MERCATUS
RESEARCH

THE ECONOMICS AND HISTORY OF CRONYISM

David R. Henderson

MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

ABOUT THE MERCATUS CENTER AT GEORGE MASON UNIVERSITY

For over 25 years, the Mercatus Center at George Mason University has been the world's premier university source for market-oriented ideas—bridging the gap between academic ideas and real-world problems. A university-based research center, Mercatus works to advance knowledge about how markets work to improve our lives by training graduate students, conducting research, and applying sound economics to offer solutions to society's most pressing problems.

Mercatus Center
George Mason University
3351 North Fairfax Drive, 4th Floor
Arlington, VA 22201-4433
(703) 993-4930
mercatus.org

Release date: July 27, 2012

ABOUT THE AUTHOR

DAVID R. HENDERSON is an associate professor of economics in the Graduate School of Business and Public Policy at the Naval Postgraduate School and a research fellow with the Hoover Institution. One of his specialties is analyzing the unintended effects of government intervention. He blogs at econlog.econlib.org.

ACKNOWLEDGMENTS

I THANK ROBERT C. SARVIS for his excellent and timely research assistance and three anonymous referees for extensive comments and criticisms, most of which affected the final draft.

ABSTRACT

Cronyism is the substitution of political influence for free markets. It comes about when government has a lot of power over private-sector decisions and when the government officials in power have great discretion over how to use it. Cronyism is not simply a zero-sum game that takes from some and gives to others; it is negative-sum. The losses to the losers substantially outweigh the gains to the winners. In short, cronyism destroys wealth. By shifting power to government, cronyism makes political power more important and increases the competition for that political power. The way to reduce or end cronyism is to reduce or end that government power.

JEL code: N4

"When you leave the honey jar open, expect ants."
—anonymous

When I speak of the benefits of economic freedom and free markets, many people in my audiences do not think of those terms the way I think of them. In the question-and-answer sessions that follow my talks, it seems people often think they are taking issue with free markets when they are actually rejecting cronyism—a term that encompasses government favoritism, special privileges, and special interests.

For example, people will object to the Wall Street bailouts carried out by the Bush and Obama administrations. As do I, because those bailouts violate free-market principles. They will object to government regulation that makes it difficult for small food producers to produce and sell food not inspected and approved by the U.S. Department of Agriculture. As do I.

As we shall see, cronyism has been around for a long time and is a bipartisan problem that has thrived under Democratic and Republican presidents and congresses. Cronyism not only picks winners based on political connections rather than on the extent to which they serve consumers, but also is destructive of wealth, sometimes highly so.

This is not a comprehensive overview of cronyism. No short study could be. Rather, it provides a perspective of cronyism: what it is, what's wrong with it, some examples of it, why it happens, and how to reduce it.

WHAT IS CRONYISM?

What is the difference between free markets and cronyism? In free markets, buyers and sellers are free to agree on price; no government agency restricts who can buy or sell, and no one is told how or what to produce.[1] In contrast, under cronyism the government rigs the market for the benefit of government officials' cronies. This

1. Of course, there are degrees of freedom. Markets in the United States are generally freer than those in Venezuela. But markets in Hong Kong are generally freer than those in the United States. Within the United States, the book market is much freer than the health care market.

takes various forms. Governments sometimes grant monopolies to one firm or limit the number of firms that can compete. For example, most U.S. municipalities allow only one cable company to operate in their area even though there is no technological reason more could not exist. The same is true for most other utilities.

Governments sometimes use quotas or tariffs to limit imports with the goal of protecting the wealth and jobs of domestic producers who compete with those imports. President George W. Bush did this in 2002, for example, when he imposed tariffs ranging from 8 to 30 percent on some types of imported steel.[2] Governments sometimes subsidize favored producers, as the Obama administration did with the politically connected solar-energy firm Solyndra. Governments may use antitrust laws to prevent companies from cutting prices so that other, less-efficient companies can prosper: For example, beginning in 1958, the U.S. government prevented Safeway from cutting prices for a quarter of a century.[3]

The entities governments help with special regulations or subsidies are not always businesses; sometimes they are unions. The federal government's National Labor Relations Board (NLRB) complained against Boeing in April 2011, for example. In response to a complaint from the International Association of Machinists and Aerospace Workers (IAM), the NLRB sought to require Boeing to produce its 787 Dreamliner in Washington State rather than in Boeing's chosen location of South Carolina. According to the NLRB, by saying that "it would remove or had removed work from the [Puget Sound and Portland] Unit because employees had struck" and by threatening that "the Unit would lose additional work in the event of future strikes,"[4] Boeing was making "coercive" statements to its employees. As a matter of fact, it was not. Boeing was simply telling the employees some likely consequences of the union's actions.

The Boeing-IAM case is not as simple as most of the press implied. It turns out there was a prior case of cronyism. The government of South Carolina promised Boeing "$900 million in tax relief and other incentives" in exchange for moving production to South Carolina.[5] Such is the tangled world of cronyism.

