Economics and Society: Barrier to a Breakthrough

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Robin Harding
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Ghaleb Ibrahim, a grizzled Jordanian immigrant with a mane of wavy grey hair, holds to a modest vision of the American dream. He wants to own and drive a taxicab in Milwaukee, Wisconsin, the city in which the television show *Happy Days* was set.

The trouble is that he does not have $150,000. That he says is what it would cost, over and above the price of the vehicle itself, to buy from its existing owner one of only 321 cab licences in issue by the city.

Mr Ibrahim drove a rented cab for some years; he tried driving a truck; now he chauffeurs an airport limousine. “The only way you can make it today is if you have your own business, your own car, your own permit,” he says.

To try to make that possible he has become the lead plaintiff in a lawsuit filed by the Institute for Justice, a libertarian law firm, that is seeking to have the cap on permits – in place since 1992 – struck down under the Wisconsin state constitution. If it succeeds, says Mr Ibrahim, “some of us who are young at least will get their own taxis and build a better life”.

Licences are so expensive because the limit on competition makes each of Milwaukee’s taxis unusually profitable: their extra earnings are an example of an “economic rent”. These are reflected in the literal rent of up to $1,000 a week that a driver must pay for a fuelled and licensed cab.

The creation of an economic rent – often by persuading the political system to grant some kind of a monopoly or privilege – means a one-off chance for someone to get rich and then a permanent barrier to newcomers entering a market. The Milwaukee cab licences are together worth $48m – and since 1991 more than half of them have migrated to companies owned by one family: the Sanfelippos. Even at their own more modest price estimate of $80,000 their permits are worth as much as $13m.

“People can’t start a business because they have to do something useless, which is cough up 150 grand to someone right now who is being protected by that system,” says Anthony Sanders, the IJ attorney leading the case.

Taxi rents in Milwaukee may seem like a minor evil but they are merely a visible and easy-to-measure example. Although Tea Party and Occupy Wall Street activists may not all be aware of it, rage against economic rents is what unites them; it is the hidden factor behind much of what they hate.

Rents allow some to grow rich at the expense of others. When the economy was booming that might not have mattered much. But as globalisation and technological change make America and other western societies ever more unequal, the fairness of the system becomes more important.

For economists, it is the waste of resources on lobbying in pursuit or protection of rents that is their greatest evil. In the jargon, this behaviour is called “rent-seeking”. Studies of economic losses due to rent-seeking and the resulting monopolies have produced figures ranging from 3 to 12 percentage points of national output for the US.

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Economic rents arise from other legal monopolies such as extended copyright protection. The financial sector is riddled with them; some analysts say that part of the reason for high executive pay is because managers can extract rents from shareholders.

Matt Kibbe, president of the Tea Party umbrella group FreedomWorks, says opposition to rent-seeking is “almost definitional” for his movement. He points to the Tea Party’s genesis in the battle over bank bail-outs: the implicit insurance of too-big-to-fail created a rent for large banks.

Business has always sought government earmarks, says Mr Kibbe, but “it seems to be escalating to the point where the unholy alliance between big business and big government is really defining public policy today”.

Yet the public at large often seems able to distinguish rents from the creation of real added value, such as in information technology. “I don’t see a lot of anger at Steve Jobs,” Dean Baker, co-director of the left-leaning Centre for Economic and Policy Research, says of the late founder of Apple. “I think people do have an intuitive sense that they are getting ripped off by people who aren’t making a great contribution to society.” No politician is likely to use the term “economic rent” in this year’s elections – but being seen as someone who is fighting rather than creating that is likely to be crucial to victory.

Martin Kretschmer, a law professor at Bournemouth University in England, helped to fight a losing battle against a colossal creation of rents in Europe last year: the extension of copyright on recorded music from 50 to 70 years. The new law transfers €1bn out of the pockets of European consumers and into those of music companies and ageing rock stars.

