive bailout funds from the Capital Purchase Program and that a bank's connection to a House member on a key finance committee was associated with a 26 percent increase[39]; that banks that engaged in more intensive lobbying efforts experienced positive abnormal returns after the TARP was announced, which suggests that the market thought that they would gain unusually large benefits from the bailout[40]; that banks who employed a director who worked at the Treasury or one of the banking regulators were 9 percentage points more like to by approved for government funds, and that firms headquartered in the election districts of House members on key finance committees were 6 percentage points more likely to be approved[41]; and finally, that firms that lobbied Congress were 42 percent more likely to receive a bailout than firms that did not lobby, that politically-connected banks had a 29 percent higher chance of receiving TARP funds than non-connected banks, and that banks that lobbied and/or were politically connected received larger bailouts than non-

[37] Jim F. Couch, Mark D. Foster, Keith Malone, and David L. Black, *An Analysis of the Financial Services Bailout Vote*, 31 Cato Journal 119 (2011), online at http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2011/1/cj31n1-8.pdf.
[38] Michael Dorsh, *Bailout for Sale? The Vote to save Wall Street*, 155 Public Choice 211 at 221 (October 2011).
[39] Ran Duchin and Dennis Sosyura, *TARP Investments: Financials and Politics?*, Ross School of Business Working Paper No. 1127 (January 2010) online at http://deepblue.lib.umich.edu/bitstream/handle/2027.42/63451/ 1127_ r10_ duchin.pdf?sequence=6.
[40] Deniz Igan, Prachi Mishra, and Thierry Tressel, *A Fistfull of Dollars: Lobbying and the Financial Crisis*, 26(1) NBER Macroeconomics Annual 195 (2011) online at http://www.jstor.org/stable/10.1086/ 663992?origin=JSTOR-pdf.
[41] Ran Duchin and Dennis Sosyura, *The Politics of Government Investment*, 106 J of Financial Econ 24 (October 2012) online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426219.

lobbying and unconnected peers[42]. While exact estimates in each of these individual studies can be challenged with various methodological quibbles, taken as a whole they paint a clear picture—that the access of banks to the taxpayer's largesse was a function of their political access, not their need. Moreover, other factors—such as the "need" for the bailout or the supposed systemic importance of a particular bank—were largely irrelevant once the political variables were taken into account.

Unsurprisingly, the post-financial crisis era has raised the dynamics of crony capitalism to still a higher and more institutionalized level. For example, while Dodd-Frank was supposed to eliminate the problem of bailouts and "Too Big To Fail" banks, a recent report by the Government Accountability Office concluded that while Dodd-Frank may have reduced the size of the so-called "TBTF subsidy" for large banks it did not eliminate it, indicating that large banks still retain an implicit government guarantee. Similarly, a study by the International Monetary Fund concluded that the subsidy to TBTF banks in the United States amounts to some $70 billion per year in lower capital costs and that in turn the existence of an implicit government guarantee promotes the moral hazard problem of greater risk-taking by large banks.[43]

At the same time that Dodd-Frank appears to have entrenched bailouts and provided a competitive advantage to large banks, it has imposed disproportionately large costs on smaller banks. As indicated earlier, many types of regulation do not impose costs that are proportional to the firm's size, thus larger firms can bear these costs at the margin

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[42] Benjamin M. Blau, Tyler J. Brough, and Diana W. Thomas, *Corporate Lobbying, Political Connections and the Bailout of Banks*, 37 J Banking & Fin 3007 (2013).

[43] International Monetary Fund, *Big Banks Benefit from Government Subsidies*, Global Financial Stability Report (2014) online at http://www.imf.org/external/pubs/ft/survey/so/2014/POL033114A.htm. Other studies reach different conclusions on the continued existence of the TBTF subsidy. For a summary of the literature as well as a caveat on the conclusions that can be drawn, see Todd J. Zywicki, *The Rule of Law During Times of Economic Crisis* (working paper on file with author).