WHAT'S WRONG WITH CRONYISM?

Good law should treat people in similar situations similarly. By definition cronyism treats people in similar situations differently. This particular individual gets a subsidy because of his connection to politicians; that one does not. This particular industry gets subsidies or government protection from competition because it is particularly effective at organizing politically; that industry, whose members are

2. "Bush Imposes Steel Tariffs," *USA Today*, March 5, 2002.
3. John B. Kirkwood, *Antitrust Law and Economics* (Bingley, UK: Emerald Group Publishing, 2004), 315.
4. NLRB, Case 19-CA-32431, April 20, 2011.
5. Carl Horowitz, "NLRB Sues Boeing; Seeks End to Commercial Jet Production in South Carolina," National Legal and Policy Center, May 4, 2011.

more into product innovation and less into lobbying, does not. In short, cronyism plays favorites.

One's first thought might be that cronyism is simply a forced redistribution from some to others and is, therefore, zero-sum. But this is false. Cronyism is negative-sum. That is, in the process of redistributing wealth, cronyism destroys wealth. Sometimes it destroys large amounts of wealth in the process of giving relatively small amounts of wealth to chosen parties. This is distinct from free markets. In every free-market transaction, both buyer and seller gain or they would not engage in the transaction.[6]

How does cronyism destroy wealth? Consider a hypothetical tariff on chewing gum. Such a tariff imposes costs on U.S. gum chewers that are larger than the benefits it confers on U.S. gum makers. Imagine that a U.S. gum maker's cost of producing a pack of gum is $0.90 and the gum maker sells the gum for $1. The gum maker earns $0.10 profit per pack of gum. Now imagine that a producer in another country produces a pack of gum for only $0.70. This gum producer tacks on a profit margin of, say, $0.07 and sells the gum in the United States for $0.77. At that price, the domestic gum maker cannot make money and is about to go out of business. The domestic gum maker lobbies the U.S. government and persuades officials that the foreign gum maker is engaging in "unfair competition." The U.S. government slaps a $0.23-per-pack tariff on gum imports. As a result, the price of the foreign producers' gum in the United States increases to $1.

Consider the gains and losses. At $1, the U.S. gum producer gains $0.10 per pack. The gain to U.S. residents producing gum from this tariff is $0.10 per pack, but the loss to U.S. gum buyers is not $0.10 per pack. Gum buyers are prevented from buying imports at $0.77 and must now pay $1. Their loss is $0.23 per pack. The net loss in wealth to the U.S. economy is $0.13 per pack:[7] the U.S. seller's gain of $0.10 per pack minus the U.S. buyers' loss of $0.23 cents per pack.[8]

Cronyism also destroys wealth by shifting the allocation of resources away from what consumers want and toward what governments with discretionary power want. Put aside for these purposes the issue of externalities, in which costs are imposed (negative externalities) or benefits are conferred (positive externalities) on people who have no market relationship with those doing the imposing or conferring. Consider instead a simple case of a company producing a product consumers are buying. If consumers decide to buy less of that product, the decrease in demand will cause the highest-cost firms to go out of business or at least to shrink. As a result, resources would leave that use and go to where consumers value them more.

6. The big exception to this principle is when one side or the other is misinformed, either because of fraud or because of inadequate information.
7. Actually, the net loss is somewhat higher. There is a deadweight loss from the exchanges that do not happen: the sales not made to buyers who valued the gum at amounts greater than $0.77 and less than $1.
8. This ignores the loss that consumers bear from not being able to buy the additional gum they would have purchased at the lower price of $0.77. My estimate of net loss, therefore, is an underestimate.

Now imagine that the government wants to "save jobs" and shore up profitability in the otherwise shrinking industry. It can do that by subsidizing the firms so they do not have to go out of business or shrink as much as they would have. Such subsidies are a typical example of cronyism.

By keeping resources in that use—in which consumers have clearly indicated their declining interest—the government prevents them from going to other uses consumers prefer. This is inefficient. It causes companies to produce more things the government wants and fewer things consumers want. The government thus distorts the economy.

Imagine what would have happened if the government had tried to preserve firms producing horse-drawn buggies after the introduction of the automobile caused the demand for buggies to fall. Resources—labor, capital, and raw materials—would have been kept in that industry and away from other industries. Such buggy subsidies would have kept the auto industry smaller.

