Crony Capitalism

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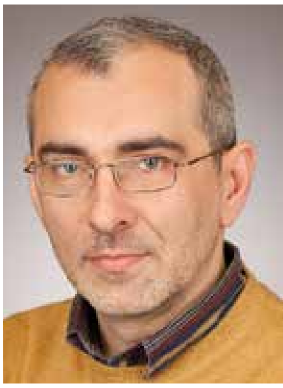

Introduction

Over the past few decades Western economies have become increasingly more regulated. Looking across 16 sectors in 49 developed nations, Jordana, Levi-Faur and Fernández i Marín (2011) have found that the rate by which new regulatory agencies (RAs) have been created has grown from about three new RAs per year in the 1970s, to seven per year in the 1980s, to about 30 per year in the 1990s. The United States provides a fairly typical example of such trends. The increase in the staffing of Federal Regulatory Agencies grew from about 50,000 in the early 1960s, to a peak of 150,000 in the early 1980s, followed by a slight decline to about 100,000 during the Reagan era, but returning to a high level of about 170,000 throughout the 1990s, and then sharply increasing to over 250,000 in the 2000s (de Rugy and Warren 2009). Similarly, the growth of federal government spending on regulation grew from about three billion USD in the 1960s (in 2000 USD adjusted for inflation), to about 15 billion in the early 1990s, to over 40 billion in the present (de Rugy and Warren 2009). The number of occupations requiring licensing in the United States grew from about five percent in the 1950s to almost one in three today (Krueger and Kleiner 2010).

Although some regulations may have a public interest rationale, most of them are probably better explained by rent-seeking and regulatory capture (Dal Bó 2006), with incumbent firms obtaining more or less transparent privileges from government agencies (Mitchell 2012; Henderson 2012). Such privileges need not take the form of direct subsidies or tax breaks, but, more subtly, they involve setting up a regulatory environment that creates greater costs to their competitors. For example, large firms have an easier time getting through various bureaucratic and regulatory hurdles. This leads to less competition and less entrepreneurial "creative destruction", and, hence, protects the profit margins of the incumbent firms. Such artificially increased profit margins are known as "rents". Rent-*seeking* refers to the resources that firms are willing to spend in order to obtain such privileges (Buchanan 1980; Tullock 2005; Congleton & Hillman 2015). Such resources are taken away from productive activities, which is why rent-seeking leads to large-scale economic inefficiencies.

In democracies, when political actors create such rents for firms, they take a risk. Even if they do not go into illegal territory (e.g. by taking bribes), voters might still penalize them if they acquire the image of corrupt politicians. For this reason, policies that create privileges are usually dressed up under the pretense that they serve the general interest (Yandle 1983). For example, environmental regulations are advocated on general welfare grounds, but the *details* of the regulations are often set up to benefit specific firms. Voters support the regulation in the abstract and do not pay attention to the details. For instance, rather than simply regulating the level of emissions, and leave the "how" question open ended, the regulations may mandate the use of a particular type of filter, which happens to be produced by few firms. Because the voting public is "rationally ignorant", i.e. people have better things to do than become informed about such details, the cover given to privileges often works.

The rent-seeking firms also have a problem. If *anyone* can lobby for such benefits, their own privileges may get eroded. This is known as the "transitional gains trap" (Tullock 1975). Because firms do not actually own the politicians, they face the risk at any time that the politicians will switch against them. In other words, rent-seeking works on a subscription model. Hence the trap: to maintain their privileges, the rent-seekers need to continue to pay, which actually erodes their rents. The higher profit margins that they obtain because of privileges do not go into their own pockets, but go into paying for the continuation of the rent-creating policies. They are thus trapped and the true beneficiaries are the

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political actors with the power to grant or lift privileges. A typical example of this is the taxi medallion system. Many cities limit the number of taxies, which artificially increases their price, and hence leads to larger profits for taxi companies. But these profits are eroded by the need to pay for the medallions, and by the need to pressure city governments to maintain their privileges (e.g. by trying to ban firms like Uber).

