

## RESEARCH SUMMARY

# Crony Capitalism: By-Product of Big Government

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Crony capitalism describes an economic system in which the profitability of firms in a market economy depends on political connections. When people see well-connected businesses benefitting from government favoritism, they often call for more government involvement in economic affairs to safeguard the public interest. In a paper for the Mercatus Center at George Mason University, economist Randall G. Holcombe shows that government intervention is not the solution to crony capitalism, but rather its cause.

The term “crony capitalism” is often used in the popular press but rarely in academic literature. Still, there is a substantial economic literature that implicitly addresses the causes and consequences of crony capitalism. This literature suggests ways to reverse the growth of crony capitalism, such as by limiting the size and scope of government and creating strong fiscal rules.

### WHY CRONYISM EXISTS

Government actors are not omniscient, yet people often assume that the government is both willing and able to achieve the desired effects of any particular policy. In reality, the government is subject to a variety of limitations:

- *Information constraints.* Policies that could theoretically be designed if policymakers had perfect knowledge often cannot be implemented in the real world, where knowledge is imperfect.
- *A perverse incentive structure.* Policymakers usually claim to be serving the public interest, but pandering to more narrow interests may more directly serve their personal interests (reelection, for instance).
- *Inertia from previous political decisions.* Even when a program is enacted for noble purposes, established government programs often create new interests. These interests do all they can to keep the programs in place.

When people in government are given power to regulate, to spend money, or to benefit some at the expense of others, cronyism is inevitable.

### HOW CRONYISM MANIFESTS ITSELF

Three manifestations of cronyism lay the foundation for understanding why cronyism persists:

- *Rent-seeking.* When the government is in a position to award privileges such as tariffs, quotas, and monopoly licenses, businesses have an incentive to devote resources to acquiring favors rather than providing what customers value.
- *Regulatory capture.* Regulated industries are often able to form a concentrated interest and actively tilt the regulatory process in their favor.

- *Interest group politics.* As nations grow and age, political interest groups solidify. Increasingly, success comes from political connections rather than productive market activity.

A real-world example is the evolution of the sugar program in the United States. This program was originally designed to protect American sugar farmers from Cuban competition. Due to rent-seeking, regulatory capture, and interest group politics, the program's trade restrictions remain long after the Cuban threat has disappeared, raising the price of sugar for American consumers.

## HOW TO LIMIT CRONYISM

The larger the government, the more fertile the breeding ground for cronyism. Only a reduction in the size and scope of government will direct resources back toward productive economic activity.

Cronyism can be limited if the rules of the game structure policymakers' incentives appropriately. One way to do this is through the "fiscal constitution," or the rules that define the government's ability to shape taxation and expenditures. A strong fiscal constitution can insulate the government from interest group pressures:

- *It can make the tax structure less arbitrary.* Currently, tax authorities can easily impose different taxes on different groups of people. If the constitutional framework prevented those with fiscal authority from using it arbitrarily, this would limit cronyism.
- *It can make expenditures less discretionary.* If relatively inflexible procedures are established for allocating the government's budget, then interest groups will have a limited ability to engage in cronyism.

However, while it is easy to identify institutions that might limit cronyism, it is far more difficult to establish them where they do not already exist. Because people with political and economic power benefit from crony capitalism—at the expense of the general public—finding practical ways to reduce cronyism is a challenge.

## CONCLUSION

Even an ideal market-oriented democracy can evolve into crony capitalism in the absence of constraints on politicians' discretionary power. More seriously, cronyism often prevents the establishment of market institutions, since those benefitting from government largesse fight to maintain their politically granted privileges. In the absence of appropriate constraints, people with political power use that power to benefit some at the expense of others. The solution is not to empower the politicians, but rather to constrain them. Crony capitalism is a by-product of big government, so shrinking the government is the most effective way to control it.