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# The Road to Crony Capitalism

## *An Introduction*

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ROBERT M. WHAPLES

This issue of *The Independent Review* is intended to open up a debate about the nature of capitalism. My coeditor, Michael Munger, and his coauthor, Mario Villarreal-Diaz, begin the discussion with a deeply disconcerting question: “Suppose it’s true that capitalism has a tendency—it’s not inevitable or irreversible, but a tendency nonetheless—to devolve into crony capitalism. Is laissez-faire simply the first step on a kind of road to serfdom, where giant corporate syndicates achieve a parallel kind of economic planning every bit as pernicious as that feared by Hayek?” They conclude by determining there’s a great deal to worry about: “[I]t is at least possible that cronyism is *intrinsic to* and not *separable from* capitalism” (emphasis in the original). And they provide much evidence that it’s not simply a possibility but a reality—firms (especially entrenched ones that are losing their innovative edge) and politicians have strong incentives to travel down this road.

To initiate the debate, Munger delivered the paper in a plenary session at the April 2018 meeting of the Association of Private Enterprise Education. We continue the debate with six papers that respond to Munger and Villarreal-Diaz’s cronyism argument. In addition, we invite readers to respond to “The Road to Crony Capitalism”—to consider how significant and inevitable the problem of crony capitalism is and to examine whether there are any real solutions to it—with the promise of publishing the

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best responses online alongside this issue of *The Independent Review* (send your formal comments to [rwhaples@independent.org](mailto:rwhaples@independent.org)).

In the first of the six responses, Geoffrey M. Hodgson, playing with another classic economics title, considers in “Capitalism, Cronyism, and Democracy” whether statistical evidence and history can help elucidate the question. Examining Munger and Villarreal-Diaz’s link between democracy and cronyism, that “allowing real democracy may doom real capitalism,” he finds a weak *negative* correlation between an international index of democracy and international indices of cronyism and corruption. However, his central argument is that “in the beginning there was cronyism.” Cronyism “has had much greater longevity than markets: it extends back to our simian ancestors. Trade . . . has been in existence for tens of thousands of years, but cronyism goes back millions of years. As a consequence, cronyism and corruption are not recent impositions on a market economy.” How can corruption and cronyism be reduced? Hodgson reports historical evidence that the establishment of a career civil service, a relatively free press, and especially military competition have favored a reduction in the governmental selling of favors.

Burton W. Folsom Jr. sees considerable merit in Munger and Villarreal-Diaz’s thesis but argues from U.S. history that the slide toward crony capitalism isn’t so inevitable. He argues in “The Fall and Rise of Laissez-Faire in the United States, 1789–1900” that cronyism is as old as the republic but that there was a distinct backlash against it in the period between the Civil War and 1900. This backlash was spurred by the excesses of cronyism exemplified by the corruption behind handouts (in both directions) connected with the construction of the Union Pacific and Central Pacific transcontinental railroad. However, this relatively crony-free era didn’t survive the rise of the Progressives at the beginning of the twentieth century. Perhaps there are rest stops on the road to crony capitalism?

Michelle Albert Vachris sees parallels between Munger and Villarreal-Diaz’s arguments and those of Edmund Phelps, who has identified a decline of “dynamism” in American society and business. She reports indications of this decline in statistics on falling business startup and entrepreneurship rates and rising levels of industrial concentration in the United States. However, there has been considerable churn in the firms at the top of the Fortune 500 list in recent decades. In her essay “Dynamism as a Bump on the Road to Crony Capitalism?” she amends Munger and Villarreal-Diaz’s thesis of capitalism’s inherent tendency toward cronyism by proposing that “well-directed innovation” can stall the process. Such innovation would probably require a shift in cultural values and especially a greater appreciation of classical liberal ideals in our educational system and society as a whole. Perhaps “dynamism” is not merely a speed bump on the road but a U-turn?