These two risks, the risk faced by the politicians who create privileges and the risk faced by rent-seeking firms caught in the transitional gains trap, find a common solution. The concept of "crony capitalism" aims to describe the system that embodies this solution. The full-fledged crony capitalist system has the following characteristics. On the one hand, in order to secure their rents, firms need a mechanism for limiting access to rent-seeking by other firms. As the name "crony" suggests, this is achieved by making sure that only those who have personal (or even family) relations with politicians can obtain privileges. In other words, access to rent-seeking is restricted based on crony relations, while everyone else is refused access to politics. But what incentives do politicians have to restrict rent-seeking? In practice, such restrictions occur when they themselves (or family and friends) are on both sides – as business owners and as regulators. On the other hand, how can such a system that institutionalizes corruption be legitimized and accepted by voters? The answer is known as "populism". Populism is a "thin ideology" (Stanley 2008) that lacks any strong policy commitments, and which projects itself by the claim to reflect the "voice of the people". This claim can be easily adapted by skilled politicians to support a variety of ad hoc policies targeting various economic sectors in order to implement strong regulations, which create rents to favored firms. Moreover, in highly corrupt countries, firms with access to crony political relations are allowed to operate outside the strictures of the law, unlike their competitors. Hence, the law is created on populist grounds, but then it is applied in a discretionary manner based on crony relations. This combination of rent-seeking, populism and personal relationships is called "crony capitalism" (Aligica and Tarko 2014).

Typical full-fledged crony capitalist countries are South American countries (Haber 2002) like Argentina and Brazil, and South-East Asian countries like Philippines and Indonesia (Kang 2002). Eastern European countries, such as Romania and Bulgaria, also have strong crony capitalist features. Advanced liberal democracies like United States and Western European countries are better understood as "regulatory capitalist" (Jordana and Levi-Faur 2004; Braithwaite 2008; Aligica and Tarko 2015). The main question about those is if their system is stable or, if it is gradually drifting towards crony capitalism instead. Prominent economists like Zingales (2012) have recently argued that a drift towards crony capitalism seems to be occurring.

The next section briefly describes full-fledged crony capitalist countries. The article then moves on to describe the regulatory capitalist reality of advanced liberal democracies and discuss Zingales's "road to cronyism" hypothesis in light of Buchanan and Hayek's analysis of the concept of rule of law.

Crony capitalism as a second-best solution to weak institutions

The first thing to bear in mind about full-fledged crony capitalist countries is that their economies operate under a very weak institutional framework (Table 1): protections of private property and the enforcement of contracts are very weak, the judiciary is subjected to political control and courts lack impartiality. As we can see from Table 1, both in South America and in South-East Asia, notable exceptions from the full-fledged crony capitalist system exist: Chile and, to some extent, Uruguay, Singapore, Malaysia, and Brunei. This suggests that the main source of their problems is institutional, and that a way out exists.

How does an economy work when property and contract protections are so weak? In full-fledged crony capitalist countries, cronyism plays an important role by providing a second-best solution to a problem facing all governments (Haber 2002, vii-viii):

"Any government strong enough to protect and arbitrate property rights is also strong enough to abrogate them. Unless the government can find a way to tie its hands, asset holders will not invest. And if there is no economic growth, the government will be unable to finance its needs because there will be insufficient tax revenue."

The Western, "first-best solution" to this commitment problem is limited government and rule of law. However, most countries lack limited governments. As seen in Table 1, many governments are doing anything but protecting property and contracts. Moreover, contrary to the belief that in crony capitalist countries businesses operate in an unregulated manner, they are actually *more* regulated than Western democracies. Yet, in order to achieve growth, the commitment problem has to be somehow solved. Crony capitalism allows the government "to guarantee a *subset* of asset holders that their property rights will be protected" and "[a]s long as their assets are protected, these asset holders will continue to invest as if there were universal protection of property rights. Thus, economic growth can occur, even though the government is not limited" (Haber 2002, xiv, emphasis added). What provides the guarantee is that the "members of the government itself, or at least members of their families … share in the rents generated by the asset holders" such that any unexpected change of policies would "have a negative effect on the wealth and happiness of crucial members of the political elite" (Haber 2002, xv). Thus, the system of property rights remains stable as long as the political elites do not change and the commitment problem is solved if they are sufficiently integrated with the economic sector. Moreover, as pointed out by Dreher and Schneider (2010), in socie-

Table 1

Institutional weaknesses in South-East Asia and South America, compared to some advanced liberal democracies, for 2012