The social argument for copyright is that it gives an incentive for artists to create work. But, as Mr Kretschmer says, “the fact that the extension was retrospective gives the game away really”. The Beatles have already recorded *Rubber Soul*; another 20 years of royalties will not make them record it again. The consensus among academics who study the term of copyright that would best balance the interests of consumers and creators, he adds, is that “14 years is not an unreasonable starting point”.

Executive pay is a more contentious case. Some academics argue that high compensation is simply the optimal way to make a manager act in shareholder interests; others that executives have the power to influence their own pay and can, in effect, extract rents.

“We know that executive pay consists at least partly of rents because both the level and insensitivity to performance of compensation increases with executive power vis a vis shareholders,” says Jesse Fried, a professor at Harvard Law School and co-author of *Pay Without Performance*, a book critiquing executive pay practices.

Improvements in corporate governance, such as new say-on-pay rules in the US, "could reduce the rent element of executive pay" if shareholders use them, says Mr Fried, "but, at the end of the day, executives of a publicly traded company with dispersed shareholders will always be able to collect rents".

Finally, the financial sector is ground zero as an arena in which some firms and individuals have power and information, while others do not. Investment banks know what securities their customers buy and sell; high-frequency traders compete to locate their computers closest to the exchange; and the entire active investment management industry, which collectively returns the same as the market minus its own fees, earns something that resembles an economic rent.

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Although you will generally find a taxi only outside one of the main hotels, the offices of the American United Taxicab Co are a short cab ride from downtown Milwaukee. The compound sprawls over much of a city block and looks more like a dotcom start-up than the grimy counter common to many cities. Teams of staff answer 6,000 calls a day as they track their taxis around the city by GPS.

Joe Sanfelippo, whose brother Mike owns the operation that his father founded, is clearly angered by IJ's assault on a company that, from his point of view, was built up by investment, hard work and savvy entrepreneurship. "They're not looking for a free market – they're looking for a free ride," says Mr Sanfelippo. "If you didn't know any better, and you looked at the rhetoric they're putting out you wouldn't think that this was coming from the Institute for Justice, you'd think that this was coming from the Institute for Occupy.

"They're trying to create almost like a class warfare or an envy system to say, 'You know what, these guys have built a business here, they must have done it by screwing somebody over, and so we are going to demand that we get something for free'."

Mr Sanfelippo offers a list of reasons why life was bad before the cap on permits. "Nobody could make a decent living driving a cab. Nobody could put a decent vehicle on the road," he says. "It wouldn't be uncommon for a cab to sit for four hours waiting for a fare. Drivers were getting into fist fights over fares." Lift the cap, he says, and Milwaukee would fill with fly-by-night operators, creating a "regulatory nightmare for the city".

All of these are possible reasons why the city of Milwaukee might want to limit the number of cab permits, but they do not imply that the existing owners must have a permanent right to them.

The city could simply auction 321 licences every year or two and capture all of the economic rents for itself. Another argument is that a permit acts as a pension for drivers that would otherwise not have a business they could sell on retirement. But that is true only for the first, lucky generation of owners.

The IJ lawsuit has reinvigorated a drive to convert the current permits into medallions similar to those in New York City, putting them on a permanent legal basis and creating a few new ones each year. Fuelled by lobbying from the Milwaukee taxicab owners, a bill sailed through

committee in the Wisconsin state assembly on Tuesday, within three weeks of introduction, and could become law before the end of March.

There is no easy way to eliminate rents, because wherever they can exist there will be a temptation to seek them. “One solution is trying to get courts to enforce the commitment device known as the US constitution,” says Peter van Doren, senior fellow at the libertarian Cato Institute. This approach, narrowing the scope of possible regulation based on a constitutional principle, is what IJ is pursuing in Milwaukee.

An alternative, where there must be regulation or where rent stems from a private transaction, is transparency. “Transparency nearly always reduces popular support for public policies which produce rents for a favoured few,” says Roger Congleton, professor of economics at West Virginia university.

For Mr Ibrahim the matter is much simpler. “It should not be monopolised,” he says. “The way it is now, you can work day and night and still not make the rent.”