In “Crony Capitalism versus Pure Capitalism,” Walter E. Block fundamentally both agrees and disagrees with Munger and Villarreal-Diaz. He endorses their argument for creeping cronyism in the case of capitalism as we know it in the United States and warns that their “contribution consists of very accurately analyzing the forces that

tend to move us in that baleful direction.” However, he notes that “their starting point is not at all the pure free-enterprise system,” which needn’t have this tendency. Rather, he says, they discuss whether a system *already* suffering from cronyism will stay the same, worsen, or improve. Block sees a ray of light in think tanks (such as the Independent Institute) that defend and advance free markets and submits that the problem would be cured if the capitalists asking for government favors (such as tariffs) were to be jailed—likewise the politicians who propose such laws that restrict entry into markets, industries, and professions. Hmm, could the police pull over these scofflaws for speeding down the road to crony capitalism?

In “We Cannot Let Cronyism Overrun Our Economic Garden,” Nick Sorrentino argues that the “road” metaphor should be supplanted. “Cronyism is not a destination. It is, in fact, the landscape”—a garden full of weeds that we need to prune. Tending this garden is a thankless, never-ending task, but it *must* be accomplished if our economic garden is to flourish. However, he holds out considerable hope because “anticrony sentiment is embedded deep in the DNA of the everyday person,” so it may be possible to limit this weed by shining a spotlight upon it, making it generally unacceptable, politically incorrect, or at least unfashionable—something Sorrentino’s organization AC2News attempts to accomplish.

In “Cronyism: Necessary for the Minimal, Protective State,” Christopher J. Coyne and Abigail R. Hall point out that “to the extent that capitalism requires the existence of a state, even a minimal state, it also *requires* some degree of cronyism” (emphasis added). Although some envision the ideal government as a simple referee, “real government can *never* be limited to a role of referee that stands entirely outside of the game it is tasked with overseeing. First, even the minimal protective state requires resources in order to operate. This requirement means that the government must intervene into private economic life to extract resources. . . . Second, the minimal protective state must also have discretion to deal with circumstances that are unforeseen at the time it is granted its initial powers” (emphasis in the original). Accordingly, “even *if* government were limited to solely providing core protective functions, cronyism would still be rampant” (emphasis in the original). In fact, one “would have a difficult time identifying a sector in the United States that better illuminates the operations of cronyism and its serious defects” than the military sector. Coyne and Hall’s essay thus explores the many ways in which the U.S. military is the quintessence of crony capitalism—the fast lane on the road to crony capitalism.<sup>1</sup>

Like the other authors, Coyne and Hall briefly consider how to slow the journey down the road to crony capitalism. They identify three modes of response to the inevitability of crony capitalism: (1) pretending the problem doesn’t exist; (2) biting the

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1. A ray of good news here is that the fraction of U.S. gross domestic product (GDP) spent on the military has declined substantially in recent decades. From 1954 to 1963 (between the Korean War and the Vietnam War), military spending was 9.5 percent of GDP (Edelstein 2000, 390). Since 2012, it has been only 3.5 percent (World Bank n.d.).

bullet—admitting the problem, concluding there’s not much to do about it, and trying to lightly tap on the brakes; or (3) realizing that the state is the root cause of crony capitalism and attempting to remove this root cause.

### **Concluding Thoughts: Off-Ramps, Speed Bumps, and U-Turns?**

Are there ways to stop traveling down the road to crony capitalism? Are there off-ramps, speed bumps, or even U-turns? Please read Munger and Villarreal-Diaz’s excellent paper before you read my conclusion to this introduction, in which I grapple with these issues.

One solution to the headlong drive toward crony capitalism is on the supply side—making the political system work better. This would involve better politicians, better bureaucrats, better voters, or a better institutional framework. Most observers don’t see much hope here because of the standard problems raised by public-choice theory—especially the rationally ignorant voters who realize they don’t have any significant impact on political outcomes and thereby allow political insiders to make crony deals. However, although the legislative and executive branches are often in league with crony capitalists, the courts may be an exception. They have sometimes struck down crony arrangements, especially in the 1800s, with rulings such as *Gibbons v. Ogden* (22 U.S. 1 [1824]), which invalidated New York’s attempt to establish an interstate steamboat monopoly; *Webber v. Virginia* (103 U.S. 344 [1880]), which invalidated licensing fees on out-of-state sellers such as Singer Sewing Machine; and *Minnesota v. Baber* (136 U.S. 313 [1890]), which overturned local meat-inspection laws aimed against more efficient out-of-state companies such as Swift and Armour. A more recent example is *North Carolina State Board of Dental Examiners v. FTC* (574 U.S. \_\_\_ [2015]), which disallowed dentists’ attempt to shut down nondentist tooth-whitening services for practicing dentistry without a license.