Yet another way to see the destruction of wealth caused by cronyism is to note that government officials who direct resources have neither the right incentives nor adequate information to make good decisions. The incentive part is fairly obvious: Government officials are spending other people's money, and no one is as careful with other people's money as with his own. The information part is more subtle and draws on an insight from a famous 1945 article by Friedrich A. Hayek.[9] In the article, which helped Hayek later win the Nobel Prize in economics, Hayek notes that the information a central planner would need to plan an economy well is information the planner cannot have because the relevant information exists in dispersed form in the minds of millions of people. That insight applies also to the government official trying to make investments of taxpayers' money. That official cannot have the information he needs to make good investments. As Lawrence Summers, Obama's former economic adviser, wrote in a 2009 e-mail about Solyndra, "The government is a crappy [venture capitalist]."[10]

Cronyism also destroys wealth by causing companies to use resources to influence government decision makers. These resources create benefits for the companies that spend them, or the companies would not do it. But they represent a loss to the economy. The term economists use to describe this investment in getting government favors is rent seeking. The term is misleading: It is really privilege-seeking.[11]

9. Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, no. 4 (September 1945): 519–30, available online at http://www.econlib.org/library/Essays/hykKnw1.html.
10. Eric Lipton and Matthew L. Wald, "E-Mails Reveal Early White House Worries over Solyndra," *New York Times*, October 3, 2011, http://www.nytimes.com/2011/10/04/us/politics/e-mails-reveal-white-house-concerns-over-solyndra.html.
11. See David R. Henderson, "Rent Seeking," in *The Concise Encyclopedia of Economics*, ed. David R. Henderson (Indianapolis: Liberty Fund, 2008), available online at http://www.econlib.org/library/Enc/RentSeeking.html.

If a company spends $10 million on lobbying for tariffs or subsidies, it is investing in reducing wealth. Although the gain in wealth to the firm is likely to exceed $10 million, the $10 million expenditure represents a loss to society. In 2009 the total amount of lobbying expenditures reported by registered federal lobbyists was $3.47 billion.[12] This is less than 0.03 percent of U.S. gross domestic product that year. The main costs of cronyism are not in the resources used in rent-seeking but in the distortions they create.

Cronyism creates privilege. We often hear that someone is privileged because he is wealthy or that someone else is underprivileged because he is poor. That was not the original meaning of the word. Hayek writes:

> It would indeed be privilege if, for example, as has sometimes been the case in the past, landed property were reserved to members of the nobility. And it is privilege if, as is true in our time, the right to produce or sell particular things is reserved to particular people designated by authority.[13]

Hayek notes that the term “privileged” had come to apply to anyone who owned property, even though virtually every adult’s right to own property has become widely accepted. We see something similar today. Those who have a great deal of wealth are called privileged even if they earned their wealth without using any political pull. Those who are poor, on the other hand, are called underprivileged, even if their poverty has nothing to do with having less than the average amount of privilege.

Nevertheless, cronyism, by creating privilege, transfers wealth from the many to the favored few. If cronyism takes the form of subsidies, the transfers are from taxpayers in general to the few privileged people or companies. If cronyism takes the form of tariffs, the transfers are from the many consumers to the favored few.

Cronyism also promotes corruption by creating a questionable relationship between businesses and government officials such that what you get depends on whom you know.

RECENT CRONYISM

On November 21, 2008, word leaked that president-elect Barack Obama had chosen Timothy Geithner as his treasury secretary. At the time, the U.S. Treasury, under the Troubled Asset Relief Program (TARP), had a great deal of discretion over which firms to bail out and at what prices. Discretion in bailing out firms is the essence of

12. “Federal Lobbying Expenditures Climb in 2009 as Lawmakers Execute Aggressive Congressional Agenda,” OpenSecrets.org, February 12, 2010, http://www.opensecrets.org/news/2010/02/federal-lobbying-soars-in-2009.html.
13. Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), 89.

cronyism. In a December 2010 study, MIT economist Daron Acemoglu and four colleagues pointed out:

> TARP explicitly granted broad powers to the Treasury to intervene in the financial sector, and [then treasury secretary Henry] Paulson had used it to pressure nine major banks into accepting $125 billion of new government capital on one day. TARP was especially significant because it gave the Treasury Department a direct role in determining which banks succeeded or failed.[14]

Acemoglu et al. found that in the 10 days following the November 21 leak, financial firms that had a preexisting connection with Geithner had "a cumulative abnormal return" of about 15 percent. Translation: the value of the stock of these Geithner-connected firms rose 15 percent after people learned that Geithner was named Treasury Secretary. Clearly, the market expected firms connected to Geithner to do better, all other things equal. Acemoglu et al. also consider—and reject, based on the evidence—alternative explanations for these abnormal stock returns.

Acemoglu et al. note that 15 percent is substantially higher than had been found in past studies of other powerful federal decision makers. For example, Columbia University economist Raymond Fisman, along with David Fisman, Julia Galef, and Rakesh Khurana, tried and failed to find similar results for firms with connections to Vice President Dick Cheney. They concluded, "Contrary to conventional wisdom, we find that in all cases the value of ties to Cheney is precisely estimated as zero."[15] Presumably the reason is that Cheney had far less discretionary power than Geithner.

