



Rent Seeking and the Flight of Capital

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The productive elements of the US economy are caught between powerful financial interests, e.g., banks seeking speculative gains, political constituencies seeking entitlements and government entities at all levels whose budgets and deficits are too large compared to their revenues. All three factions are competing for the same economic resources and all three are net consumers of wealth. The triumph of any one faction or of any combination thereof, promises to erode capital and to encumber production and economic growth in the future. As a consequence, capital can be expected to flow away from the United States to other parts of the world.

If banks dominate over government, for example, ever larger shares of tax revenues will likely flow to banks as a consequence of interest payments and taxes will certainly rise despite inevitable austerity measures. If government triumphs at the expense of banks, setting aside questions related to bank failures, bailouts or sovereign defaults, there is no reason to believe that government entities will become fiscally responsible or that the pattern of government expansion, as a percent of GDP, will reverse in the foreseeable future. The banking and financial services industries also represent a disproportionate share of US GDP. Political constituencies seeking entitlements are, in part, a reaction against and a consequence of disproportionate growth of government and of the banking and financial services industries. In advocating for or against any of the above factions, what seems to be ignored is where sustainable economic growth will come from in the future.

Surrounded on all sides are entrepreneurs and private capital, which are the historical engines of US economic growth. As the nation struggles to recover from the unprecedented global recession and the financial crisis that began in 2008, the competition between banks, government entities and political constituencies seeking entitlements represents a diversion of wealth and future production into economically unsustainable pursuits, such as bank profits, government stimulus or social welfare programs. In economic terms, the relationship of banks, government entities and political constituencies seeking entitlements to the productive elements of the economy can be described as one of [rent seeking](#).

Rent seeking is a relationship where an individual, company or other organization seeks income by capturing the production of others through manipulation or exploitation of the financial, legal or political environment, rather than through ordinary market participation or the production of wealth. Analogous to parasitism in biology, rent seeking means obtaining an economic gain at the expense of others without any reciprocal benefit. Common examples of rent seeking include tariffs sought by industries for no purpose other than to boost profit margins and efforts by special interest groups to redistribute wealth in their favor by shifting tax burdens or government spending where there is no reciprocal benefit to any other group in society.

Businesses that produce physical goods, i.e., real production, along with labor and existing capital derived from past production surpluses are the targets of rent seeking strategies. The central question for economists is whether rent seeking is sustainable as an economic paradigm, i.e., as the dominant form of economic relationship in an economy. If so, spending by those who successfully gain control of wealth will stimulate economic activity in a sustainable way and the economy will return to genuine growth. For example, economic growth might return as bank profits trickle down through the economy; or as government borrowing and spending or expansion stimulate the economy and create jobs, e.g., government jobs; or as social entitlements, such as guaranteed retirement incomes or medical care, prove to be more efficient and less costly to society when provided by government and funded by tax revenues rather than by private industry. If it turns out, however, that rent seeking is not a sustainable economic paradigm, then the future of the US economy will be characterized by an erosion of capital and an absence of sustainable economic growth. One question that might arise in the latter scenario is whether capital will stay in the US or migrate to other parts of the world. The answer to this question lies in the nature of capitalism, as well as in the historical origins of American capitalism.

Property and Liberty

In terms of both economics and political philosophy, there are links between rent seeking where government is involved, the fundamental relation of individual citizens to the institution of the state, and macroeconomic developments in the US particularly since 1971. These links became increasingly clear after the start of the global financial crisis that began in 2008.

History bears out that capitalism, compared to other economic systems, has created more wealth, raised the living standards of more people, and has increased individual liberty to a greater extent. The reasons for the success of capitalism lie not only in economics but also in philosophy. The historical innovation and entrepreneurship and the immense industrial production of the United States in the past occurred both in the context of capitalism and in a social and legal framework established by the US Constitution. Going back to the American Revolution and before, the ownership of an individual person of their own body and of the labor that it can produce literally distinguished a free person from a slave. This concept is the common root of private property and of capitalism. The natural right of a person to the fruits of their labor, i.e., to own property, is, therefore prerequisite to other rights. In his seminal book, *The Road to Serfdom*, F. A. Hayek explained the interdependence of private property, the division of labor and freedom.

