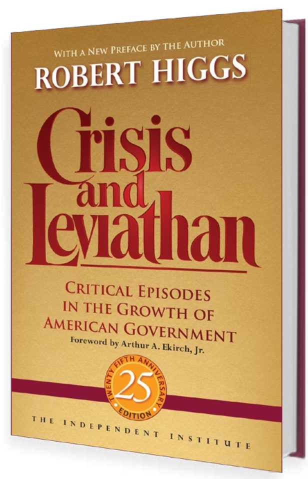
SUBSCRIBE NOW AND RECEIVE *CRISIS AND LEVIATHAN** FREE!

"***The Independent Review*** does not accept pronouncements of government officials nor the conventional wisdom at face value."
—**JOHN R. MACARTHUR**, Publisher, *Harper's*

"***The Independent Review*** is excellent."
—**GARY BECKER**, Noble Laureate in Economic Sciences

Subscribe to [***The Independent Review***] and receive a free book of your choice* such as the 25th Anniversary Edition of ***Crisis and Leviathan: Critical Episodes in the Growth of American Government***, by Founding Editor Robert Higgs. This quarterly journal, guided by co-editors Christopher J. Coyne, and Michael C. Munger, and Robert M. Whaples offers leading-edge insights on today's most critical issues in economics, healthcare, education, law, history, political science, philosophy, and sociology.



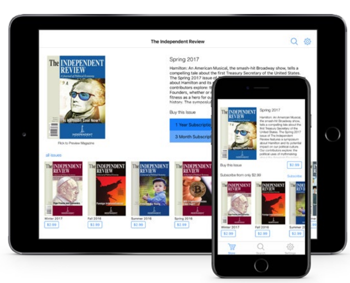
Thought-provoking and educational, ***The Independent Review*** is blazing the way toward informed debate!

Student? Educator? Journalist? Business or civic leader? Engaged citizen? This journal is for YOU!

*Order today for more *FREE* book options

SUBSCRIBE

Perfect for students or anyone on the go! ***The Independent Review*** is available on mobile devices or tablets: iOS devices, Amazon Kindle Fire, or Android through Magzter.



Download on the App Store | Available at amazon | Available on MAGZTER

INDEPENDENT INSTITUTE, 100 SWAN WAY, OAKLAND, CA 94621 • 800-927-8733 • REVIEW@INDEPENDENT.ORG PROMO CODE IRA1703

Crony Capitalism

By-Product of Big Government

Randall G. Holcombe

Economic policy issues often divide 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 to the entry of foreign competitors. Pro-government arguments point to capitalism's abuses and argue that big government is necessary to correct market failures, to regulate business so it will act in the public interest, and to oppose crony capitalism. Pro-business arguments, viewed most charitably, rest on the idea that some government policies create an uneven playing field, and they recommend offsetting government policies to level it.[1] These arguments sometimes rest on the idea that government support can create more economic prosperity than the free market can.[2] Government support can create jobs and help establish infant industries. Regardless of the motivation behind these pro-business arguments, government intervention in the economy to benefit business firms lays the foundation for crony capitalism. When business can profit from government policies, that potential entices firms to pursue benefits through government favors rather than through productive activity. The more government is involved, the more business profitability depends on government support rather than on productive activity, so political connections

Randall G. Holcombe is DeVoe Moore Professor of Economics at Florida State University.

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

2. The industrial policies that Japan and South Korea used to promote specific firms and industries after World War II are examples. See Holcombe forthcoming for a discussion of the politics behind South Korea's industrial policy.

The Independent Review, v. 17, n. 4, Spring 2013, ISSN 1086–1653, Copyright © 2013, pp. 541–559.

become all the more important for business success. Crony capitalism is an economic system in which the profitability of business depends on political connections.[3]

Proponents of the argument that more government involvement in the economy and greater regulatory oversight can control crony capitalism misunderstand its actual cause. Crony capitalism is *caused by* government involvement in the economy, and additional government involvement makes the problem worse.

Crony capitalism is a term that has been used in the popular press, but rarely in the academic literature. However, when one understands crony capitalism as an economic system in which the profitability of business depends on political connections, one sees that a substantial body of academic literature explains its causes and consequences. My purposes in this article are, first, to demonstrate that the academic literature has analyzed crony capitalism's components for decades and that those components are well understood; second, to show that all of these components point toward big government as crony capitalism's cause; and, third, to consider ways in which crony capitalism can be controlled.

