Why is vigorous economic competition a good thing?

An interview with Brink Lindsey, an expert on competition at the Niskanen Centre

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ECONOMISTS are becoming increasingly worried that capitalism today is less competitive than it once was. Some argue that much of what is wrong with rich-world economies today—from high income inequality to measly wage growth—has its roots in markets that are uncompetitive.

However, much of the discussion about competition is fairly abstract and difficult to understand. To help readers get a grip of one of the most important issues today, we turned to an expert on competition to ask him some simple questions.

Brink Lindsey is the vice-president for policy at the Niskanen Centre, a nonpartisan think tank in Washington, DC. His book "The Captured Economy", co-written with Steven Teles, is reviewed by *The Economist* here. The conversation has been lightly edited for clarity.

The Economist: Why do economists believe that vigorous competition is a good thing?

Brink Lindsey: Well, the first thing to say is that economists haven't always thought that. In much of the postwar period, economists argued that big firms, with huge market power, were the mark of a successful economy. People back then had been influenced by the work of Joseph Schumpeter and John Kenneth Galbraith. The argument went that only these behemoths had the resources to invest in research and development, which would lead to higher productivity and living standards.

Think of it as a kind of triumvirate. You had big businesses. You had an interventionist government. And you had organised labour. All three used their economic muscle to work together and manage the economy. Competition was something that happened somewhere else—in the "mom and pop" sector of

the economy, where unproductive businesses battled it out. The idea of a plucky entrepreneur coming up with some amazing new idea in her garage seemed faintly ridiculous. Something almost pre-industrial. Only big businesses could hope to do that.

The Economist: So what changed?

Brink Lindsey: What changed was that the 1970s were marked by lousy economic performance. So people started to wonder whether that big-business model was all it was cracked up to be, or whether it was too cosy and staid. And at the same time, you had an IT revolution, as well as more and more small businesses coming up with interesting ideas.

Today, there is a robust consensus among economists that rivalry between firms is an essential precondition of a dynamic, innovative market economy. A wealth of studies looking at the micro level assess what happens when firms are subjected to some sort of unexpected shock—say, the removal of trade barriers, leading to higher import competition. Those enterprises that suffer the shock also see higher productivity growth. The evidence is really overwhelming that having the wolf at your door, looking at the gallows, all of that concentrates the mind wonderfully.

Larger-scale studies, meanwhile, find negative effects when product markets are tightly regulated. These negative effects include lower productivity growth and GDP growth. One thing to point out is that these losses seem especially large in poorer countries. Allowing firms in poor countries to freely adopt the technologies and labour practices of richer countries can lead to really rapid economic growth. The downsides of overbearing regulation are smaller in rich countries, but still significant.

The Economist: When did you start to worry that competition in the American economy was not as vigorous as it should be?

Brink Lindsey: It was all to do with the aftermath of the financial crisis of 2008-09. Normally, when you have a big recession, as we did, you get a really speedy recovery. But that did not happen this time. Initially, you look for cyclical explanations for why this might be, such as how banks are lending.

But after a while you start to think that there might be a structural explanation. I also started to worry that something had gone structurally wrong with the American economy long before the financial crisis, but that these problems had been masked by the vigorous economic growth associated with an asset-price bubble. At first, of course, I remained sceptical. Whenever there is a crisis, people always talk about there being a "new normal". But what I gradually came to believe was that the economy had been captured by vested interests.

The Economist: Can you give any examples?

Brink Lindsey: The book outlines four case studies of where things have gone wrong. The most obvious one is the financial sector, which had blown up in 2008. That sector was revealed to have massive structural problems. The financial sector exhibits something that economists call "regulatory capture"—where regulations are formulated to benefit the industry itself, not the consumers.

Let's think about what this might mean in the case of finance. Throughout the 1980s and 1990s, time and again American banks were bailed out by government. Think of the third-world debt crisis of the 1980s—we bailed out American banks through the IMF bailing out foreign borrowers. Then you have the peso crisis, the Asian financial crisis, the ruble crisis, Long Term Capital Management. The Feds came in again

and again. So the folk impression of finance is more or less correct. People got rich making irresponsible bets with other people's money. And there was no downside.

The Economist: So what are the consequences of this arrangement?

Brink Lindsey: Well, there are a few consequences. One is obvious: that occasionally you get a big bust, as we did in 2008. You also have a massive misallocation of labour within the economy. Our smartest people are engaged in tasks such as trying to shave a fraction of a millisecond off a trade. How is that socially useful? In other words, the capture of the economy by a certain interest group has led to an economy that is worse off.

The Economist: How else is the economy captured?

Brink Lindsey: Another example relates to the protection of intellectual property. Now, don't get me wrong. Protecting intellectual property often makes sense. Actually, it has a pro-competition justification. A patent is a temporary monopoly on a new invention. So that incentivises people to create things in the first place—you don't want people coming in and copying the thing that you have spent years developing. The authority to grant patents is in the American constitution.

But over the past 30-40 years, there has been a big rise in patent protection. Today the balance is out of whack. The Patent and Trademark Office grants about five times as many patents as it did in the 1980s. Standards for patentability have declined. And patents have expanded in scope, to include things like software and business methods. For instance, Amazon's 1-Click button was patented. So what we have seen is a dramatic expansion in the number of monopolies that have been created.

The Economist: What is the upshot of this?

Brink Lindsey: The upshot is that innovation has become more difficult. Patents in things like business methods are described in vague, abstract language. It's not like a chemical, where it's very easy to see what is being patented.

So, all these new patents turn innovation into a legal minefield. Software producers live in fear—are we infringing on someone else's work? Everybody is flying blind, waiting to be shaken down by someone who claims that their work has been infringed. These days you even have so-called "patent trolls". These are firms that do not produce anything—they just buy up patents to monetise them through litigation. The vast bulk of infringement litigation is between firms who don't make anything against firms who are trying to innovate.

Also, this way of doing things pushes firms towards being really big, and makes it harder for new ones to enter the market. Big firms sign non-aggression pacts in which they license their patents to each other. And smaller firms do not have the in-house expertise to deal with patent trolls and the like.