The Bush administration exhibited numerous instances of cronyism, particularly in its last year. Perhaps the most egregious of these instances occurred during the fall 2008 bail out of the insurance giant AIG, which received over $100 billion in U.S. government funds. The bailouts were engineered under the discretionary authority of then treasury secretary Henry Paulson, who prior to that appointment made a considerable fortune largely as a long-term employee of Goldman Sachs. If it is true, as seemed likely, that without this bailout AIG would have gone bankrupt, then it would not have been able to pay all its debts, and in fact, Goldman Sachs was the biggest single recipient of the bailout funds AIG paid. Goldman Sachs received $12.9

14. Daron Acemoglu, Simon Johnson, Amir Kermani, James Kwak, and Todd Mitton, "The Value of Political Connections in the United States" (working paper, Massachusetts Institute of Technology, Cambridge, MA, December 2010), http://www.hbs.edu/units/finance/pdf/Value%20of%20Political%20Connections%20Dec%207%202010%20v2.pdf.
15. David Fisman, Ray Fisman, Julia Galef, and Rakesh Khurana, "Estimating the Value of Connections to Vice-President Cheney" (working paper, Princeton University, Princeton, NJ, 2006), http://fairmodel.econ.yale.edu/ec483/ffgk.pdf.

billion.[16] Paulson had sold his shares of Goldman Sachs upon becoming treasury secretary, so he did not gain directly from the indirect largesse the federal government bestowed upon Goldman Sachs.[17] Still, through the AIG bailout, Paulson restored or preserved the wealth of many of the high-level managers of Goldman Sachs, many of whom were former colleagues of Paulson. That is cronyism.

Another example of cronyism is the Obama administration's huge subsidy to Solyndra that became a news-worthy scandal in 2011. One reason people noticed is that the federal government's highly touted $535 million investment in Solyndra went sour. Another reason for the scandal is that e-mails between various officials in the Obama administration show their desperation to shovel hundreds of millions of dollars into this politically privileged company. The *Washington Post* reports:

> [Steve] Spinner came from Silicon Valley to serve as a senior adviser [to the Energy Department] on the loan program, and his wife was a lawyer with Wilson Sonsini, the law firm representing Solyndra in its application. Despite an ethics agreement under which he said he would recuse himself from Solyndra's loan application, correspondence shows that Spinner defended the company, worked to get the president or vice president to visit its factory, and pushed for a final decision on approving the company's loan.
>
> "How [expletive] hard is this?" Spinner wrote to a career staffer on Aug. 28, 2009, asking for answers about final approval from an OMB [Office of Management and Budget] official. "What is he waiting for? Will we have it by the end of the day?"[18]

Of course, a much larger instance of cronyism under the Obama administration, one that makes the Solyndra case tiny by comparison, is the bailout of General Motors (GM) and Chrysler. Bush and Obama together diverted $77 billion in TARP funds to GM and Chrysler. In organizing their bailouts and bankruptcies, Obama violated the rights of Chrysler's creditors and gave a sweetheart deal to the United Auto Workers union. Law professor Todd Zywicki explains:

> In the years leading up to the economic crisis, Chrysler had been unable to acquire routine financing and so had been forced to turn

16. Michael Mandel, "German and French Banks Got $36 Billion from AIG Bailout," *Bloomberg Businessweek* "Econochat," March 15, 2009, http://www.businessweek.com/the_thread/economicsunbound/archives/2009/03/german_and_fren.html.
17. Rebecca Christie and Matthew Benjamin, "Paulson Risks Goldman Standard as Fannie, Freddie Shares Erode," *Bloomberg*, August 21, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&refer=home&sid=a8w9MI4Btco4.
18. Joe Stephens and Carol D. Leonnig, "Solyndra Loan Deal: Warning about Legality Came from within Obama Administration," *Washington Post*, Oct. 7, 2011, http://www.washingtonpost.com/politics/solyndra-obama-and-rahm-emanuel-pushed-to-spotlight-energy-company/2011/10/07/gIQACDqSTL_story.html.

> to so-called secured debt in order to fund its operations. Secured debt takes first priority in payment; it is also typically preserved during bankruptcy under what is referred to as the "absolute priority" rule— since the lender of secured debt offers a loan to a troubled borrower only because he is guaranteed first repayment when the loan is up. In the Chrysler case, however, creditors who held the company's secured bonds were steamrolled into accepting 29 cents on the dollar for their loans. Meanwhile, the underfunded pension plans of the United Auto Workers—unsecured creditors, but possessed of better political connections—received more than 40 cents on the dollar.[19]

Moreover, in a typical bankruptcy case in which a secured creditor is not paid in full, he is entitled to a "deficiency claim"—the terms of which keep the bankrupt company liable for a portion of the unpaid debt. In both the Chrysler and GM bankruptcies, however, no deficiency claims were awarded to the creditors. Were bankruptcy experts to comb through American history, they would be hard-pressed to identify any bankruptcy case with similar terms.[20]

Why did the Chrysler bondholders not object? Many did. But, Zywicki notes, the federal government (in this case, the U.S. treasury secretary) had enormous power over financial institutions through TARP, and these institutions owned much of Chrysler's secured debt. This also helps explain why Geithner-connected firms' stocks increased in value so much when his appointment became known.

