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CRONY CAPITALISM: By-Product of Big Government

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-Abstract-

Crony capitalism describes an economic system in which the profitability of firms in a market economy is dependent on political connections. The term has been used in the popular press but rarely appears in academic literature. However, there has been a substantial amount of academic research on various components that, when aggregated, describe crony capitalism. This literature shows that crony capitalism exists only because those in government are in a position to target benefits to their cronies, and have an incentive to do so, because they get benefits in return. The ability to target those benefits is a result of the spending and regulatory power of government, so big government causes cronyism. One remedy often suggested for cronyism is more government regulation and oversight of the economy, but this remedy misunderstands the cause of cronyism. The substantial and well-established economic literature on the components of crony capitalism shows that big government is the cause of crony capitalism, not the solution.

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1. Introduction

Economic policy debates often divide participants along pro-business and pro-government lines. Pro-business advocates push for tax incentives, subsidies, protection from foreign competition, and regulations that often create barriers for foreign competitors. Pro-government advocates point to the abuses of capitalism and argue that big government is necessary to correct the failures of the market, regulate business so it will act in the public interest, and stand up to crony capitalism. The most charitable way to view pro-business arguments is that some government policies create an uneven playing field, and that government policies can be used to level it.[1] Sometimes pro-business arguments build from the idea that government support can create more economic prosperity than the market can if it is left to its own devices.[2] Regardless of the motivation behind those pro-business arguments, government intervention in the economy to benefit businesses lays the foundation for crony capitalism. When businesses can profit from government policies, they have an incentive to pursue benefits through government favors rather than through productive activity. The more the government is involved, the more business profitability depends on government support rather than productive activity, so the more important political connections become to business success. Crony capitalism is an economic system in which the profitability of business depends on political connections.[3]

The pro-government argument that more government involvement in the economy and greater regulatory oversight can control crony capitalism misunderstands the cause of crony capitalism. Crony capitalism is caused by government involvement in the economy, and additional government involvement makes the problem worse. Government intervention is not the solution for crony capitalism, it is the cause of crony capitalism.

Crony capitalism is a term that has been used in the popular press, but rarely in academic literature. However, when one understands crony capitalism as an economic system in which the profitability of business depends on political connections, there is a substantial body of academic literature that explains the causes and consequences of crony capitalism. This paper (1) demonstrates that the academic literature has analyzed the components of crony capitalism for decades, and those components are well understood; (2) shows that all those components point toward big government as the cause of crony capitalism; and (3) considers ways in which crony capitalism can be controlled.

2. Public Policy and Cronyism

The academic literature on the components of crony capitalism is built on models that depict the actual decision-making processes of those in government and their cronies in the private sector, rather than just assuming the government makes policy decisions that promote the public interest. Economic analysts often suggest government interventions in an economy to correct problems with the market or improve economic performance, making the assumption that the government is both willing and able to implement the policies that economists' models show would be helpful in theory. Recommendations suggest that if the government pursued a certain course of action, certain improvements would result. Holcombe (2012) argues that recommendations like this ignore limits on the availability of information, the incentive structure that government decision-makers actually face, and the collective decision-making procedures that actually produce government policies. A real-world government may not be willing or able to implement the recommended policies. Government decisions are made by individuals, and almost always, one individual cannot make those decisions unilaterally, so it is unrealistic to depict "the government" as a single decision-maker. Public policies will be the result of some collective decision-making process. A recommendation that the government should do "this" to accomplish "that" treats the government as an omniscient, benevolent dictator, and ignores the possibility that those in government may not have the information or incentives to actually implement the recommended policy.

The government is not omniscient. Often, the information the government would need to implement the recommended policy is not available to government decision-makers. For example, optimal tax theory requires policy makers to know elasticities of supply and demand, which exist in theory but cannot be observed in practice. Optimal government production of public goods requires that policy makers know individuals' demands for those goods, but in the absence of a market for those goods, those demands cannot be observed in practice. Optimal policy to correct externalities requires that policy makers know the magnitude of external costs, which exists in theory but cannot be observed in practice. Sometimes, the information that would be required is decentralized so that it could never be available to a single decision-maker, as Hayek (1945) emphasizes. Policies that can be designed in theory, with perfect knowledge, often cannot be implemented in the real world where knowledge is imperfect.

The government is not always benevolent. Policy makers consider their own interests when making decisions and policies. Because bureaucrats do not profit from the good decisions they make, but may be penalized for bad ones, they tend to be less entrepreneurial. Niskanen (1971) has developed a frequently cited model of bureaucracy that concludes that government bureaucrats attempt to maximize their budgets, so inefficiently large amounts of resources are allocated to them. Elected officials often design policies to gain support for their reelection rather than to serve the public interest.