Public Policy and Cronyism

The academic literature on the components of crony capitalism comprises models that depict the actual decision-making processes of those in government and their cronies in the private sector rather than simply assuming that the government makes policy decisions that promote the public interest. Economic analysts often suggest that the government intervenes in an economy to correct market problems or to improve economic performance, implicitly assuming that the government is both willing and able to implement the policies that economists' models show would be helpful. Such analysts claim that if the government were to pursue a particular course of action, specific improvements will result. Such recommendations ignore the 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 (Holcombe 2012). A real-world government may not be willing or able to implement the recommended policies. Individuals make government decisions, but one individual cannot make the decisions unilaterally, so it is unrealistic to depict "the government" as a single decision maker. Public policies emerge from a 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 implement the recommended policy.

The government is not omniscient. The information the government would need to implement the recommended policy is often not available to government

3. This definition does not imply that cronyism always makes firms profitable or that without political connections firms will not be profitable, but only that firms' profits will be higher (or losses smaller) with political connections than without them.

decision makers. For example, optimal tax theory requires policymakers to know the elasticities of supply and demand, which exist in theory but cannot be observed in practice. Optimal government production of public goods requires that policymakers 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 policymakers know the magnitude of external costs, which exist in theory but cannot be observed in practice. The necessary information is sometimes decentralized so that, as Friedrich Hayek (1945) emphasizes, it is never available to a single decision maker. 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 benevolent. Policymakers consider their own interests when they make decisions and shape policies. Because bureaucrats do not profit directly from the good decisions they make but may be penalized for the bad ones, they tend to be less entrepreneurial. William Niskanen (1971) has developed a frequently cited model of bureaucracy that shows that if government bureaucrats attempt to maximize their bureaus' budgets, inefficiently large amounts of resources will be allocated to them. Elected officials often design policies to gain support for their reelection rather than to look out for the public interest.

The government is not a dictator. Even a dictator requires a power structure to keep him in power, so people with political power must provide benefits to those who support them. Such is the case whether a dictator supports his cronies or elected officials provide special-interest benefits to the majority coalition that elects them. In a democracy, many people must agree and work together to implement a public policy. An analysis of public policy must take into account the actual information available to decision makers and the actual decision-making process 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 have the power to benefit some at the expense of others. This potential 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 claim is not a new insight: a well-established academic literature explains and elaborates on it. The common element in this literature is that rather than assuming that because an optimal policy exists in theory, the government will implement it in practice, it takes account of the actual information available to government decision makers and the incentives they face when making decisions.

In the following sections, I describe the literature on rent seeking, regulatory capture, and interest-group politics to show how these ideas relate to crony capitalism. This discussion describes the academic foundation already in place for analyzing crony capitalism and provides a deeper understanding of the mechanisms that create and sustain it.

Rent Seeking and Crony Capitalism

One manifestation of crony capitalism falls under the rubric of rent seeking. When the government can deliver favors to businesses, the latter have an incentive to devote resources to acquiring the favors, which may take many forms. Firms often approach the government with the claim that they have unfair foreign competition, and they seek protection in the form of tariffs, quotas, or regulations that protect domestic firms. Businesses also seek protection from domestic competitors, sometimes in the form of monopoly franchises that prohibit other competitors from entering the market and sometimes in the form of regulatory barriers that increase the costs for the protected firms' rivals. As Gordon Tullock (1967) notes, such firms devote resources to obtaining government favors, expending resources that might otherwise have been devoted to productive activity. These resources are a waste for the economy as a whole—they are "directly unproductive activity," to use Jagdish Bhagwati's (1982) terminology—even though they provide private benefits to the firms that obtain the favors.

Firms increase their profits through government favors, and in exchange they support the politicians who provide the favors. That relationship is cronyism. The profits that arise from rent seeking benefit the firm, but rather than adding value to the economy, as is the case when profits come from productive activity, these profits subtract value. Not only are the resources used in rent seeking wasted, but the profits associated with restrictions that give some degree of monopoly power to rent seekers are economically inefficient for the same reason that any monopoly is inefficient. As Janos 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 the government favors and would go out of business but for the government support. Rent-seeking activity is thus one form of crony capitalism.

Anne Krueger (1974) describes how this rent-seeking activity seriously hampered the Indian economy in the 1970s. Many of the best and brightest Indians, she notes, were not engaged in producing anything or adding value to the Indian economy but rather were employed to try to negotiate their firms' way through the morass of government regulations so that they would profit from the restrictions on other firms. For example, because imports of foreign goods were restricted, those who could get import licenses could profit from selling the goods in short supply owing to the restrictions. In such situations, the licenses often go to people who have connections with those in government, which is a form of crony capitalism.

When government has the power to impose costs on businesses by taxation or by imposing regulatory burdens, businesses may be compelled to engage in the political process to protect themselves from these impositions. If they want to survive, they must participate in crony capitalism even though they may prefer to avoid politics, as Fred McChesney (1987, 1997) notes. Those with connections use those connections to avoid burdens that the government will impose on other firms.