“... [T]he system of private property is the most important guaranty of freedom. It is only because the control of the means of production is divided among many people acting independently that we as individuals can decide what to do with ourselves. When all the means of production are vested in a single hand, whether it be nominally that of "society" as a whole or that of a dictator, whoever exercises this control has complete power over us. In the hands of private individuals, what is called economic power can be an instrument of coercion, but it is never control over the whole life of a person. But when economic power is centralized as an instrument of political power it creates a degree of dependence scarcely distinguishable from slavery. It has been well said that, in a country where the sole employer is the state, opposition means death by slow starvation.”
– F. A. Hayek, *The Road to Serfdom* (1944)

Of course, a human being is much more than an economic unit and the natural rights of individuals do not end with the absence of slavery, thus private property can be viewed as the keystone of all human rights. In fact, provisions of the American Bill of Rights, such as the prohibition against unreasonable search and seizure are an elaboration and enumeration of private

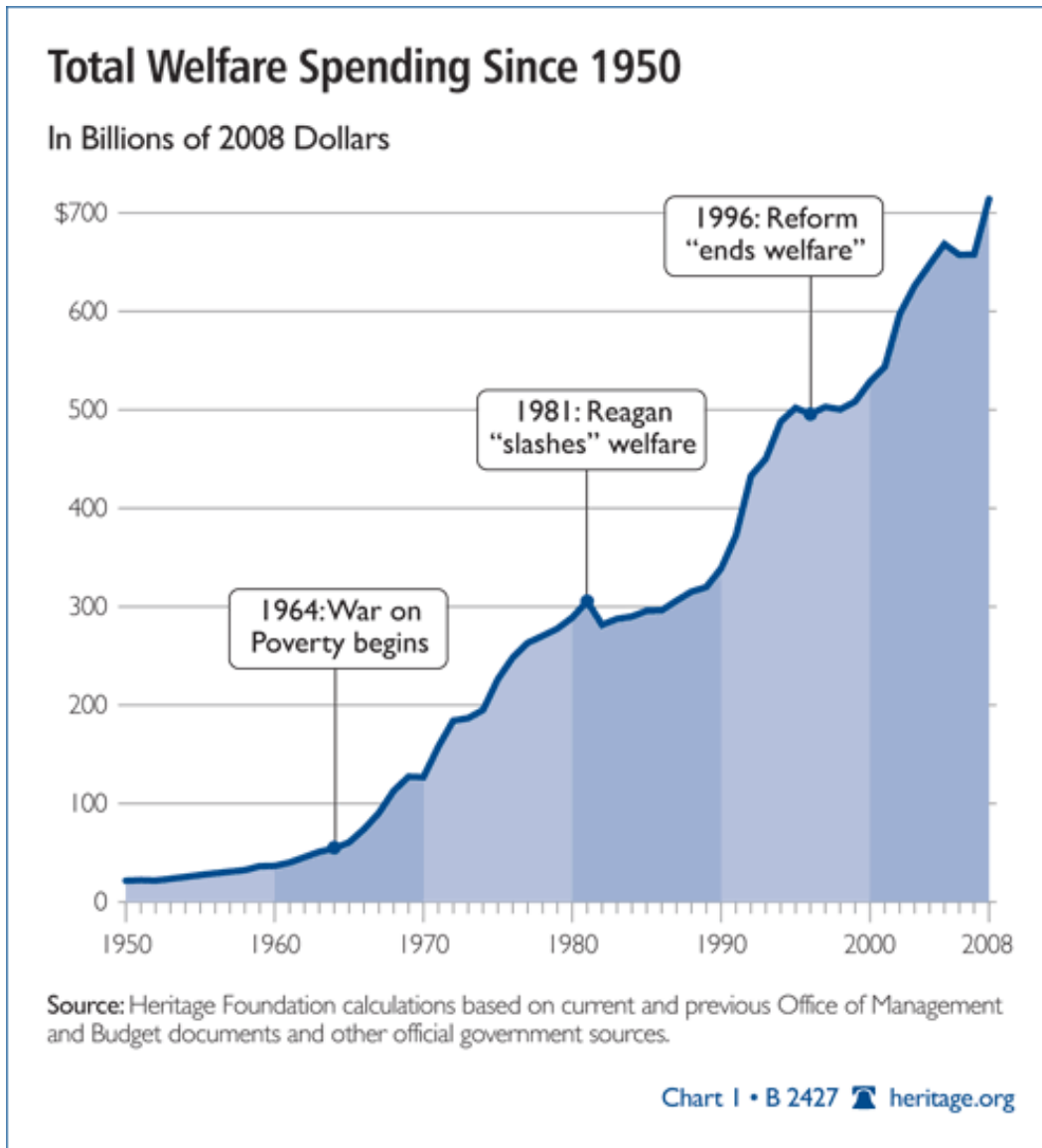
property rights vis-à-vis the rights of government. Interestingly, the American Bill of Rights contains broad prohibitions against actions by government, rather than positive rights, such as the right of an individual to a particular social benefit. In the modern world, private property and, therefore, other rights are not threatened directly by violence and coercion as they were prior to the American Revolution, but they are threatened today by excessive growth of government, by private concerns pursuing rent seeking profit strategies and by political constituencies seeking entitlements.