The government is not a dictator. Even the dictators in actual dictatorships must rely on a power structure to keep themselves in power, so people with political power must provide benefits to those who support them. This is true when a dictator supports his cronies, and also in democracies, when elected officials provide special-interest benefits to the majority coalition that elects them. In a democracy, many people must agree, and must work together, to implement any public policy. An analysis of public policy must take into account the actual information available to decision-makers, and the actual decision-making process that will be used to implement policies.

When those in government—bureaucrats or elected officials—are given the power to implement or enforce regulations, or to spend money, they are given the power to benefit some at the expense of others. This lays the foundation for cronyism, because people have an incentive to seek government favors, and to protect themselves from regulations or expenditures that will put them at a competitive disadvantage. This is not a new insight: a well-established body of academic literature explains the ways this can happen. The common element in that literature is that it takes into account the actual information available to government decision-makers, and the incentives they face when making decisions, rather than assuming that because there is some optimal policy in theory, the government will implement it in practice.

The next several sections describe the literature on rent-seeking, on regulatory capture, and on interest group politics to show the relationship between these ideas and crony capitalism. This both shows the academic foundation already in place that describes crony capitalism, and provides a deeper understanding of the mechanisms that create and sustain crony capitalism.

2.1 Rent-Seeking and Crony Capitalism

One manifestation of crony capitalism goes under the label “rent-seeking.” When the government is in a position to deliver favors to businesses, businesses have an incentive to devote resources to acquiring those favors. Those favors can come in many forms. Firms often approach the government claiming that they are facing unfair foreign competition, and seek protection in the form of tariffs, quotas, or other regulations that shield domestic firms from foreign competition. Businesses also seek protection from domestic competitors, sometimes by lobbying for permission to be awarded monopoly franchises that prohibit competitors from entering an industry and sometimes by lobbying for regulatory barriers that increase costs for their rivals. As Tullock (1967) notes, these firms devote resources to obtaining government favors—resources that could otherwise be devoted to productive activity. This use of resources is a waste to the economy as a whole—it is directly unproductive activity, to use Bhagwati’s (1982) terminology—even though it provides private benefits to the firms that get the government favors.

Firms increase their profits because of government favors, and in exchange provide support to the politicians who provide those favors. The profits that arise from rent-seeking benefit the firm, but rather than adding value to the economy—as is the case with profits that come from productive activity—they subtract value. Not only are the resources used in rent-seeking wasted, profits that come from restrictions that give some degree of monopoly power to rent-seekers are economically inefficient for the same reason that any monopoly is inefficient. As Kornai (1986) notes, government subsidies create a barrier to entry, to the benefit of the cronies who receive subsidies, and at the expense of their competitors who do not. In some cases, firms may be totally dependent on government favors and would go out of business were it not for the government's support. Rent-seeking is one form of crony capitalism.

Krueger (1974) describes how rent-seeking was seriously hampering the Indian economy in the 1970s. Many of the best and brightest Indians, she says, were not engaged in producing anything or adding value to the Indian economy, but rather were employed trying to negotiate the morass of government regulations so that their firms could profit from the restrictions placed on others. For example, because imports of foreign goods were restricted, those who could get import licenses could profit from selling goods that were in short supply due to the restrictions. In this type of situation, licenses often go to people who have connections with those in government, which is a form of crony capitalism.

When the government has the power to impose costs on businesses through taxation or through regulatory burdens, businesses may not be able to avoid engaging in the political process to protect themselves from government-imposed costs. They may be forced to participate in crony capitalism if they want to survive, even if they would prefer to avoid politics. As McChesney (1987, 1997) notes, businesses may need political connections to protect themselves from government-imposed tax and regulatory burdens. Those with connections can avoid costs that will be imposed on other firms.

Crony capitalism emerges spontaneously as a result of government involvement in the economy, and not necessarily because of bad intentions or unethical people in business and government. Krueger (1990) describes the evolution of the sugar program in the United States, which limits imports to protect domestic business. The program was originally designed to protect American owners of Cuban sugar farms, but that motivation disappeared after Castro assumed power in Cuba in 1959. The sugar program remains, however, supported not only by American sugar farmers who benefit from the restrictions that raise the price of American sugar, but also by corn farmers whose corn can be processed into corn syrup that is a substitute for sugar. The current beneficiaries of this program are not the ones the program was originally intended to benefit, nor were the current beneficiaries involved in establishing the program to begin with. But, once established, government programs create new interests, and those interests have an incentive to engage in rent-seeking to keep the programs in place. Politicians provide benefits to rent-seekers, and in exchange the rent-seekers support their cronies in government.