Crony capitalism emerges spontaneously as a result of government involvement in the economy, not necessarily because people in business and government have bad intentions or lack ethics. Krueger (1990) describes the evolution of the U.S. sugar program, which limits imports in order to protect domestic business. The program was originally designed to protect American owners of Cuban sugar farms, but that motivation disappeared after Fidel Castro assumed power in Cuba in 1959. The program remains, however, and is supported not only by U.S. sugar farmers, who benefit directly from restrictions that raise the price of U.S. sugar, but also by corn farmers, whose corn can be processed into corn syrup, a substitute for sugar. The program's current beneficiaries are thus not the ones it was originally designed to benefit, nor were the current beneficiaries involved in the program's initial establishment. Once government programs have been established, however, they create new interests, and these interested parties have an incentive to engage in rent seeking to keep the programs in place. Politicians provide benefits to these rent seekers, who in exchange support their cronies in the government.

Regulatory Capture and Crony Capitalism

The capture theory of regulation introduced by George Stigler (1971) complements the theory of rent seeking. Stigler argues that although regulation may be introduced to promote the general public interest, once regulatory agencies have been established, they tend to be captured by the industries they were established to regulate and tend to work for the benefit of those who are regulated. Following Mancur Olson (1965), Stigler argues that firms in the regulated industry constitute a concentrated interest group better able to organize to further its interests than is the populace in general, whom regulations are nominally designed to benefit. The general public will be rationally ignorant of government regulatory agencies' activities, as Anthony Downs (1957) notes, because its members realize they have almost no chance of influencing regulations, and even if one individual has influence, his benefit from wielding it is small because the benefit of his action is spread across a large population. Small costs per capita, imposed on members of the general public, can add up to large gains for concentrated interests, however, so the latter interests have an incentive to become informed and active in trying to influence the regulatory process.

In addition, people in the regulated industry have more information about their industry than do either members of the general public or the regulators who are nominally regulating the industry. Regulators must rely on those in the industry for information. As those in the regulated industry push for regulations favorable to them, members of the rationally ignorant general public know little about the process. Regulators who help the industry can generate political support for themselves 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 would not be informed enough to know about them. Furthermore, those in the industry come to know the regulators personally, and their personal relationships can develop into future employment prospects. For many reasons, regulations over time tend to favor the regulated industries rather than the general public because of the relationships that develop between the regulators and the regulated. Regulatory capture is thus another example of crony capitalism.

Once those regulatory benefits are produced, they create what Tullock (1975) calls the "transitional gains trap." The regulatory benefits that are captured become capitalized into the value of the assets that produce them so that over time the transitional gain from the regulatory capture becomes only a part of a normal profit. For example, the American sugar program Krueger (1990) describes benefits corn farmers by raising the price of corn, which in turn raises the price of farmland on which corn is grown. After the new regulatory regime has become established, anybody who buys that farmland earns only a normal rate of return from growing corn because the value of the regulation has been capitalized into the land's value. However, if the regulation were to be removed, landowners would suffer a capital loss because the value of their land would fall. Their profitability depends on the government regulation. This situation turns the owners of farmland into crony capitalists because the regulatory environment gives them no alternative but to rely on government for their earnings. The sugar industry made about $5 million in political contributions in 2010 and spent another $7 million in lobbying efforts to maintain the benefits they get from the sugar program ("Sugar Cane and Sugar Beets" 2012). This evidence shows that they are willing to pay substantial sums to maintain their crony status and to 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 them, which is cronyism.

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. He points out 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, entrepreneurial individuals have an incentive to engage in economically productive activity, which results in economic growth. This process is the rise of nations, as Olson describes it. Over time, political interest groups grow, solidify, and establish relationships with those who have government power, and hence success increasingly comes from the ability to use political connections rather than to engage in economically productive activity. When the power of political connections overwhelms the power of economic productivity, nations enter a decline owing to the workings of crony capitalism.

William Baumol (1990, 1993) suggests that the amount of entrepreneurial activity is roughly the same in every society, but in some places the institutional framework is organized so that the payoff to economically productive activity is greater than the payoff for the use of political connections to get ahead. Such societies prosper. In other nations, where political connections are relatively more important, some people are favored in the legal system, and property rights are not well protected, entrepreneurial individuals engage in political entrepreneurship to try to place themselves in the power elite and to prosper by sapping others' productivity.