Taxes levied on privately owned businesses or on private individuals for the purposes of social welfare programs function as a proxy for rent seeking in that they affirm a positive right to an economic benefit for one group at the expense of another group that receives no reciprocal benefit. For example, the establishment of a legal right of a person with no means to pay for it, to obtain medical care, takes precedence over the property rights of individuals who have the means to pay for medical care on their own behalf. In the example of medical care, it is likely that those upon whom the financial burden falls have little or no objection to the arrangement because a majority of individuals probably believe that their contribution is for a worthy cause, but the precedent of government intervention over volunteerism is a dangerous one from the standpoint of individual rights.

While one group bears the economic cost, even if the only cost is reduced access to medical care or reduced quality of care, there is a more broad cost to society in terms of the erosion of individual rights. In a rent seeking economic relationship where government is the agent of wealth transfers, it is not only exploited groups that lose rights but, in fact, all citizens. When wealth is transferred or redistributed by government, rights removed from exploited groups are not transferred to groups that receive the resultant economic benefits but rather accrue to the government itself, thus diminishing the rights of all and expanding the power of government, i.e., the power to claim the wealth of its citizens for whatever purposes are deemed worthy.

“The preservation of freedom is the protective reason for limiting and decentralizing governmental power. But there is also a constructive reason. The great advances of civilization, whether in architecture or painting, in science or in literature, in industry or agriculture, have never come from centralized government.” – Milton Friedman, Capitalism and Freedom (1962)

While wealth transfers may be undertaken with the best intentions, over time, the eventual consequence is an aggregation and concentration of power in government at the expense of individual rights. Among other things, a precedent is established whereby rights are granted by government to citizens and not the reverse. Wealth transfers by government, therefore, result in the expansion and centralization of economic and legal power in the government at the expense of the rights of individual citizens.



In the extreme, the flow of rights from individuals to government may eventually result in a totalitarian state structure where rights *per se* no longer exist, or exist in name only, replaced, in practice, by privileges granted by government at its sole discretion. In terms of political philosophy, a constitutional republic aims to prevent totalitarianism (historically referred to as tyranny) by establishing that the people are sovereign and that the limited rights of government are granted to it at the sole discretion of the people. In contrast, an economic system, based on government redistribution of wealth, is ultimately incompatible with a structure where the people are sovereign, i.e., a constitutional republic, simply because wealth redistribution requires that the rights of government take precedence over the property rights of individuals.

There's been one underlying basic fallacy in this whole set of social security and welfare measures, and that is the fallacy - this is at the bottom of it - the fallacy that it is feasible and possible to do good with other people's money. That view has two flaws. If I want to do good with other people's money, I first have to take it away from them. That means that the welfare state philosophy of doing good with other people's money, at its very

bottom, is a philosophy of violence and coercion. It's against freedom, because I have to use force to get the money. In the second place, very few people spend other people's money as carefully as they spend their own. The real problem with government is not the deficit. The real problem with government is the amount of our money that it spends.