2.2 Regulatory Capture and Crony Capitalism

The capture theory of regulation introduced by George Stigler (1971) is complementary to the theory of rent-seeking. Stigler argues that while regulation may be introduced with the intention of furthering the general public interest, once regulatory agencies are established they tend to be captured by the industries they were established to regulate, and work for the benefit of those regulated industries. According to Olson (1965), the regulated industry forms a concentrated interest group that is better able to organize to further its interests. Concentrated interest groups are better able to organize than the disbursed interests of the general public, the people regulations are nominally designed to benefit. The general public will be rationally ignorant of the activities of government regulatory agencies, as Downs (1957) notes, because members of the general public realize they have almost no chance of influencing regulation, and even if one individual did have an influence, the benefit to that individual would be small because it would be spread among a large population. Small costs imposed on members of the general public can add up to large gains for concentrated interests, however, so those concentrated interests do have an incentive to become informed and to actively try to influence the regulatory process.

In addition, people in each regulated industry have more information about their industry than either members of the general public or the regulators who are nominally regulating them. Regulators must rely on those within the industry for information. While those in the regulated industry push for regulations favorable to them, however, members of the rationally ignorant general public know little about the process. Regulators who help the industry can generate political support from the industry, whereas hindering the industry, even if it is in the public interest, brings no political benefit, because those who receive the benefits are not informed enough to know about them. Furthermore, those in the industry come to know the regulators personally, and those personal relationships can develop into future employment prospects. There are many reasons why, over time, regulations tend to favor the regulated industries rather than the general public. Regulatory capture is another example of crony capitalism.

Once the benefits from regulatory capture are produced, they create what Tullock (1975) called the “transitional gains trap.” The regulatory benefits that are captured are capitalized into the value of the assets that produce them, so that over time the transitional gain from the regulatory capture becomes a normal profit. For example, the American sugar program Krueger (1990) described benefits corn farmers by raising the price of corn, which in turn raises the price of the farmland on which corn is grown. After the new regulatory regime has become established, anybody who buys that farmland earns only a normal profit from growing corn, because the value of the regulation is capitalized into the value of the farmland. However, if the regulation were to be removed, owners of the farmland would suffer a capital loss because the value of their farmland would fall. Their profitability is dependent on government regulation. This turns the owners of farmland into crony capitalists, because the regulatory environment gives them no alternative but to be dependent on the government for their profitability. The sugar industry made about $5 million in political contributions in 2010 and spent $7 million more in lobbying efforts to maintain the benefits it gets from the sugar program.[4] This shows that sugar producers are willing to pay substantial sums to maintain their crony status and prevent the capital loss they would incur should the sugar program be eliminated. They provide benefits to those in government in exchange for the benefits the regulatory regime provides to them, which is cronyism.

With a protective regulatory regime in place, those who make the government’s rules can depend on the support of their cronies in exchange for maintaining those rules. Regulation opens the door to regulatory capture, which leads to cronyism, because the regulated have no alternative but to depend on the regulators, and in exchange the regulators get support from their regulated cronies.

2.3 Interest Group Politics and Crony Capitalism

In an insightful analysis, Mancur Olson (1982) argues that nations decline when interest groups become well established in the political process, so that firms gain more from their political connections than from their economic productivity. Olson argues that a young political system will have weak political interest groups because political connections develop over time, and a young system will not have had time to develop to the point where those in business can count on favors from those in government. When political interests are weak, entrepreneurs have an incentive to engage in economically productive activity, which results in economic growth. The economic growth that results from this productive activity is what Olson describes as the rise of nations. Over time, political interest groups grow and solidify, and establish relationships with those who have governmental power. As they do, success increasingly comes from the ability to use political connections rather than from engaging in economically productive activities, and when the power of political connections overwhelms the power of economic productivity, nations begin to decline. The decline comes as a result of the substitution of political connections for economically productive activity, a form of crony capitalism.

Baumol (1990, 1993) suggests that the amount of entrepreneurial activity is roughly the same in every society, but that in some places the institutional framework is organized in such a way that the payoff for economically productive activity is higher than the payoff for using political connections to get ahead. Those societies are prosperous. In other nations where political connections are more important, where some people are favored under the legal system, and where property rights are not well-protected, entrepreneurs engage in political entrepreneurship to try to place themselves within the power elite, so that they can prosper by taking from the productivity of others.

Where institutions allow individuals to gain more wealth through political connections than through productive activity, people have less incentive to be productive and more incentive to seek profitable political connections. Acemoglu (1995) develops a model demonstrating that when rent-seeking is a more significant part of the institutional structure, more resources flow into professions like law that can take advantage of rent-seeking opportunities, at the expense of professions like engineering that are more likely to produce value for the economy. Murphy, Shleifer, and Vishny (1991) show empirically that countries with a higher proportion of engineering majors in college have higher rates of economic growth than those with a higher proportion of law majors.