Where poor 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. Daron Acemoglu (1995) has developed a model of how in institutional structures where rent seeking is a more significant part of the institutional structure, more resources flow into professions such as law that can take advantage of rent-seeking opportunities at the expense of professions such as engineering that are more prone to produce value for the economy. Kevin Murphy, Andrei Shleifer, and Robert Vishny (1991) show empirically that countries with a greater proportion of engineering majors in college have higher rates of economic growth than those with a higher proportion of law students.

Barry Weingast, Kenneth Shepsle, and Christopher Johnsen (1981) describe a government engaged in distributive politics, where everyone engages in political exchange to provide special interests benefits to all. Rent seeking is reinforced because others' support is needed to gain advantages in a democratic government, so political exchange occurs and creates a system in which everyone must join a coalition and vote for political benefits for others in order to get political benefits for himself. Insiders gain at the expense of outsiders, so everyone has an incentive to become an insider—in other words, a crony. With those institutions, entrepreneurial individuals are predatory rather than productive, and their actions give rise to the decline of nations that Olson describes.

Some nations never get to that point of prosperity. Recent work in the new institutional economics, including that of Douglass North, John Wallis, and Barry Weingast (2009) and that of Daron Acemoglu and James Robinson (2012), describes the poor institutions in which rising to the top of the income distribution depends on political power and connections rather than on economic productivity. As North, Wallis, and Weingast argue, social orders in poorly performing societies are based on personal connections and favorable treatment of individuals who have accumulated power rather than on the rule of law independent of people's personal identities. Acemoglu and Robinson describe poor institutions as extractive rather than inclusive, which gives an advantage to being in a position to extract benefits from others rather than to engage in productive activity. Bruce Bueno de Mesquita and his associates (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 in which they can benefit from political favoritism rather than toward engaging in economically productive activity. Cronyism offers more benefit than economic productivity in such systems.

The economic analysis of interest-group politics has a history that goes back decades, and the interest groups that benefit from their lobbying for benefits do so because they obtain benefits for themselves that are not available to others. If the special-interest benefits were instead generally available to everyone, no one would need to lobby for them. The relationship between political interest groups and those in government who provide the special-interest benefits entails that those interest groups' profitability is determined by their political connections—still another form of cronyism.

The Academic Foundations of a Theory of Crony Capitalism

The purpose of this review of academic literature is to show that although academic economists rarely use the term *crony capitalism,* an extensive body of economic research and analysis has explained how and why cronyism exists and how it manifests itself. Contributors to the academic literature have examined several aspects of cronyism, but they have not drawn them together under that single heading. The literatures on rent seeking, the capture theory of regulation political entrepreneurship, and interest-group politics analyze how cronyism works, but because those literatures have developed relatively independently of one another, they have not been seen as components of a comprehensive theory of crony capitalism. Pulling all this literature together reveals a solid academic foundation for understanding the forces that underlie crony capitalism.

Crony Capitalism and Big Government

The feature that unites all of the component theories of crony capitalism is the argument 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 to dole out in transfers and subsidies, so engaging in rent-seeking activity to gain a share of government's budget is potentially more profitable when the government 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 into a form 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 lobby for those construction contracts and for a road location that provides them with private benefits.

Thus, even in providing "public goods," government can steer funds 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 benefit some firms more than others, then all firms have the incentive to enter the political process to gain these government favors. Stigler's capture theory of regulation applies only to the extent that government regulations and regulatory agencies exist. If the government has no regulatory powers, no regulatory agencies can be captured. The more pervasive government regulation is in an economy, the more important engagement in the political process to try to steer regulatory benefits favorably will be for the profitability of business. As with rent seeking, the benefits of regulatory capture and cronyism increase with the government's regulatory scope, regardless of the motivation for the regulation. Regulation may have good public-interest justifications, such that if government were an omniscient benevolent despot, the regulations would promote the public interest. But because the government consists of individuals who take into account their own individual interests, even the most public-spirited regulations are subject to regulatory capture and cronyism. The public sector's information and incentive structure means that regulations will over time increasingly come to benefit cronies and thus lay the foundation for crony capitalism's further growth.

Government intervention not only steers economic interests toward seeking political benefits but often gives them no alternative but to engage in the political process to protect themselves from harm. As McChesney (1987, 1997) shows, government often threatens to impose tax or regulatory burdens on businesses, pushing even those who prefer to avoid the political process to lobby in order to protect themselves from predatory government. These threats are sometimes the result of cronies who see the opportunity to gain a competitive advantage if government imposes costs on their rivals. Big government's ability to engage in such activities pushes everyone into the political process regardless of motivation 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.