Although examples of cronyism are prevalent under the Obama administration, cronyism did not begin there. For example, what gave Timothy Geithner such great power was TARP. Obama was responsible for TARP only to the extent that one senator's vote matters, because TARP passed when he was a junior senator, before he became president.

THE BUSH BAILOUTS

Many forget that the Obama administration did not initiate the bailout. George W. Bush, in one of his last major actions as president, handed Obama the blank check called TARP. Despite a vote by the U.S. Senate against bailing out auto companies,[21] the Bush administration used TARP money to do just that.[22] It is true that the

19. Todd Zywicki, "The Auto Bailout and the Rule of Law," *National Affairs*, no. 7 (Spring 2011), http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law.
20. Ibid.
21. David M. Herszenhorn and David E. Sanger, "Senate Abandons Automaker Bailout Bid," *New York Times*, December 11, 2008, http://www.nytimes.com/2008/12/12/business/12auto.html?pagewanted=all.
22. David E. Sanger, David M. Herszenhorn, and Bill Vlasic, "Bush Aids Detroit, but Hard Choices Await Obama," *New York Times*, December 19, 2008, http://www.nytimes.com/2008/12/20/business/20auto.html?pagewanted=all.

law creating TARP two months earlier had given significant discretionary power to the U.S. treasury secretary. But this power was to help financial institutions, not auto companies. That is why the U.S. Senate voted on an auto bailout. The senators recognized that an auto bailout required special legislation. But Bush flouted their will and, in the process, broke the law.

This was not the first time Bush had made decisions based on cronyism. In March 2002, he imposed tariffs on steel. He specifically singled out tin-mill steel for special treatment, imposing a tariff of 30 percent. Domestic tin-mill steel was produced by Weirton Steel, "one of the biggest employers in West Virginia."[23] Bush narrowly won West Virginia's electoral votes, partly by promising to give the steel industry special treatment. Note the irony. The Bush administration purposely used government power to drive up the price of steel, which raised auto manufacturers' costs, and then used further government power to help auto manufacturers.

Most instances of cronyism are facilitated not only by government power in general, but also by government's discretionary power. When government officials have a lot of leeway in the decisions they can make about which companies and unions to help and which to harm, cronyism is at its ugliest.

OTHER INSTANCES OF CRONYISM

It is not difficult to find many examples of cronyism in the 20th-century United States. One famous example not reported until decades after it occurred is the case of young Texas congressman whose wife became the nominal owner of a business that he used his political power to help her obtain.

Here's what happened. Between December 1939 and January 1943, despite countless attempts, the owners of Austin, Texas, radio station KTBC were unable to get permission from the Federal Communications Commission (FCC) to sell the station. But on January 3, 1943, the wife of a Texas congressman filed her application to buy the station and 24 days later, after waiting more than three years, the owners were allowed to sell. The congressman's wife paid $17,500 for the radio station. In June 1943, she applied for permission to operate 24 hours a day, up from daylight hours only, and at a much better part of the AM frequency. The FCC granted permission one month later. While all this was happening, the FCC was under attack by another powerful congressman, Eugene Cox of Georgia. The aforementioned Texas congressman strategized secretly with FCC official Red James and used his influence with Speaker of the House Sam Rayburn to deflect the attack. In fact, James later admitted that he had recommended to the congressman's wife that she apply for the license. In 1943, the congressman and his wife had a net worth of approximately zero. But by 1964, when this congressman was elected president

23. "Bush Imposes Steel Tariffs," *USA Today*, March 5, 2002, http://www.usatoday.com/money/general/2002/03/05/bush-steel.htm.

of the United States, Lyndon Baines Johnson and his wife's net worth was at least $14 million. The radio station's value accounted for about half of this $14 million.[24]

Some of the most egregious examples of cronyism in U.S. history involve defense contractors. There's a reason for this. The cases of cronyism I have discussed so far involved private companies generally producing goods they sell to other private companies or individuals. That's true of solar panels, cars, and steel. The private market constrains cronyism because there is a market test. Ultimately, the goods will be sold to people or entities spending their own money, which produces a strong incentive to take care in purchasing.

In contrast, defense contractors sell products almost exclusively to government buyers, who have much less incentive to spend money carefully. After all, they are spending other people's money. Therefore the waste can be much greater.

The insidious connection between defense contractors and the military so concerned President Dwight Eisenhower that he highlighted his concern in his farewell address.[25] In that speech, he coined the famous term "military industrial complex." Admirals in the Navy and generals in the Army, Air Force, and Marine Corps often push to get aircraft carriers, tanks, fighter jets, and helicopters, for example, even if they do not anticipate a likely mission for which these would be needed.