Weingast, Shepsle, and Johnsen (1981) describe a government engaged in distributive politics, where everyone engages in political exchange to provide special-interest benefits to all. Rent-seeking is reinforced because to gain advantages in a democratic government the support of others is needed, so political exchange occurs and creates a system where everyone must join a coalition and vote for political benefits for others to get political benefits for themselves. Insiders gain at the expense of outsiders, so everyone has an incentive to become an insider—a crony. Under these institutions, entrepreneurs are predatory rather than productive, resulting in the decline of nations that Olson describes.

Some nations never get to that level of prosperity. Recent work in the new institutional economics, including the work of North, Wallis, and Weingast (2009) and Acemoglu and Robinson (2012), describes the poor institutions in which rising to the top of the income distribution scale depends on political power and connections rather than economic productivity. As North, Wallis, and Weingast describe it, social systems in poorly performing societies are based on personal connections and the favorable treatment of individuals who have accumulated power, rather than on the rule of law independent of people's personal identities. Acemoglu and Robinson (2012) describe poor institutions as extractive rather than inclusive, so there is an advantage to being in a position to extract benefits from others rather than engage in productive activity. Bueno de Mesquita et al. (2003) and Niskanen (2003) analyze political institutions in which those with political power rely on the support of a group of cronies to remain in power, and as a result dole out benefits to those cronies to buy their support. Entrepreneurial individuals, to follow Baumol's line of reasoning, have an incentive to work toward obtaining positions where they can benefit from political favoritism rather than to engage in economically productive activity. Cronyism offers more benefit than economic productivity in such systems.

The economic analysis of interest group politics has a history going back decades, and the interest groups that benefit from their lobbying do so because they are able to obtain benefits for themselves that are not available to others. If the special-interest benefits were generally available to everyone, there would be no need to lobby for them. The relationship between political interest groups and those in government who provide the special-interest benefits means that the profitability of those interests is determined by their political connections. This is another example of cronyism.

2.4 The Academic Foundations for a Theory of Crony Capitalism

The purpose of this review of academic literature is to show that while academic economists do not often use the term crony capitalism, there has been an extensive amount of economic research and analysis that has explained why cronyism exists and how it manifests itself. The academic literature has looked at several aspects of cronyism, but has not drawn them together under that single heading. The literature on rent-seeking, on the capture theory of regulation, on political entrepreneurship, and on interest group politics all analyzes how cronyism works, but because these subjects have been investigated relatively independently of one another, they have not been analyzed as components of a comprehensive theory of crony capitalism. There is a well-established academic literature on the various forms of crony capitalism, although it has gone by different names. Pulling all this literature together reveals a solid academic foundation for understanding the forces underlying crony capitalism.

3. Crony Capitalism and Big Government

The feature that unites all the component theories of crony capitalism is the idea that cronyism is enabled by the power of government. The bigger the government, measured both in its expenditures and its regulatory power, the bigger the potential for cronyism.

The potential profitability of rent-seeking is directly related to the size and scope of government. A government that spends a substantial share of the nation's income has more money that can be doled out in transfers and subsidies, so engaging in rent-seeking to gain a share of the government's budget is potentially more profitable when the government's budget is larger. Even government expenditures on items that might be considered "public goods," such as national defense, encourage cronyism. Somebody must get the defense contracts. Military bases must be located somewhere. Rent-seekers will try to direct that spending in a way that benefits them. Roads may be public goods, but somebody will get the construction contracts to build them, and the choice of routes for new roadways can benefit private interests, so rent-seekers will be lobbying for those construction contracts, and to have roads located to provide them with private benefits.

Even in the case of public goods, government funds can be steered to benefit cronies, so crony capitalism is fostered by any government spending, even when the rationale for that spending has a public-interest foundation. More government spending for any reason increases the incentives for cronyism.

The government's regulatory reach is also an important determinant of the potential profitability of rent-seeking. If the government has the regulatory power to differentially benefit some firms, then all firms have the incentive to enter the political process to gain those government favors. Stigler's capture theory of regulation applies only to the extent that there are government regulations and regulatory agencies that can be captured. If the government has no regulatory powers, there are no regulatory agencies to be captured. The more pervasive government regulation is in an economy, the more important to the profitability of business it will be to engage in the political process to try to steer regulatory benefits. As with rent-seeking, the benefits of regulatory capture and cronyism increase with the regulatory scope of the government, regardless of the motivation for the regulation. There may be good public-interest justifications for regulation, such that if the government were an omniscient, benevolent despot the regulations could further the public interest. But because the government is made up of individuals who take into account their own individual interests, even the most public-spirited regulations are subject to regulatory capture and cronyism. The information and incentive structure of the public sector means that over time, regulations will increasingly come to benefit cronies, and lay the foundation for the growth of crony capitalism. Government intervention into market activity produces crony capitalism.