– Milton Friedman

If the basic economic rights of individuals are undermined and government power expands, becoming more centralized, then controlling government spending may be problematic, particularly if doling out entitlements is central to the political goals of the regime in power, e.g., remaining in power. As has been seen in Europe, government spending for the purposes of expanding entitlements is constrained only by the capacity to borrow and to service debt, which is a pattern that can lead to economic collapse.

“A democracy cannot exist as a permanent form of government. It can only exist until the majority discovers it can vote itself largess out of the public treasury. After that, the majority always votes for the candidate promising the most benefits with the result the democracy collapses because of the loose fiscal policy ensuing, always to be followed by a dictatorship, then a monarchy.” – Scottish historian Alexander Fraser Tytler, Lord Woodhouselee (1747-1813), unverified attribution

Totalitarianism: Public or Private?

Wealth redistribution is not the exclusive domain of government. Inflationary policies by the US Federal Reserve erode the value of money and dilute the share of wealth held by the majority of those who rely on the monetary system while transferring wealth either to banks or to those who first receive newly created money. In fact, the institution of central banking is itself a form of rent seeking where governments borrow their own currencies into existence from private banks passing the burden of repayment with interest on to taxpayers, e.g., as a value added or income tax, rather than maintaining the national currency as a public facility. Central banking is associated both with economic rent seeking insofar as private interests successfully influence the central bank in their favor, and with political philosophy where the rights of individuals are concerned, e.g., monetary inflation deprives savers of the right to spend tomorrow money obtained in exchange for labor today at a value consistent with the terms of the exchange. In the latter case, the central bank produces a *de facto* breach of contract. As John Maynard Keynes famously said, “By a continuing process of inflation, government [or private interests that control the central bank] can confiscate, secretly and unobserved, an important part of the wealth of their citizens.” In this regard, one can see the extent of the powers abdicated by governments to central banks. Central banks have the power to redistribute wealth and can do so either at the behest of government or, more importantly, in the service of private concerns, e.g., the owners of the private central bank.

The advent of bank bailouts, amounting to roughly [\\$4 trillion](#) in the US officially, but perhaps as much as [\\$23.7 trillion](#), during the global financial crisis that began in 2008 was remarkable for two reasons other than the danger of systemic collapse thus averted and the amounts of money involved. First, it became apparent that large banks, and central banks, had more influence over governments than their own citizens. In fact, [a majority of Americans opposed bank bailouts](#). Second, the power of central banks to transfer wealth was laid bare by the Federal Reserve's purchase of mortgage backed securities which traded newly created money for what most observers agree was little more than worthless paper in an attempt to render otherwise bankrupt financial institutions solvent again.

The independent actions of the US federal government and Federal Reserve produced record profits and bonuses in the banking sector while, at the same time, household wealth in America fell significantly, creating the popular impression that Wall Street was somehow looting Main Street. The mechanism of wealth transfer, however, was actually the Federal Reserve, which had then been in place for 94 years prior to the crisis and during which, arguably, a similar process of wealth transfer had taken place gradually on a smaller scale. The arbitrary and sweeping nature of the emergency actions taken by the federal government and Federal Reserve in response to the financial crisis revealed the extent to which the powers of both the federal government and Federal Reserve had quietly expanded and become more centralized over a period of less than 100 years to a point of near absolute control over the wealth, i.e., the property, of US citizens. The roots of these developments, however, lay not in the economic bubbles leading up to the financial crisis that began in 2008 but in the 1913 Federal Reserve Act and in the New Deal that followed the resulting Great Depression.