Gary Becker (1983) describes a legislature as a political marketplace in which interest groups on both sides of an issue offer political support to legislators who will decide the issue. In his model, legislators weigh the political costs and benefits to them from interest groups on both sides and produce the policy outcome that maximizes the political support for themselves. He describes this model as demonstrating 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 burdens on rivals, and the other side is lobbying to be free of these burdens, it is difficult to see that any outcome besides government's not imposing burdens on anyone is an economically efficient outcome, even though the imposition of burdens may be politically beneficial to those who make the rules. Furthermore, because the process involves rent-seeking costs that squander resources, 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 the government grows and the more regulatory power it acquires, the more the political system draws economic actors into engagement in interest-group politics, and as a result those who have the political power and those who pay the price that the political system demands become cronies who benefit from political favoritism rather than from economic productivity. Donald Wittman (1989, 1995) takes the Becker model one step further to argue that there are always economic incentives to allocate resources efficiently, whether through market mechanisms or political means, and, essentially applying the Coase (1960) theorem to politics, he argues that political transaction costs are low enough that government will allocate resources as efficiently as the market. Wittman's first premise is correct. There are always incentives to allocate resources efficiently. However, his analogy between incentives in markets and those in government does not hold up because in government, unlike in market transactions, people can use the government's force—taxing and regulatory power—to transfer resources forcibly from some to others without the original resource owners' consent. 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. So even though there is always an incentive to do things efficiently, the incentive to obtain benefits by using government's force is sometimes greater than any incentive to do things efficiently.

Following Wittman's logic, a burglar might reason that it would be efficient to have a homeowner open a door so that the homeowner does not have to incur, in addition to a loss of property, the cost of fixing the window that the burglar broke to gain access to the house. However, the burglar is more concerned with his own gain than with any costs the homeowner will bear as a result of the theft. The burglar's chance of success is greatly diminished if the homeowner knows what the burglar is doing. Rent seekers similarly focus on the benefits they get, not on the losses imposed on everyone else, and they are more likely to succeed if those who bear the costs are unaware of such rent seekers. Absent transaction costs, rent seekers might bargain with the millions of citizens who pay for the benefits they get in order to arrange an efficient transfer, but only because most citizens are uninformed about most of what government does can rent seekers can secure their benefits, as Downs (1957) observes. The cronies know what benefits they supply to each other, and crony capitalism continues because most citizens are unaware of these exchanges. If

Wittman's assumptions held and transaction costs were low, the general public would not allow the 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 state the argument that they are lobbying for benefits for themselves at others' expense. Instead, they claim that 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 big government amplifies each of those components. The larger the government's budget and regulatory powers, the greater is the potential for crony capitalism. Conversely, a reduction in the size and scope of government reduces the benefits from cronyism, which helps to direct participants in the economy away from trying to obtain political benefits at the expense of others and toward engagement 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 capitalism's abuses, can correct the market's failures, and can regulate business so it will act in the public interest. In other words, the argument goes, big government is needed to stand up to crony capitalism. Once one understands crony capitalism's causes, however, it becomes apparent that this reasoning is exactly backward. Government powers *allow* some interest groups to impose burdens 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 but rather caused by it.

For example, in Walter Isaacson's biography of Steve Jobs, he states: "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" (2011, 323). 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 in order to gain a competitive advantage. Many countries have a much worse crony capitalism problem than the United States, so seeing what actually happens in the United States illustrates the size of the problem in nations where the rule of law is less well established and where political connections are even more important. The big government's regulatory power encourages crony capitalism.

The Fiscal Constitution as a Constraint on Cronyism

James Buchanan (1967) has emphasized 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 taxation and government expenditures. In one work, Geoffrey Brennan and Buchanan (1980) develop an analytical framework within which they evaluate the benefits of placing constitutional constraints on the fiscal powers of government, and in another (Brennan and Buchanan 1985) they go on to describe the value of constitutional constraints more generally in providing 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), he 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 government's powers is Buchanan's idea in the sense that it thoroughly permeates his published research throughout his career as a scholar.

Although developing this idea, he recognizes that its origins go back at least to the writing of the U.S. Constitution, which was designed to limit the government's power and to confine its scope to the exercise of specific enumerated powers. A strong fiscal constitution can help to control the capacity of those with power to engage in cronyism. If the fiscal constitution establishes a relatively inflexible tax structure and therefore makes the political system relatively immune to interest-group politics, then cronyism will be limited because people cannot use their political power to turn public policy in their favor (Buchanan 1993; Holcombe 1998). This idea applies to the expenditure side of the budget as much as to the revenue side. If relatively inflexible procedures are established for allocating the government's budget, then interest groups will have limited ability to engage in cronyism. Political discretion fosters cronyism, and an inflexible fiscal constitution limits political discretion.