Government intervention not only steers economic interests toward looking for political benefits, it often gives them no alternative but to engage in the political process to protect themselves from harm. As McChesney (1987, 1997) shows, the government often threatens to impose tax or regulatory costs on businesses, pushing even those that want to avoid the political process to get involved in lobbying to protect themselves from the predatory government. Sometimes these threats are the result of cronies who see the opportunity to gain a competitive advantage if the government will impose costs on their rivals. Regardless of the motivation, big government's ability to engage in such activities pushes everyone into the political process, and forces everyone to offer some kind of support to those with political power in exchange for perhaps nothing more than being left alone. In an economy characterized by crony capitalism, businesses have no choice but to participate.

Becker (1983) describes a legislature as a political marketplace in which interest groups on both sides of an issue are able to offer political support to the legislators who will decide the issue. In Becker's model, legislators weigh the political costs and benefits to themselves from interest groups on both sides and produce the policy outcome that maximizes their own political support. Becker presents this model as a demonstration of the efficiency of the political marketplace, but the process does not appear so benign when one considers what is being bought and sold. For example, when one side is lobbying to impose costs on its rivals and the other side is lobbying to be free of these costs, it is difficult to see how any outcome other than the government not imposing costs on anyone would be an economically efficient outcome, even though imposing costs may be politically beneficial to those who make the rules. Furthermore, because the process involves rent-seeking costs on both sides that squander resources, it appears that the optimal outcome is not the one that weighs the political costs and benefits on both sides, but rather the one in which no interest group politics takes place at all.

The larger government grows, and the more regulatory power it acquires, the more economic actors are forced by the political system into engaging in interest group politics—and the result is that those who have the political power and can pay the price demanded by the political system become cronies who benefit from political favoritism rather than from economic productivity. Wittman (1989, 1995) takes the Becker model one step further, arguing that there are always economic incentives to allocate resources as efficiently as possible, whether through market mechanisms or political means. Essentially applying the Coase (1960) theorem to politics, he argues that political transaction costs are low enough that the government will allocate resources as efficiently as the market. Wittman's first premise is correct. There are always incentives to allocate resources as efficiently as possible. However, his analogy between incentives in markets and incentives in the government does not hold up, because—unlike private actors—the government can use force to transfer resources from some to others without the consent of the resources' original owners. A market exchange takes place with the consent of all parties to the transaction, so if one party does not agree, no transfer of resources takes place. The government uses its taxing and regulatory power to forcibly transfer resources from some to others, so even though there is always an incentive to do things more efficiently, sometimes the incentive to obtain benefits by means of government force is greater.

Following Wittman's logic, a burglar might reason that it would be more efficient to have a homeowner open a door than to break into the house—that way the homeowner would not incur the cost of fixing a broken window in addition to the cost of the property lost to the burglar. But the burglar is more concerned with his own gain than with any costs borne by the homeowner as a result of the theft. The burglar's chances of success are greatly diminished if the homeowner knows what the burglar is doing. Similarly, rent-seekers focus on the benefits they get, not the losses imposed on everyone else, and they are more likely to succeed if those who pay the costs are unaware of the rent-seekers. If there were no transaction costs, rent-seekers might bargain with the millions of citizens who pay for the benefits they get in order to find a more efficient transfer, but it is because most citizens are uninformed about most of what the government does that rent-seekers can get their benefits, as Downs (1957) observed. The cronies know what benefits they supply to each other, and crony capitalism continues because most citizens are unaware. If Wittman's assumptions were correctand transaction costs were low, the general public would not allow cronyism, just as homeowners would not allow burglars access to their property.

Popular opinion—personified by the 2011 “Occupy” movement—shows that the general public opposes crony capitalism when they become aware of it, so its success depends on keeping it out of public view. Cronies never say that they are lobbying for benefits for themselves at the expense of others. They claimthat the benefits they lobby for are in the public interest. Meanwhile, the public knows little about the political exchanges that take place among cronies in the political process.

When one looks at the academic literature in economics that describes the components of crony capitalism—rent-seeking, regulatory capture, interest group politics—the common element is that those components are all amplified by big government. The larger the government's budget and regulatory powers, the greater the potential for crony capitalism. Conversely, a reduction in the size and scope of government reduces the benefits from cronyism, which helps to direct resources away from trying to obtain political benefits at the expense of others and toward engaging in productive economic activity.

One of the justifications often given for expanding the scope of government is that a bigger government presence in a market economy can help to control the abuses of capitalism, can correct the failures of the market, and can regulate business so it will act in the public interest. In other words, big government is needed to stand up to crony capitalism. Once one understands the causes of crony capitalism, it becomes apparent that this reasoning is exactly backward. Government powers allow some interest groups to impose costs on others, which forces everyone to engage in the political process and compete to be the cronies who benefit from this government interference. Crony capitalism is not controlled by big government, it is caused by big government.