“Legal plunder can be committed in an infinite number of ways; hence, there are an infinite number of plans for organizing it: tariffs, protection, bonuses, subsidies, incentives, the progressive income tax, free education, the right to employment, the right to profit, the right to wages, the right to relief, the right to the tools of production, interest free credit, etc., etc. And it is the aggregate of all these plans, in respect to what they have in common, legal plunder, that goes under the name of socialism.” – Frederic Bastiat, The Law (1848)

After World War II, the United States had embraced labor unions and social programs partly in response to the ideological struggle between the US and the Soviet Union, which was a totalitarian state, but the US, while fighting totalitarianism, planted the seeds of totalitarianism in its own backyard. Following decades during which social welfare programs expanded, and during which both the federal government and the financial sector grew dramatically as percentages of US GDP, the centralization of power revealed in 2008 indicated a largely unrecognized shift in political philosophy toward a totalitarian state structure.

A Monetary Empire in Decline

Perhaps every empire in decline witnesses a transition from surplus production to excess consumption and that is precisely what happened in the United States in the 1970s, marked first (after the establishment of the US Federal Reserve and then of a welfare state by President Franklin Delano Roosevelt) by the [final abandonment of the gold standard in 1971](#) then by the [1975 shift from trade surplus to trade deficit](#). Both events were a consequence of spending in excess of real wealth production. These events ushered in the era of offshoring in the 1980s and of outsourcing to foreign firms in the 1990s. The idea was simple: exchange higher domestic costs for lower costs abroad and sell virtually the same products to the same domestic customers at higher margins, lower prices to gain market share, or simply hold prices at competitive levels by cutting costs. Under the banner of free trade, and later of globalization, the US government did virtually nothing to curtail these trends and the US economy appeared to expand as US dollars flooded the world in an unprecedented period of monetary expansion. As the accompanying deindustrialization of the United States progressed, two developments, in addition to the then accumulated capital in the US, mitigated the impact of declining US industrial production: (1) growth in service industries and (2) a combination of asset appreciation and increased consumer borrowing and spending (eventually reaching an unsustainable 70% of GDP), but both were fundamentally linked to monetary expansion and neither proved to be sustainable.

Replacing industrial production with a service economy was a flawed concept because as domestic production fell, it was, in fact, debt expansion that replaced the creation of real wealth, thus the US trade deficit soared. As factories closed and as jobs departed US shores for Taiwan, China, India and elsewhere, the selling of equivalent foreign-made goods and offshore services into a domestic market that included a growing number of displaced workers, became less and less plausible. The idea that displaced American workers would eventually embark upon new, service industry careers and, therefore, maintain their spending levels, in retrospect, was plainly wrong. While perhaps viable in a perfectly balanced global economy, it is difficult to imagine a sustainable domestic economy, in itself, comprising a majority of services since it would have to rely on material goods from abroad, i.e., it would suffer a chronic trade deficit. The answer for American businesses was to expand into global markets but this did little for the domestic economy, thus the US service economy failed to replace declining industrial production. What happened, in reality, was that the percentage of the total US population in the work force simply declined, flooding welfare roles and producing a growing political constituency favoring wealth redistribution.