A good illustration of these relationships can be seen in a comparison between many Scandinavian countries with high levels of government spending as a share of gross domestic product (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, the Scandinavian countries have relatively inflexible fiscal constitutions that limit the discretion of those with political power. Furthermore, the state's regulatory powers are more constrained and tend to follow rule of law in contrast to the substantial discretion that exists in other nations' regulatory apparatus. Peter Lindert (2004) argues that social spending programs in Scandinavia have not reduced economic growth because institutions have historically developed to constrain government from engaging in more pernicious activity. His overall conclusion may be premature, but it is consistent with the analysis done by James Gwartney and Robert Lawson (2009), who find that despite high taxes and government transfers, the Scandinavian "welfare states" have relatively market-friendly institutions in other dimensions.

For a government of a given size, measured by both expenditures and regulatory powers, a more inflexible fiscal constitution can limit cronyism. This fact points toward the establishment of public policies that constrain the discretion of government decision makers. However, the conclusion remains that the greater the government's presence in an economy, the greater the incentive 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 forty-two 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 income per capita, and improvements in a country's EFW measure are associated 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 government's discretion, so high rankings imply a relatively inflexible fiscal constitution and a limited ability to engage in cronyism. Two important components are rule of law and protection of property rights. If everyone is subject to an objective set of laws, the government's discretion is reduced, and if property rights are protected, using political connections to claim others' property is more difficult. The index also measures tax and regulatory burdens and the level of government expenditures, showing that lower levels of each are associated with more economic freedom. The EFW index gives a good indication of the economic institutions that create a relatively inflexible fiscal constitution and hence limit cronyism.

Although identifying the institutions that can limit cronyism is fairly easy, it is difficult to establish those institutions in nations where they do not exist. Cronyism, by its nature, benefits cronies both in government and in the business sector. Crony capitalists enhance their incomes through government favors, and they reward those who grant them the favors. 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 people with political and economic power who can determine the rules.

Crony capitalism can be limited by establishing a relatively inflexible fiscal constitution, but this option is not really a solution to crony capitalism because those who hold the power will resist it. Indeed, in the United States and elsewhere, it is often easy to see what types of institutional changes would result in economic gains, but frustratingly difficult to bring about those changes.

Furthermore, interest groups tend to solidify and concentrate their power over time, 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) tells us will lead to the nation's economic decline. He explains that even if a big-government economy at one point in time has limited cronyism, the incentives created associated with that government will push that economy increasingly toward cronyism.

Crony Capitalism and Democracy

After the collapse of the Berlin Wall in 1989, followed by the dissolution of the Soviet Union, Francis 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 ultimate outcomes of the evolution of economic and political institutions. Fukuyama's characterization of democratic government as the "end of history" depreciates the importance of constitutional constraints on government. Modern Western democracies do not operate on the principle that government does whatever the majority wants; rather, democratic governments have constitutional constraints on the activities they can undertake. The U.S. Constitution provides a good example of a formal constitution that explicitly enumerates the government's powers. The constitutional framework of other Western democracies is similar, although each differs in the details. Great Britain, for example, does not have a formal written constitution, but the constitutional rules under which British government operates resemble those in 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 a fiscal constitution limit the government's powers, regardless of what the majority might prefer that the government do.

These constitutional constraints on government have been eroding over time, however, so that the government has increasingly made its decisions with fewer constitutional constraints (Holcombe 2002). This change allows interest-group politics to have an increasing influence on government decision making, thus opening the door to crony capitalism, which leads to the Olsonian "decline of nations." As political pressures come to have greater influence on the government's decisions—that is, as the government becomes more democratic—the more the economy will turn toward cronyism.

Thus, the Western democracies' prosperity has not been a product of their democratic governments; instead, it has rested on the constitutional constraints that have limited these governments' powers. 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, a mechanism that citizens use to replace peacefully 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, one of crony capitalism's components, 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 therefore not a cure for cronyism; rather, 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 hold on power subject to public approval. If democracy is interpreted as government's carrying out the will of its citizens, however, the door opens to cronyism. Most citizens are rationally ignorant of politics, as Downs (1957) emphasizes, so the citizens who are in a position to influence government are those with concentrated special interests who can provide support—financial and otherwise—to those with political power in exchange for having their demands met. Without constitutional constraints on the discretionary power of those in government, the ideal of democracy can evolve into crony capitalism.

The Market Economy versus Crony Capitalism

Fukuyama's argument about capitalist democracies as 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. With a general acceptance of the benefits of those institutions, there was optimism in the 1990s that the former centrally planned economies previously under the USSR's domination would prosper under market institutions, like the economies that had been on the other side of the capitalism–socialism divide. The reality, however, is that cronyism often prevents the establishment of market institutions because the cronies do not want to lose their existing advantages. Thus, former centrally planned countries have met with varying degrees of success as in their transitions to capitalism.