For example, in Isaacson's (2011: 323) biography of Steve Jobs, the author relates, "President Clinton's Justice Department was preparing a massive antitrust case against Microsoft. Jobs invited the lead prosecutor, Joel Klein, to Palo Alto. Don't worry about extracting a huge remedy against Microsoft, Jobs told him over coffee. Instead simply keep them tied up in litigation. That would allow Apple the opportunity, Jobs explained, to make an 'end run' around Microsoft and start offering competitive products." Jobs is rightly considered one of the greatest entrepreneurs of all time, and Apple one of the most entrepreneurial and innovative companies ever, yet this example shows Jobs attempting to use his connections to impose costs on a rival to gain a competitive advantage. Many countries have a far worse crony capitalism problem than the United States, so seeing what actually happens in the United States gives an idea ofthe type of problems that occur in nations where the rule of law is less well established and where political connections are even more important. The regulatory power of big government encourages crony capitalism.

The well-established academic literature in economics shows that crony capitalism is the by-product of big government. Government intervention and oversight in the economy is not the solution for crony capitalism, it is the cause of crony capitalism.

4. The Fiscal Constitution as a Constraint on Cronyism

Buchanan (1967) emphasizes the importance of the "fiscal constitution," his term for the rules that define the procedures and constraints that limit the government's ability to determine public-sector taxation and expenditures. Brennan and Buchanan (1980) have developed an analytical framework within which they evaluate the benefits of placing constitutional constraints on the fiscal powers of government, and they go on to describe the value of constitutional constraints more generally (Brennan and Buchanan 1985), to provide a framework within which constitutional procedures prevent those with political power from using it arbitrarily. Buchanan (1993) describes the benefits of having tax rules apply generally to all taxpayers, rather than allowing tax authorities to impose different taxes on different groups of people. In his Nobel Lecture, Buchanan (1987) gives a general outline of the role that constitutional constraints on political power play in preventing those who have that power from using it to provide benefits to their cronies at the expense of the general public. The importance of constitutional constraints on the powers of government is Buchanan's idea, in the sense that it thoroughly permeates decades of his published research. Buchanan, while developing this idea, recognizes that its origins go back at least to the writing of the Constitution of the United States, a document that was designed to limit the power of government, and to limit its scope to specific enumerated powers.

A strong fiscal constitution can help control the ability of those with power to engage in cronyism. If the fiscal constitution establishes a tax structure that is relatively inflexible, and therefore relatively immune to interest group politics, then as Buchanan (1987) and Holcombe (1998) describe, cronyism will be limited because people cannot use their political power to turn public policy in their favor. This idea applies to the expenditure side of the budget as much as the revenue side. If relatively inflexible procedures are established for allocating the government's budget, then interest groups will have a limited ability to engage in cronyism. Political discretion fosters cronyism, and an inflexible fiscal constitution limits political discretion.

A good illustration is the comparison between many Scandinavian countries with high levels of government spending as a share of GDP and many African and Latin American countries with lower government spending as a share of GDP, but with more manifestations of cronyism. Compared to many African and Latin American nations, Scandinavian nations have relatively inflexible fiscal constitutions that limit the discretion of those with political power. Furthermore, the regulatory powers of Scandinavian countries are relatively constrained and tend to follow the rule of law, when compared to the substantial amount of discretion that exists in the regulatory apparatus of other nations. Lindert (2004) argues that social spending programs in Scandinavia have not imposed costs on economic growth, because institutions have historically developed to constrain the government from engaging in more pernicious activities. His overall conclusion may be premature, but it is consistent with the analysis of Gwartney and Lawson (2009), who find that despite high taxes and government transfers, in other dimensions the Scandinavian “welfare states” have relatively market-friendly institutions.

For a government of a given size, measured in both expenditures and regulatory powers, a more inflexible fiscal constitution can limit cronyism. This points toward establishing public policies that put constraints on the discretion of government decision-makers. However, that does not alter the conclusion that the bigger the presence of government in an economy, the greater the incentive there will be for both those in government and those in business to engage in cronyism.

The Gwartney and Lawson (2009) Economic Freedom of the World (EFW) index, with 42 components grouped into five areas, measures the degree of economic freedom in 127 countries. A large number of studies have consistently shown that countries with more economic freedom as measured by the EFW index have higher levels of prosperity. Higher rankings are strongly correlated with higher per capita incomes, and improvements in a country’s EFW measure areassociated with higher rates of economic growth. An examination of the EFW index components shows that many of them are closely associated with a fiscal constitution that limits the discretion of the government, so high rankings imply a relatively inflexible fiscal constitution and a limited ability to engage in cronyism. Two important components captured in the EFW index are the rule of law and the protection of property rights. If everyone is subject to an objective set of laws, government discretion is reduced, and if property rights are protected, that prevents some from using political connections to claim the property of others. The index also measures tax and regulatory burdens, and the level of government expenditures, with lower levels being associated with more economic freedom. The EFW index gives a good indication of the economic institutions that create a relatively inflexible fiscal constitution, and so limit cronyism.