	Property rights protection	Legal enforcement of contracts	Judicial independence	Impartial courts	Business freedom
Brunei	6	4.2	6.7	5.2	7.1
Cambodia	4.4	1.8	2.9	4.2	5.3
Indonesia	5.1	1.7	4.4	4.9	6.2
Myanmar	2.5	1.9	3.1	2.4	4.6
Philippines	5.6	3.4	3.6	4.2	6.5
Thailand	5.1	6.2	4.7	4.5	6.2
Timor	3	0	4	3.9	5.8
Vietnam	4.2	5.7	3.9	3.9	5.2
Malaysia	7	5.6	5.9	6.5	7.1
Singapore	8.9	7.8	7.8	7.5	7.9
Average (without Malaysia and Singapore)	4.5	3.1	4.2	4.2	5.9
Argentina	2.5	4.8	2.3	2.1	4.9
Bolivia	3.7	4	3.5	4	4.5
Brazil	6	4	4.8	4	3.6
Colombia	4.7	2.1	3.4	3.8	6.4
Ecuador	4.6	4.4	3.6	3.7	5.6
Guyana	4.8	4.6	4.2	4.4	6.2
Paraguay	3.4	4.2	1.2	3	6.1
Peru	4.5	5.1	2.6	3.5	6
Suriname	4.3	2.7	5	3.5	5.7
Uruguay	6.5	3.8	7.4	4.9	6.3
Venezuela	1	3.2	0.2	1.1	3.6
Chile	6.8	5.1	7.1	5.9	6.9
Average (without Chile)	4.2	3.9	3.5	3.5	5.4
United States	7	6.6	6.7	5.9	6.7
United Kingdom	8.6	4.7	8.7	7.3	7
Switzerland	8.7	6.1	8.5	7.5	7
Sweden	8.1	6.2	8.6	7.6	7
France	7.8	6.4	6.8	5.3	6.2
Germany	8.1	6.6	8.4	6.8	6.6
Average	8.1	6.1	8.0	6.7	6.8

Source: Fraser Institute's Economic Freedom of the World Index (2014).

ties with weak institutions, the privileged firms operate outside the law on the books (e.g. they are allowed to engage in massive tax evasion), while their competitors lacking crony relations are subjected to very heavy regulations.

Such an institutional arrangement based on personal relationships is very different from that in advanced, "open access", capitalist countries (North, Wallis and Weingast 2009). And, yet, as Zingales (2012) argues, while some crony capitalist countries may be moving in the direction of rule of law "open access societies", Western democracies are also in danger of moving in the opposite direction.

Regulatory capitalism and the road to cronyism

As Buchanan (1999) has pointed out, the fall of socialism in 1989 may have led to a "loss of faith in politics", but has not been "accompanied by any demonstrable renewal or reconversion to a faith in markets" (Buchanan 1999, 186): "We are left, therefore, with what is essentially an attitude of nihilism toward economic organisation". This "attitude of nihilism" is ripe for the growth of populism, which rationalizes state interventions, but not from a coherent ideological perspective. Under the regime of such a "thin ideology", one may offer justifications and legitimacy to any types of government interventions on the market. A rent-seeking oligarchy or any rent-seeking group finds in populism a wonderfully malleable and effective instrument. This is visible on a grand scale in countries like Venezuela and Bolivia, but it is also a non-negligible reality in Western democracies.

Zingales describes a vicious cycle created by the combination of rent-seeking and populism (2012, xxii):

"[P]opulism really becomes a threat to the survival of the free-enterprise system when markets lose legitimacy as a way of allocating rewards – in other words, when the system looks unfair to growing numbers of people. … [W]hen voters lose the confidence in the economic system because they perceive it as corrupt, then the sanctity of private property becomes threatened as well. … In response to the uncertainty stemming from today's populist backlash, companies have begun to demand special privileges and investment guarantees. … Such privileges and guarantees stoke the public anger that generated the populist backlash in the first place by confirming the sense that government and large-market players are cooperating at the expense of taxpayers and the small investors. … No longer certain they can count on contracts and the rule of law, legitimate investors then grow scarce. This, in turn, leaves troubled businesses little recourse but to seek government assistance, thereby reinforcing crony capitalism."

He also cites examples that showcase the fact that this vicious cycle is not inevitable. To date, however, we only have anecdotic evidence about the way in which the problem has been avoided. Thus, gaining a better understanding of this process becomes an important task for political economy.