Another solution might be on the demand side—better business leaders and investors—who swear off manipulating the political system for profit. Again, few observers see much hope here because there is rational ignorance on the part of most investors, who don’t know what CEOs are up to—and even if they did know, they would probably punish more ethical executives for failure to maximize profits, even if the profits did arise from rent seeking. As a footnote, one might also mention better customers, who could penalize firms that engage in rent seeking, but this solution has limited scope as well. Few would boycott a business that was bailed out or subsidized by the government, and customers cannot patronize businesses that have never been born due to government-created barriers to entry. Imagine boycotting Ma Bell before regulations finally allowed competition in the telephone business.

However, this solution leaves out what may be the surest protection against the entrenchment of crony capitalism—competition. Munger and Villarreal-Diaz (as well as

most of our commentators) seem implicitly to see the U.S. economy as closed. However, even when the authorities attempt to hermetically seal off their nation from economic competition, they cannot seal it off from political and military competition (Hodgson touches upon this point). When Japan's leaders realized that Western imperialists were an existential threat after the defeat of China by Britain in the First Opium War and the arrival of U.S. naval vessels under Commodore Matthew Perry, they realized they needed to transform their feudal economy into a modern market economy. To gain military power, they needed economic power, which could be achieved only by importing technology and institutions from abroad and by engaging in international economic competition. If a modern economy, such as the U.S. economy, were to stall due to stultifying cronyism, it too would begin to slip behind its international rivals and could face a crisis due to its sclerosis. Imagine the United States stalling as China accelerated past it. This would create immense pressure for a change of direction in economic policy. In some sense, cronyism is a luxury that one can afford when there's little international competition but becomes a life-threatening liability in a competitive world.

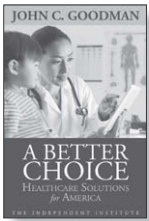
The same kind of process can also occur at the state level. In the early 1800s, most states (and the U.S. government) chartered banks individually, based on political connections—restricting entry “to create rents shared among bankers and the government” (Mittal, Rakove, and Weingast 2011, 45). However, Massachusetts discovered that it could earn more in taxes if it chartered many small banks (which competed with a large bank, of which the state owned a large share). This discovery led it to remove many of its barriers to entering the industry, which “gave Massachusetts banks a competitive edge over all other U.S. banks. Merchants, enterprises and transactions funded in Boston . . . had an economic edge over their competitors from other states,” and that edge pushed other states to do the same rather than fall behind—an example of what Sonia Mittal, Jack Rakove, and Barry Weingast call “market-preserving federalism” (2011, 45). New York's success after its general incorporation law for manufacturing corporations in 1810 had a similar effect, and cronyism was on the wane throughout the U.S. economy.

I end this introduction on a note of optimism. Crony capitalism seems to be endemic in the U.S. economy—from the military-industrial complex to vast subsidies of higher education to a rise in professional licensing requirements and favors handed out in the climate-industrial complex (see Darwall 2017). However, as of the middle of 2018 (*Wikipedia* n.d.), the U.S. companies with the largest market capitalizations are not generally ones that have relied extensively on crony-capitalist deals and tactics: Apple, Alphabet (Google), Microsoft, Amazon, Facebook, Berkshire-Hathaway, JP Morgan Chase, and Exxon-Mobil. Aside from the one bank on the list, I don't see a lot of cronyism here. Most of these companies have climbed to the top by offering innovative products and services that many consumers love, or they are involved in very competitive markets (such as the international oil market and the retail sales market).

However, farther down the list are many firms that have prospered from ties to and protection from the government. I second Michelle Vachris's call for a cultural and educational turn against crony capitalism, Walter Block's admonition to call a spade a spade by labeling such firms thieves rather than mere rent seekers as well as his urging of concerned individuals to support market-friendly think tanks that try to thwart cronyism, and Nick Sorrentino's attempts to expose crony capitalists to the light of day. Sunshine can be a disinfectant—crony capitalism flourishes best in the shadows.

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