One might think the U.S. Congress would act as a check on the military, but it probably makes things worse. Members of Congress are notorious for pushing for a particular weapons system or airplane engine even when Department of Defense officials have made it clear they do not want these things. In the 1990s, for example, Dianne Feinstein, a U.S. senator from California, pushed for the B-2 stealth bomber even though the Defense Department did not want to spend further money on the program. Senator Feinstein made an interesting slip in defending the program that gave away her true motive: "The bomber," she declared, "can deliver a large payroll, precision or carpet." In the *Congressional Record* the next day, her remarks were amended to read "payload."[26]

In a more recent case, Speaker of the House John Boehner (R-OH) pushed for funding for an alternate engine for the F-35 joint strike fighter, even though Defense Secretary Robert Gates claimed the extra engine "would be a waste of nearly $3 billion."[27] General Electric, which, with Rolls Royce Group, is the engine's producer, had "about 1,000 employees working on the engine in a facility near Cincinnati" at

24. This story is told masterfully and in great detail in Robert A. Caro, *The Years of Lyndon Johnson: Means of Ascent* (New York: Alfred A. Knopf, 1990), 82–111.
25. Dwight D. Eisenhower, "Farewell Address," speech, 1961, in *Public Papers of the Presidents* (Washington, DC: Government Printing Office, Various), 1035–40, http://www.h-net.org/~hst306/documents/indust.html.
26. Harvey S. Rosen, *Public Finance*, 7th ed. (New York: McGraw-Hill Irwin, 2005), 258.
27. Roxana Tiron, "U.S. House Votes to Kill GE Engine for F-35 Fighter," *Bloomberg*, February 16, 2011, http://www.bloomberg.com/news/2011-02-16/u-s-house-votes-to-kill-f-35-backup-engine-from-ge-rolls-with-funds-cut.html.

the time.[28] In this case, the nearly $3 billion has not yet been wasted because the House of Representatives voted to kill the funding.

IS BUSINESS BAD?

Many people look at the sorry record of cronyism and conclude that big business is bad. But this does not follow. Some big businesses do not engage in cronyism at all. In the recent bailout, General Motors did but fellow auto giant Ford Motor Co. did not. (Ford Motor Co. did its share in the past, however, lobbying for restrictions on auto imports in the early 1980s.[29]) Some small businesses do engage in cronyism. Solyndra, for example, is not a large firm. Size is not what matters.

Is business bad? No. Under the right rules—enforcement of contracts, open entry, no special favors, and so forth—business is good. A business is a voluntary association of people who put resources together to produce something other people value. In other words, businesses create value. Whether it is Apple producing the iPhone and iPad or the locally owned 7-11 store making sure milk is available for customers at 10:30 p.m., businesses are trying to make money and have found, as Adam Smith noted in *The Wealth of Nations*,[30] that the surest way to do this is to provide goods and services people are willing to buy. Not only are businesses in general not problematic, there are also cases in U.S. history in which businesses and businessmen have been maligned unjustly, leading to increased government power over the economy. One prime example involves the so-called trusts of the 19th century and the infamous robber barons. There are two problems with this term: The so-called robber barons were neither robbers nor barons. That they were neither robbers nor barons is most clearly exemplified by so-called robber baron Cornelius Vanderbilt. Vanderbilt started building his fortune by competing with a legal monopoly on steamship travel granted by the New York state government. When he was 23, Vanderbilt became the business manager for a ferry entrepreneur named Thomas Gibbons. Gibbons's goal was to compete with Aaron Ogden, who ran a ferry between New Jersey and New York. Gibbons and Vanderbilt achieved this goal by charging low fares, thus benefiting passengers. Vanderbilt and Gibbons were breaking the law because Ogden had a legal monopoly on that route. In the case *Gibbons v. Ogden*, the U.S. Supreme Court ruled that the New York state government could not legally grant a monopoly on interstate commerce.[31]

The Vanderbilt case was not unusual. If the trusts of the late 19th century had

28. Ibid.
29. See, for example, "Ford Chairman Urges Auto Import Restrictions," *Toledo Blade*, October 9, 1980, http://news.google.com/newspapers?id=4klPAAAAIBAJ&sjid=IQMEAAAAIBAJ&pg=7087%2C4753935.
30. Adam Smith, *The Wealth of Nations*, ed. Edwin Cannan (New York: Modern Library, 1994 [1776]), Book I, Chapter 2.
31. This fascinating story is told in Burton W. Folsom Jr., *The Myth of the Robber Barons*, 6th ed. (Herndon, VA: Young America's Foundation, 2010), 2–4.