The most striking and disturbing aspect of the cycle described by Zingales (2012) for the United States is how similar it sounds to Haber's theory of full-fledged crony capitalism described above. Zingales basically describes a process whereby the United States may be gradually turning into a crony capitalist country of the South American kind. As individual firms seek guarantees against outbreaks of populism, they effectively seek to obtain individual favors which begin to look suspiciously similar to business-politics crony relations. Similar fears about the drift towards more and more rent-seeking have been raised before by authors like Hayek (1960), Buchanan (1980), and Olson (1982). What is the alternative? As Buchanan (1980, 11) pointed out,

"[R]ent seeking emerges under normally predicted circumstances because political interference with markets creates *differentially advantageous positions* for some persons who secure access to the valuable 'rights'. From this fact, we may derive a 'principle'. *If political allocation is to be undertaken without the emergence of wasteful rent seeking, the differential advantages granted to some persons as a result of the allocation must be eliminated*." *(emphasis added)*

In other words, rule of law must be carefully guarded to prevent the slide towards cronyism. Rule of law, or the "generality norm" (Buchanan and Congleton 1998), is the idea that all laws must be non-discriminatory to avoid creating differential costs and benefits for some groups and not others. Such differential costs and benefits generate conflicts between those groups and spur rent-seeking – i.e. some groups using their resources in a bid to gain the benefits and protect themselves against the costs. This idea of rule of law is fundamentally at odds with the empirical reality described in the introduction – the extraordinary growth of regulatory bodies and increasingly arcane regulations.

The question thus arises: is the Hayek-Buchanan solution the *only* possible solution? To put it differently, their argument describes a *sufficient* condition for preventing the slide to cronyism – if we were to comply with the generality norm, we would be safe from this danger. But is this also a *necessary* condition? Can this slide be avoided by some other means, without the generality norm?

The literature on regulatory capitalism and on entrepreneurial capitalism (Vogel 1996; Aligica and Tarko 2015) offers some (perhaps meager) grounds for hope. We can observe the evolution of *outcomes* using Fraser´s sub-indices (Aligica and Tarko 2015, Ch. 3). The size of government can be measured as an average of Fraser's Area 1 sub-indices for government consumption spending, transfers, and government enterprises. Regulation can be measured by Fraser's Area 5 aggregate sub-index, "Regulation of Credit, Labour, and Business".

While on average, between 1970 to the present the size of government in OECD countries fluctuated back and forth, as far as regulation is concerned we observe a much clearer trend towards deregulation (despite the institutional increase of regulatory agencies). This trend in terms of regulatory outcomes (the increasing ease of doing business), creates the puzzle of "more rules, freer markets" (Vogel 1996). What are the regulatory agencies doing if their growth corresponds to deregulation in terms of outcomes? Two main ideas have been proposed as a solution to this puzzle.

First of all, the Hayek-Buchanan argument relies on the hidden assumption that regulatory bodies have monopoly power, and hence the ability to abuse their positions. But do they? As noted by Vogel (1996), economic freedom can increase in an environment of numerous regulators if market players can engage in "regulatory arbitrage". Economic actors can often choose their favorite regulator, e.g. pick the most favorable state in a federal system. Moreover, if one regulator provides an unfavorable decision, economic players can often contest the decision to another authority, while a favorable decision is definitive. This creates a business-friendly dynamic. Some waste is indeed present in this system, especially as far as the legal expenditure involved in the process of challenging the undesired rules is concerned. However, it is not clear to what extent or whether this type of order creates the transition toward fully-fledged crony capitalism.

Secondly, it is often the case that entrepreneurial innovations undermine the existing regulatory order. As Meltzer (2012, 9) put it: "Lawyers and bureaucrats regulate. Markets circumvent regulation. … Regulations are static. Markets are dynamic. If circumvention does not occur at first, it will occur later." The growth of regulatory bodies may partly reflect the failed attempt to keep up with entrepreneurial developments.

Such processes highlight that the relationship between regulatory capitalism and crony capitalism is more subtle than many people assume. While we believe that the Hayek-Buchanan emphasis on the generality norm is still significant, at least as a normative benchmark, and that Zingales's warning requires more attention than it has received to date, we also need to recognize the polycentric nature of modern regulatory systems (Ostrom, Tiebout and Warren 1961; Ostrom 1999; 2014), rather than operate under the monopolistic assumption as Hayek and Buchanan did. We are still far from fully understanding the structural, long-term dangers posed by regulatory capitalism, and the best institutional means of avoiding them.

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