As Joel Moykr (1990) and David Landes (1998) note, throughout history everywhere in the world, countries that have adopted a capitalist economy have prospered, and those that have not done so 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," and even the most market-oriented economy has a substantial government involvement through taxes, government expenditures, and regulations. Economic research consistently shows that market economies perform worse when they have a higher degree of government intervention.

Crony capitalism is a feature 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 in Japan and South Korea rest on the idea of cronyism, and cronyism is apparent in the U.S. economy—for example, when government money is directed to particular firms,[4] when interest groups receive targeted regulatory benefits, and when imports are limited to protect domestic products, as in the sugar program (Krueger 1990). Vocal critics of crony capitalism, such as members of the Occupy movement that began in 2011, raise valid issues. The open question is how these issues should be handled.

A common response to cronyism is to call for additional government regulation and oversight of markets, but this response 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 or a smaller budget will be less prone to cronyism. A larger government presence in an economy tends to foster cronyism, not prevent it. When government regulations are put into place to control crony capitalism, they give people in government additional power to provide protections and benefits to their cronies at the public's expense. Capitalism becomes crony capitalism when those in government gain sufficient power to provide their cronies with special-interest benefits.

Conclusion

Crony capitalism is a popular term that has rarely been used in the academic literature, but a review of this literature shows that crony capitalism's components—rent seeking, regulatory capture, political entrepreneurship, and interest-group politics—have been analyzed extensively, and their common element 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, taxing authority, and expenditures on transfers and subsidies, business profitability depends on the degree to which businesses can get subsidies, tax breaks, and regulations that work in their favor. This situation induces businesses to turn their attention toward the quest for favorable government treatment and away from entrepreneurial activity that adds to the economy's productivity. Insiders with political connections get those benefits; outsiders do not. This setup is crony capitalism. Cronies support their partners in government in exchange for the benefits they receive from government.

Pro-government, anticapitalist arguments point to capitalism's abuses and argue that big government is necessary to protect against market failures, 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 actually a product of big government. The increased government involvement in the economy that the big-government advocates promote ends up increasing crony capitalism, not controlling it, and hence leads to calls for even more government intervention, as Sanford Ikeda (1997) argues.

4. For example, President Obama directed more than $500 million in government money to the 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 the company emerged from bankruptcy, giving the workers priority over the company's bondholders, who should have had a prior claim according to bankruptcy law. Cronyism clearly overrode rule of law.

Crony capitalism is a by-product of big government because the more government is involved in an economy, the more the profitability of business depends on government policy. Even entrepreneurs who 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, firms and other organized economic groups push for government policies that will help them and try to prevent the harm that is caused by government policies that work against them. If one's competitors are engaging in cronyism, trying to remain free of cronyism means that those competitors will gain government-bestowed advantages. A well-established academic literature stands behind these conclusions. Crony capitalism is a by-product of big government, so the maintenance of small government is the most effective means of controlling it. More government control of the economy is not the remedy for crony capitalism, but rather its cause.

References

Acemoglu, Daron. 1995. Reward Structures and the Allocation of Talent. *European Economic Review* 39, no. 1 (January): 17–33.

Acemoglu, Daron, and James Robinson. 2012. *Why Nations Fail: The Origins of Power, Prosperity, and Poverty.* New York: Crown.

Baumol, William J. 1990. Entrepreneurship: Productive, Unproductive, and Destructive. *Journal of Political Economy* 98, no. 5, Part 1 (October): 893–921.

————. 1993. *Entrepreneurship, Management, and the Structure of Payoffs.* Cambridge, Mass.: MIT Press.

Becker, Gary S. 1983. A Theory of Competition among Pressure Groups for Political Influence. *Quarterly Journal of Economics* 98 (August): 371–400.

Bhagwati, Jagdish N. 1982. Directly Unproductive, Profit-Seeking (DUP) Activities. *Journal of Political Economy* 90, no. 5 (October): 988–1002.

Brennan, Geoffrey, and James M. Buchanan. 1980. *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge, U.K.: Cambridge University Press.

————. 1985. *The Reason of Rules: Constitutional Political Economy.* Cambridge, U.K.: Cambridge University Press, 1985.

Buchanan, James M. 1967. *Public Finance in Democratic Process.* Chapel Hill: University of North Carolina Press.

————. 1987. The Constitution of Economic Policy. *American Economic Review* 77, no. 3 (June): 243–49.

————. 1993. The Political Efficiency of General Taxation. *National Tax Journal* 44, no. 4 (December): 401–10.