monopolized the industries in which they operated, as most people believe, those trusts should have kept output low and prices high. In some path-breaking research in the 1980s, however, Loyola University economist Thomas DiLorenzo found the opposite. In a 1985 article, DiLorenzo found that between 1880 and 1890, while real gross domestic product rose by 24 percent, real output in the allegedly monopolized industries for which data were available rose by 175 percent, seven times the economy's growth rate. Meanwhile, prices in these industries were falling. Although the consumer price index fell by 7 percent in that decade, the price of steel fell by 53 percent, refined sugar by 22 percent, lead by 12 percent, and zinc by 20 percent. The only price that fell less than 7 percent in the allegedly monopolized industries was that of coal, which stayed constant.[32] In his 1987 book *A Theory of Efficient Cooperation and Competition*, University of Chicago economist Lester Telser reinforced DiLorenzo's theme, pointing out that between 1880 and 1890 the output of petroleum products rose by 393 percent and the price fell by 61 percent.[33] Telser writes: "The oil trust did not charge high prices because it had 90 percent of the market. It got 90 percent of the refined oil market by charging low prices."[34]

Unfortunately, because the myth of the robber barons became so widely believed, one of the damaging pieces of legislation we have inherited from the late 19th century was the Sherman Antitrust Act. This Act and subsequent laws have been used by many firms to hobble their successful competitors. As Northwestern University law professor Fred S. McChesney put it:

> One of the most worrisome statistics in antitrust is that for every case brought by government, private plaintiffs bring ten. The majority of cases are filed to hinder, not help, competition.[35]

In this way, the antitrust laws have contributed to the rise of cronyism.

ECONOMIC POWER IS NOT POLITICAL POWER

There is a difference in kind between economic power and political power. Economic power is based on wealth, but the wealthiest person in the world cannot, simply by being wealthy, force me to do anything. Even the largest, wealthiest corporations must pay attention to their customers. Any one customer, unless he buys a large percentage of a firm's product, has little control over a large corporation.

32. Thomas DiLorenzo, "The Origins of Antitrust: An Interest-Group Perspective," *International Review of Law and Economics* 5, no. 1 (1985): 73–90.
33. Lester Telser, *A Theory of Efficient Cooperation and Competition* (New York: Cambridge University Press, 1987).
34. Ibid. 41.
35. See Fred McChesney, "Antitrust," in David R. Henderson, ed., *The Concise Encyclopedia of Economics*, Indianapolis: Liberty Fund, 2008, http://www.econlib.org/library/Enc/Antitrust.html.

But when a large number of customers react negatively to a particular firm's product, the firm has a strong incentive to adjust and better cater to its customers. The mighty Coca-Cola Corporation, for example, faced such stiff consumer resistance when it launched "New Coke" in the 1980s that it quickly dropped the product and resumed producing the original Coca-Cola.[36] Gap faced resistance for changing its logo; the resistance was so strong that Gap returned to its old logo.[37] In addition, economic power tends to be fleeting. Peter Senge finds that the average life of an individual Fortune 500 company is only 30 years.[38] Only 71 of the original 1955 Fortune 500 companies are still on the list,[39] and in the 10 years from 1999 to 2009, almost half of the companies in the Fortune 500 were replaced.[40]

Political power, by contrast, is the power to coerce. Lowly bureaucrats in federal, state, and local governments have the power to coerce me. A city official in Pacific Grove, California, for example, can credibly threaten me with jail time if I cut down a tree on my own property without permission. But Home Depot and Costco, two large retail establishments where I might buy the saw to cut down my tree, cannot force me to do or prevent me from doing anything.

Governments sometimes use their power of eminent domain to seize private property and sell it at a low price to large developers. This is what the city government of New London, Connecticut, did in the infamous *Kelo v. City of New London* case.[41] The government seized Susette Kelo's land, despite her desire to stay in her house, in order to lure Pfizer to build a large facility and not have the facility be "surrounded by tenements," as one Pfizer employee told a reporter.[42] The crucial ingredient here is government. No matter how strong Pfizer's desire to possess the land upon which Kelo's house sat, without the government's power of eminent domain, Pfizer could not have acted on this desire.[43]

36. See "New Coke," Wikipedia, http://en.wikipedia.org/wiki/New_Coke. I thank an anonymous referee for this suggestion.
37. Nate Jones, "Haters Gonna Win: Gap Returns to Old Logo," Time NewsFeed, October 12, 2010, http://newsfeed.time.com/2010/10/12/haters-gonna-win-gap-returns-to-old-logo.
38. Peter M. Senge, *The Fifth Discipline: The Art and Practice of the Learning Organization* (New York: Doubleday, 2006 [1990]).
39. Jim Collins, "The Secret of Enduring Greatness," *Fortune*, May 2008.
40. Toby Elwin, "The Cost of Culture, a 50% Turnover of the Fortune 500," *Toby Elwin* blog, http://www.tobyelwin.com/the-cost-of-culture-a-50-turnover-of-the-fortune-500.
41. See "Kelo v. City of New London," Wikipedia, http://en.wikipedia.org/wiki/Kelo_v._City_of_New_London.
42. Jeff Benedict, "Taken in Vain: New London's Folly," *Hartford Courant*, November 15, 2009, http://articles.courant.com/2009-11-15/news/hc-commentarybenedict1115.artnov15_1_urban-fort-trumbull-neighborhood-barren-weed-fields-pfizer-wanted-next-door.
43. After building its large research and development facility on the cleared land, Pfizer announced its plans to shut down the facility. See ibid.