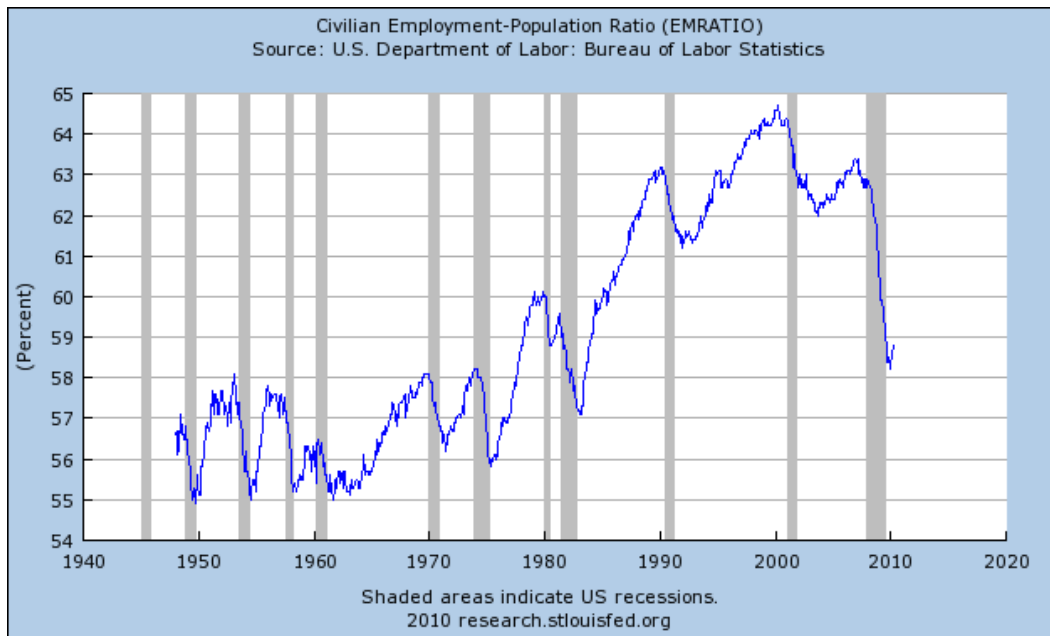


Chart courtesy of the [Federal Reserve Bank of St. Louis](http://www.federalreservebankofstlouis.org)

One way to characterize the sequence of events in the US is to say that a paradigm shift took place where the US economy moved from production to consumption; from an industrial economy to a (so-called) service economy; from wealth creation to wealth extraction; from increasing living standards to wealth redistribution; from a nation of citizens and workers to a nation of “consumers,” all the while transitioning from the largest lender in the world to the largest debtor nation in the history of the world. In terms of US government spending, unsustainable growth in entitlements and pork barrel politics became business as usual in Washington D.C., while Wall Street shifted from investing, in order to participate in dividends and capital gains resulting from production and value creation, to trading based on technical indicators; a competition where participants seek to extract wealth from investors and other traders in what amounts to a casino game, i.e., a rent seeking structure. Flash trading using automated trading systems and high-frequency trading algorithms, for example, are rent seeking in the garb of high technology.

Other advanced economies, in varying degrees, have followed the American example, resulting in the emergence of rent seeking as the dominant economic paradigm of Western countries. To make matters worse, rent seeking by private concerns has become confused with capitalism.

The Flight of Capital

In the past, capital and individual entrepreneurs flowed into the United States from around the world because it represented two related things: freedom and economic opportunity. The post bailout world is one where large banks have, to some degree, hijacked the emergent totalitarian powers of governments in a model where perpetual sovereign debt represents a virtually unlimited flow of wealth from the subjects of totalitarian states to the banks that, through the institution of central banking, exert considerable influence over each nation's government. The post bailout economy seems to be a veritable frenzy of rent seeking activity by banks, governments and political constituencies seeking entitlements. In all three cases, individual liberty, e.g., the right to own property is an impediment and the success of any of the three factions promises to encumber or to prevent entirely future economic growth. It makes little difference to individuals if the fruits of their labor are confiscated by inflation, by taxes to fund unsustainable government expansion, or by taxes to fund social welfare programs. In all three cases, the impetus toward entrepreneurship and the incentives for putting private capital, i.e., private property, at risk in new business ventures are reduced or eliminated. Regardless of which rent seeking faction wins, capitalism, which has created more wealth, raised the living standards of more people and which, because of its intrinsic compatibility with private property, has increased individual liberty more than any other economic system in the history of the world, is set to lose.

Capitalism, rather than ceasing to exist, will adapt, thus capital will migrate away from economies characterized by rent seeking, i.e., by the consumption of wealth, to parts of the world characterized by the production of wealth. Capital may also be driven into black markets as seen under the former Soviet Union. All other things being equal, the next decade is likely to see a massive flight of capital from the United States to countries where property rights are respected (or where government is simply smaller) and where the values of investments are less vulnerable to the ravages of excess monetary expansion, counterproductive taxation and sovereign debt risk or redistribution by government in the service of political constituencies seeking entitlements. Within the latter constraints, China and emerging economies that are rich in natural resources and that produce commodities or physical goods will surely become the new bastions of capitalism.

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