Bueno de Mesquita, Bruce, Alastair Smith, Randolph M. Siverson, and James D. Morrow. 2003. *The Logic of Political Survival.* Cambridge, Mass.: MIT Press.

Coase, Ronald H. 1960. The Problem of Social Cost. *Journal of Law & Economics* 3: 1–44.

Downs, Anthony. 1957. *An Economic Theory of Democracy.* New York: Harper & Row.

Fukuyama, Francis. 1992. *The End of History and the Last Man*. New York: Free Press.

Gwartney, James, and Robert Lawson. 2009. *Economic Freedom of the World 2009 Annual Report*. Vancouver: Fraser Institute.

Hayek, Friedrich A. 1945. The Use of Knowledge in Society. *American Economic Review* 35, no. 4 (September): 519–30.

Holcombe, Randall G. 1998. Tax Policy from a Public Choice Perspective. *National Tax Journal* 51, no. 2 (June): 359–71.

———. 2002. *From Liberty to Democracy: The Transformation of American Government.* Ann Arbor: University of Michigan Press.

———. 2012. Make Economics Policy Relevant: Depose the Omniscient Benevolent Dictator. *The Independent Review* 17, no. 2 (Fall): 1–12.

———. Forthcoming. South Korea's Economic Future: Industrial Policy or Economic Democracy? *Journal of Economic Behavior and Organization*.

Ikeda, Sanford. 1997. *Dynamics of the Mixed Economy: Toward a Theory of Interventionism.* London: Routledge.

Isaacson, Walter. 2011. *Steve Jobs.* New York: Simon & Schuster.

Kornai, Janos. 1986. The Soft Budget Constraint. *Kyklos* 39, no. 1 (February): 3–30.

Krueger, Anne O. 1974. The Political Economy of the Rent-Seeking Society. *American Economic Review* 64 (June): 291–303.

———. 1990. The Political Economy of Controls: American Sugar. In *Public Policy and Economic Development,* edited by Maurice Scott and Deepak Lal, 170–216. Oxford: Clarendon Press.

Landes, David S. 1998. *The Wealth and Poverty of Nations: Why Some Are so Rich and Some so Poor.* New York: W. W. Norton.

Lindert, Peter. 2004. *Growing Public: Social Spending and Economic Growth since the Eighteenth Century.* Cambridge, U.K.: Cambridge University Press.

McChesney, Fred S. 1987. Rent Extraction and Rent Creation in the Economic Theory of Regulation. *Journal of Legal Studies* 16: 101–18.

———. 1997. *Money for Nothing: Politicians, Rent Extraction, and Political Extortion.* Cambridge, Mass.: Harvard University Press.

Moykr, Joel. 1990. *The Lever of Riches.* Oxford: Oxford University Press.

Murphy, Kevin M., Andrei Shleifer, and Robert W. Vishny. 1991. The Allocation of Talent: Implications for Growth. *Quarterly Journal of Economics* 106, no. 2: 503–30.

Niskanen, William A. 1971. *Bureaucracy and Representative Government.* Chicago: Aldine-Atherton.

———. 2003. *Autocratic, Democratic, and Optimal Government: Fiscal Choices and Economic Outcomes.* Cheltenham, U.K.: Edward Elgar.

North, Douglass C., John Joseph Wallis, and Barry R. Weingast. 2009. *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History.* Cambridge, U.K.: Cambridge University Press.

Olson, Mancur. 1965. *The Logic of Collective Action*. New York: Shocken Books.

————. 1982. *The Rise and Decline of Nations*. New Haven, Conn.: Yale University Press.

Stigler, George J. 1971. The Theory of Economic Regulation. *Bell Journal of Economics and Management Science* 2 (Spring 1971): 3–21.

Sugar Cane and Sugar Beets. 2012. OpenSecrets.org. Available at: http://www.opensecrets.org/industries/indus.php?ind=A1200.

Tullock, Gordon. 1967. The Welfare Cost of Tariffs, Monopolies, and Theft. *Western Economic Journal* 5 (June 1967): 224–32.

————. 1975. The Transitional Gains Trap. *Bell Journal of Economics* 6, no. 2 (Autumn): 671–78.

Weingast, Barry R., Kenneth A. Shepsle, and Christopher Johnsen. 1981. The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. *Journal of Political Economy* 89, no. 4 (August): 642–64.

Wittman, Donald A. 1989. Why Democracies Produce Efficient Results. *Journal of Political Economy* 97: 1395–424.

————. 1995. *The Myth of Democratic Failure*. Chicago: University of Chicago Press.

Acknowledgments: I am grateful for helpful comments by Ted Bolema, Russell Sobel, and two anonymous reviewers. The Mercatus Center at George Mason University provided financial support for this project.