IS ALL BUSINESS LOBBYING BAD?

One conclusion a reader might be tempted to reach at this point is that all lobbying of government by business is bad. But this is false. We need to distinguish between two kinds of lobbying. One is lobbying to persuade government officials to implement a special privilege, a special regulation, a special subsidy or tax break. An example is Solyndra's lobbying for a government loan. The other kind of lobbying is lobbying to reduce government's power, whether over the firm or industry that lobbies or, more rarely, government's power in general. An example would be a corporation that pushes for a cut in the corporate tax rate. Another example would be a corporation that lobbies against heavier government regulation of medical care.

Microsoft represents an example of lobbying to reduce government power. Before the federal antitrust suit of 1997, Microsoft, which had almost no lobbying presence in Washington, D.C., learned the hard way that it had only two U.S. senators on its side, both from Washington State.[44] As a result, Microsoft substantially increased its lobbying presence in Washington, D.C. OpenSecrets.org writes the following about Microsoft:

> Microsoft Corp. is the world's top computer software company. It is also one of the biggest campaign contributors in Washington—an astounding fact when you consider that Microsoft is a relatively new player on the political scene. Prior to 1998, the company and its employees gave virtually nothing in terms of political contributions. But when the Justice Department launched an antitrust investigation into the company's marketing of its popular Windows software, things changed. The company opened a Washington lobbying office, founded a political action committee and soon became one of the most generous political givers in the country. The move eventually galvanized an entire industry, as computer and Internet companies quickly moved to emulate Microsoft's political savvy. Between 2000 and 2010, Microsoft spent at least $6 million each year on federal lobbying efforts.[45]

Lobbying against government power, if successful, tends to protect the rule of law and property rights and tends to limit government subsidies, regulations, and taxes. For that reason, I think of it as usually good.[46] In contrast, lobbying for special privilege is generally bad.

44. For a fairly comprehensive history of the antitrust case against Microsoft, see Ken Auletta, *World War 3.0: Microsoft and Its Enemies* (New York: Random House, 2001).
45. "Heavy Hitters: Microsoft Corp.," OpenSecrets.org, http://www.opensecrets.org/orgs/summary.php?id=D000000115&cycle=2012.
46. I say "usually" rather than "always" because lobbyists against government power might also lobby against government's attempts to internalize externalities such as pollution.

Unfortunately, lobbies that start out simply trying to protect themselves from intrusions by the federal government often morph into all-purpose lobbies that also try to hamper their competitors and seek other special privileges. As pundit Michael Kinsley, a former Microsoft employee, points out, “Microsoft . . . piled on, bringing charges against Google at the European Union, accusing it of a variety of nefarious practices, including some the EU had formerly accused Microsoft of.”[47]

HOW TO END CRONYISM

There is only one way to end, or at least to reduce, the amount of cronyism, and that is to reduce government power. To reduce cronyism, we must abolish regulations and cut or abolish special government subsidies. That way, there is nothing to fight about. For example, the government should not bail out companies or give special subsidies and low-interest loans to companies like Solyndra that use technologies or produce products that the government favors. It should have unilateral free trade rather than tariffs, import quotas, and other restrictions on imports.

Why is the liquor lobby fairly unimportant in federal politics but very important in Albany, Sacramento, and other state capitals? The reason is that the bulk of liquor regulation is at the state level, and there is relatively little regulation at the federal level. Regulation creates cronyism. Columnist Dan Walters, whom many Californians think of as the dean of California political reporting, made a related point in a 1988 column: “It’s no accident that the largest contributors of legislative campaign funds are from the liquor, horse racing, medical, insurance and other regulated industries.”[48]

In *The Road to Serfdom,* Hayek, discussing the almost total government control Nazi, fascist, and communist governments had over their economies, writes: “As the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of this directing power.”[49]

Fortunately, the United States is not close to a situation where the government has total power over the economy, but the principle still applies. The more power the government has over the economy, the more allocation of resources will depend on political connections. The way to eliminate cronyism is to have free markets and little government control.

47. See Michael Kinsley, “The Washington Lobbying Dance,” *Los Angeles Times*, April 5, 2011, http://articles.latimes.com/2011/apr/05/opinion/la-oe-kinsley-column-microsoft-20110405.
48. Dan Walters, “Regulation Can Hurt Public,” February 2, 1988. I am indebted to Dan Walters for sending me a copy of this article. It is not available online.
49. Hayek, *Road to Serfdom*, 119.