While it is relatively easy to identify the institutions that can limit cronyism, it is more difficult to put those institutions in place in nations where they do not already exist. Cronyism, by its nature, benefits cronies both inside the government and in the business sector, who are able to use the power of the government to obtain favorable treatment. Crony capitalists find their incomes enhanced by government favors, and those who grant the favors are rewarded by the support of the crony capitalists. Because people with political and economic power benefit from crony capitalism—at the expense of the general public—finding ways to reduce cronyism is a challenge. The beneficiaries of crony capitalism are the people with political and economic power, so they are able to dictate the rules.

Crony capitalism can be limited by establishing a relatively inflexible fiscal constitution, but this is not really a solution to crony capitalism, because those who hold the power will resist this type of change. People who hold political power benefit from their ability to use discretion to direct benefits toward themselves and their cronies. Often, it is easy to see what types of institutional changes would result in economic gains, but frustratingly difficult to see how those changes can actually be implemented.

Furthermore, over time interest groups tend to solidify and concentrate their power, so an economy with solid constitutional constraints that limit crony capitalism, but with a big government budget and substantial government regulation, has set in place the forces that Olson (1982) says lead to the decline of the nation. Even if a big government economy at one point in time has limited cronyism, Olson (1982) shows that the incentives created by big government will push that economy increasingly toward cronyism.

5. Crony Capitalism and Democracy

After the collapse of the Berlin Wall in 1989, followed by the dissolution of the Soviet Union, Fukuyama (1992) declared the triumph of democratic government and market economies to be the end of history, in the sense that democracy and market-oriented economies were the final evolution of economic and political institutions. Fukuyama's characterization of democratic government as the end of history understates the importance of constitutional constraints on government. Modern Western democracies are not run according to the principle that government does whatever the majority wants; rather, democratic governments have constitutional constraints on the activities they can undertake. The Constitution of the United States provides a good example of a formal constitution that enumerates the powers that belong to the government. The government can exerciseonly those powers that are specifically allowed to it in the Constitution. The constitutional framework of other Western democracies is similar, although every nation is different. Britain, for example, does not have a formal written constitution, but the constitutional rules under which the British government is run are similar to those of the United States. The point is that the Western democracies that Fukuyama sees as the end of history do not make their political decisions democratically, if by democratically one means that governments carry out the will of the majority. Rather, constitutional constraints and fiscal constitutions limit the powers of those governments, and in particular limit the ability of the governments to respond to the will of the majority.

Holcombe (2002) argues that over time those constitutional constraints on government have been eroding, so that government has increasingly made its decisions with fewer constitutional constraints. This allows interest group politics to have an increasing influence on government decision-making, opening the door to crony capitalism, which leads to what Olson (1982) has described as the decline of nations. The more that government decisions can be influenced by political pressures—that is, the more democratic a government is—the more the economy will turn toward cronyism.

The prosperity of Western democracies has not been due to their democratic governments; it has been due to the constitutional constraints that have limited the powers of those governments. Democracy poses a danger to the economy, because it opens the door to political pressures that lead to cronyism. In Western democracies, democracy has been a means to an end. It has been a mechanism that citizens can use to peacefully replace the people who hold political power. For democracies to be productive rather than destructive, those who hold political power must work within clear constitutional constraints that limit their discretion—that is, that limit their ability to engage in cronyism.

Rent-seeking is an example of cronyism produced because government decisions are made democratically. Interest group politics, which is based on cronyism, is an integral part of democratic government. Democratic oversight is not a cure for cronyism; democratic decision-making leads to cronyism because it allows a majority to impose costs on a minority.

Democracy is correctly seen as a mechanism to limit the power of those who hold political power. It does so by making their holding of that power subject to public approval. If democracy is interpreted as having the government carry out the will of its citizens, this opens the door to cronyism. Most citizens are rationally ignorant of politics, as Downs (1957) emphasized, so the citizens who will be in a position to influence the government will be those with concentrated special interests, who can provide support—financial and otherwise—to those with political power, in exchange for having their demands met. The ideal of democracy can evolve into crony capitalism, if there are no constitutional constraints on the discretionary power of those in government.

6. The Market Economy versus Crony Capitalism

Fukuyama's argument that capitalist democracies are the end of history has its foundation in the general acceptance of the superiority of capitalism and democracy after the triumph of capitalist democracies in the Cold War. Due to a general acceptance of the benefits of capitalism and democracy, there was optimism in the 1990s that the economies that had been centrally planned under the umbrella of the Soviet Union would prosper as they developed market institutions, like the economies that were on the other side of the capitalism-socialism divide. The reality is that cronyism often prevents the establishment of market institutions, because the cronies do not want to lose the benefits they are able to obtain through crony capitalism.