more easily than smaller firms. Empirical research on the impact of Dodd-Frank finds that this is exactly what has happened. For example, a recent study by scholars at the Kennedy School of Government found that in the period since Dodd-Frank was enacted, the asset bases of smaller banks has shrunk twice as fast as large banks, a result that they attribute to the high regulatory costs imposed by Dodd-Frank.[44] In addition, a detailed Mercatus Center study of the impact of Dodd-Frank on smaller banks has found that the law has imposed huge compliance costs on small banks and that they have been less able to bear those costs than large banks.[45] Thus, large banks have grown still larger as smaller community banks have disappeared from the market under Dodd-Frank's regulatory burden. In fact, large banks have admitted as much. For example, JP Morgan Chase CEO Jamie Dimon observed that because of the aggregate costs of complying with all of the rules, regulations, and capital costs associated with Dodd-Frank has built a "bigger moat" between it and its smaller competitors.[46] Similarly, Goldman Sachs CEO Lloyd Blankfein announced in 2010 that the bank would be "among the biggest beneficiaries" of Dodd-Frank as its regulatory costs and regulatory-created profit opportunities would be particularly advantageous to large banks that could bear those costs more easily than smaller competitors.[47]

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[44] Marshall Lux and Robert Greene, *The State and Fate of Community Banking*, M-RCBG Associate Working Paper No.37 (February 2015) online at http://www.valuewalk.com/wp-content/uploads/2015/02/Final_State_and_Fate_Lux_Greene.pdf.

[45] Hester Pierce, Ian Robinson and Thomas Stratmann, *How Are Small Banks Fairing under Dodd-Frank?*, George Mason University Mercatus Center Working Paper No. 14-05 (February 2014) online at http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank; *see also*

[46] Rouan, Rick. 2013. *Dimon says Dodd-Frank puts 'bigger moat' around JPMorgan Chase*. *Columbus Business First*. Febuary 5. Accessed on January 30, 2015. At http://www.bizjournals.com/ columbus/blog/2013/02/dimon-says-dodd-frank-puts-bigger.html. Accessed on January 30, 2015.

[47] Carney, Timothy P. 2015. "Goldman and JPMorgan sit safely behind the walls of Dodd-Frank." *Washington Examiner*. February 12. At http://www.washingtonexaminer .com/goldman-and-jpmorgan-sit-safely-behind-the-walls-of-dodd-frank/article/ 2560179.

## V. Is There a Road Back From Cronyism?

In this sense, the clear benefits to big labor and big government distinguish modern crony capitalism from the rent-seeking state of the 1970s. One notable feature of the movement for deregulation in the 1970s was its bipartisan feature—deregulation began during the presidency of Jimmy Carter and was championed by Senator Ted Kennedy before being accelerated by President Reagan.[48] The reasons for this were somewhat unique at the time—this was during the era in which "capture" theory was a preeminent theory of understanding how regulation worked. Under capture theory, loosely stated, it was believed that laws were initially enacted to further the public interest, but when the locus of decision-making passed from Congress to the dark corridors of the bureaucracy, interest groups eventually were able to "capture" the regulators and pervert them to produce rules that favored the very industries that they were supposed to regulate.[49] The end result, in industries ranging from trucking, to airlines, to railroads, was that regulation came to function as a device to cartelize regulated industries, leading to higher prices and lower-quality service for consumers.

This produced a rare opportunity for an alignment of those who championed free markets and competition with those who had become cynical about the ability of government to resist big business to push for deregulation. The result of this alliance was not only the reform of existing regulation and the crashing of old regulatory institutions but the establishment of a general suspicion of government regulation that prevailed not only during the Reagan-Bush years but into the Clinton era and early Bush era and which created the breathing room for—most notably—the Internet economy to boom as a result

[48] See Andrew D. Crain, *Ford, Carter, and Deregulation in the 1970s*, 5 J. on Telecomm. & High Tech. L. 413 at 416, 425 (2007).
[49] See Stearns and Zywicki (cited in note 5) (discussing capture theory).

of its "permissionless" structure, i.e., a general presumption against regulation unless there is a demonstrated market failure and that regulation can improve the situation.[50]

As a political matter, however, this bipartisan consensus in favor of markets, or perhaps more accurately, suspicion of regulation, eventually broke down, thereby setting the stage for the Obama Administration's policies which has reversed this consensus and in so doing created the conditions for modern crony capitalism. More important, however, there are reasons to believe that Bush-Obama crony capitalism may prove more difficult to supplant than the rent-seeking state of the 1970s and that bipartisan opposition to crony capitalism may prove difficult to create. This is primarily because the left has come to appreciate that their interests are served through crony capitalism and, equally important, large corporations have come to see that their interests are naturally aligned with the crony capitalist system. Disruptive entrepreneurial capitalism is the real enemy of today's corporate behemoths, as shown by the earlier story of the transition of Microsoft and other technology firms entrepreneurial to crony capitalist business practices. Corporations, labor unions, politicians, and leftist interest groups have all come to see a natural alignment in crony capitalism and against entrepreneurial capitalism.