Countries have met with varying degrees of success as they have begun their transition to capitalism.

Moykr (1990) and Landes (1998) note that, throughout history, everywhere in the world, countries that have adopted capitalist economies have prospered, while those that have not have remained poor. No economy finds itself at either extreme of the continuum between market allocation of resources and government planning of the economy. Even the most centrally planned economy has a significant amount of market exchange, including activity in an underground economy or "informal sector." Meanwhile, even the most market-oriented economy has substantial government involvement through taxes, government expenditures, and regulation. Economic research consistently shows that market economies perform less well when they have a higher degree of government intervention.

Crony capitalism shows up to some degree in all market economies, because it is impossible to separate economic power from the ability to influence political decisions. Industrial policies such as those of Japan and South Korea are built on the idea of cronyism, and cronyism is apparent in the United States economy—for example, when government money is targeted to particular firms,[5] and when interest groups receive targeted regulatory benefits. Krueger's (1990) analysis of the sugar program in the United States provides an example that has already been analyzed. Vocal critics of crony capitalism, such as members of the "Occupy" movement that began in 2011, highlight valid issues. The open question is how those issues should be addressed.

A common response to cronyism is to call for additional government regulation and oversight of markets, but this often makes the problem worse. Cronyism is caused by those with political power using that power to their advantage, so a government with less regulatory power, and a government with a smaller budget, will be less prone to cronyism. A larger presence of government in an economy tends to foster cronyism, not prevent it. When government regulations are put in place to control crony capitalism, they give people in government additional power to provide protections and benefits to their cronies at the expense of the public interest. Capitalism becomes crony capitalism when those in government gain sufficient power to provide special interest benefits to their cronies.

7. Conclusion

Crony capitalism is a popular term that has rarely been used in academic literature, but a review of the academic literature shows that the components of crony capitalism—rent-seeking, regulatory capture, political entrepreneurship, and interest group politics—have been analyzed extensively, and the common element in all of them is that people with political power use that power to benefit some at the expense of others. When the government looms large in the economy, through its regulatory power, its taxing authority, and expenditures on transfer payments and subsidies, business profitability depends on the degree to which businesses can get subsidies, tax breaks, and regulations that work in their favor. This pushes businesses to turn their attention toward how to get favorable treatment from the government, and away from entrepreneurial activity that adds to the productivity of the economy. People with political connections get benefits; outsiders do not. This is crony capitalism: an economy in which cronies profit at the expense of outsiders. Cronies support their partners in government in exchange for the benefits those in government provide to them.

Pro-government, anti-capitalist arguments point to the abuses of capitalism and argue that big government is necessary to protect the public fromthe failures of the market, to regulate business so it will act in the public interest, and to stand up to crony capitalism. The problem with the pro-government argument is that crony capitalism is a product of big government. Ikeda (1997) argues that increased government involvement in the economy—the solution promoted by the big-government advocates—ends up increasing crony capitalism, not controlling it, which leads to calls for even more government intervention.

The more government is involved in an economy, the more the profitability of business will depend on government policy. Even those entrepreneurs who would prefer to avoid cronyism are pushed into it, because they must become politically active to maintain their profitability. When the government looms large in economic affairs, businesses push for government policies that can help them, and try to avoid suffering harm as a result of government policies that can work against them. If one’s competitors are engaging in cronyism, avoiding cronyism means that one’s competitors will gain government-bestowed advantages. A well-established body of academic literature stands behind these conclusions. Crony capitalism is a by-product of big government, so small government is the most effective way to control it. More government control of the economy is not the solution to crony capitalism; it is the cause.

Notes

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[1] Tariffs and other trade barriers are often justified on the grounds that they counter anticompetitive policies of foreign governments, but domestic producers have an incentive to make arguments like this regardless of whether they are true, as Tullock (1967) insightfully argues.

[2] The industrial policies that Japan and South Korea used to promote specific firms and industries in their post–World War II economies are examples. See Holcombe (forthcoming) for a discussion of the politics behind South Korea's industrial policy.

[3] This definition does not imply that cronyism always makes firms profitable, or that without political connections firms will not be profitable. Rather, it means that firms' profits will be higher (or their losses lower) with political connections than without.

[4] See www.opensecrets.org/industries/indus.php?ind=A1200, accessed August 20, 2012.

[5] For example, President Obama targeted more than $500 million in government money to energy firm Solyndra, which went bankrupt two years later, and in the bankruptcy of General Motors the president brokered an arrangement to provide stock ownership in the company to the auto workers' union after it emerged from bankruptcy, ahead of company bondholders who should have had a prior claim according to bankruptcy law.

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