This point was illustrated to me recently in a conversation a former Director of the Office of Information and Regulatory Affairs (OIRA) in the Office of Management and Budget. I noted the curiosity of the window in time in the late-1970s when this unlikely alliance of leftist consumer activists such as Ralph Nader (and liberal politicians such as Ted Kennedy) came together with free marketers such as Ronald Reagan to support deregulation. The alliance proved short-lived, of course—it was only a few years before

[50] Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Mercatus Center at George Mason University 2014).

the Naderites and others on the left came to repudiate the deregulatory agenda. And I asked why the Naderites turned, especially given that if anything, regulatory capture theory seems even more validated by experience since that time.

This person related a story of meeting with the great deregulator Alfred Kahn just before his death and posing the same question. Why did Nader turn away from deregulation? According to Kahn, it was because Nader came to appreciate that the provision of economic rents through regulation was the necessary condition for labor union strength and collective bargaining. As noted, a corollary of rent-seeking is rent-sharing: the economic rents, once created, must be divided between shareholders, management, and workers. And the primary effect of labor unions is to bargain over the distribution of those rents and to try to direct as much as possible to union members. Without the creation of rents in the first place, however, then there is nothing to be directed to the unions, and labor (like capital and managerial labor) will be expected to receive only a competitive return. The government creation of rents in the first place is the necessary predicate for rent-sharing. Nader eventually came to recognize that is was precisely *because* regulation created rents by redistributing wealth from consumers to favored industries (and eventually, their workers) that Nader rejected deregulation. In short, when confronted with the choice between labor unions on one hand and consumers on the other, Nader and his allies threw their lot with the labor unions at the expense of consumers. While the earlier left of the 1970s believed that only corporations benefited from crony capitalism, they later came to realize that regulation benefited labor unions as well by creating rents in which they could share. In the end, the left sided with the crony

capitalists of labor unions and large corporations at the expense of consumers and entrepreneurs.

Today's generation of crony capitalists seem to recognize that the creation of regulatory-induced economic rents is the precondition for politicians and regulators to be able to carve up and redistribute wealth to favored interest groups. One suspects that it is an anticipated feature of the system: that the likely effect of Dodd-Frank will be to promote consolidation in virtually every industry that it touches, from banks to debt collectors and payday lenders. Industry players that are larger in size and fewer in number are easier to regulate than sprawling competitive industries with many players and lower barriers to entry. Fewer, larger, and more politically-connected firms will be easier to regulate through the subtle pressures of informal regulation without having to litigate or engage in formal rule-making and a source of political favors to politicians and regulators. And industries defined by fewer and larger firms and protected by regulation are necessary to generate a pool of rents that can be handed out to favored interest groups and politicians. Everyone wins from crony capitalism—except for the ordinary American who lacks political clout and connections.

## VI. Conclusion

In 1982 Mancur Olson identified the dire state of the American economy and diagnosed its ills as resulting from rent-seeking by important corporations and interest groups that had stifled innovation and thrown a blanket of stasis over the economy. Yet Olson's dire predictions proved unwarranted—the next two decades unleashed a period

of deregulation and entrepreneurial creativity that transformed America's economy and even society.

Today we stand at a similar juncture: crony capitalism, defined as a systemic integration of political and economic activity such that large wealth can be amassed or destroyed through government connections and industry protections, has overtaken the American economy in the post-crisis era. From banking to healthcare to the Internet, fortunes today are gained and lost on the basis of political connections and regulatory pull. Yet, perhaps Olson was not incorrect, just premature—today's crony capitalists have created a political-economic system that integrates big government, big business, and big labor in a tripartite deal to carve up the American economy. And because this iron triangle benefits precisely those groups best positioned to engage in rent-seeking, it will be harder than ever to dislodge. Crony capitalism may be here to stay.