Dynamism as a Bump on the Road to Crony Capitalism?

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In their essay "The Road to Crony Capitalism" in this issue of *The Independent Review,* Michael Munger and Mario Villarreal-Diaz ask whether "corporatist cronyism" is a natural tendency of capitalist economic systems set within democratic political systems. They argue that it is possible that the lure of rent seeking in political markets is too great, especially for mature firms nearing the end of their innovation cycle. At some point, it becomes more profitable to seek rents than to innovate. "Those who can, compete, those who cannot, rent-seek" (Vachris 2014). The authors conclude that "[i]t may be the case that cronyism and the tendency to demand redistributive state interventions are features of free-market capitalism." They also conclude, however, that free-market capitalism has the feature of "a constant influx of creative individuals who demand adequate conditions to advance their productive efforts." It is this second conclusion that is the primary focus of my essay.

First, I relate the authors' conclusions to Edmund Phelps's work on dynamism. Then I explore the link between Munger and Villarreal-Diaz's argument and concepts of rent extraction and transitional gains. I present some data on the dynamism of the current U.S. economy to address whether dynamism can serve as a bump on the road to crony capitalism or not. The essay concludes with a discussion of the road back to dynamism.

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Dynamism Defined

Edmund Phelps's research on dynamism can be traced back to a keynote lecture given in 2002 (published as Phelps 2006) examining why Continental Europe experiences higher unemployment rates than Canada, the United Kingdom, and the United States. He finds that countries in Continental Europe are less entrepreneurial, less dynamic, and more corporatist than the Anglo-Saxon countries. Dynamism, to Phelps, means "vitality plus direction" or "well-directed innovation" (2006, 58). He attempts to measure this dynamism using four indicators. He finds that the more dynamic countries have well-developed stock markets, low levels of red tape, low levels of coordination between unions and employers, and high levels of human-capital formation. All of these things lead to a more flexible labor market and hence to lower unemployment rates in Canada, the United Kingdom, and the United States relative to those in Continental Europe. Phelps (2007) continues this line of comparative inquiry as he applies the concept of dynamism more generally to overall economic performance and prosperity. He finds, again, more dynamism in Canada, the United Kingdom, and the United States relative to Continental Europe.

Phelps's work on dynamism culminates with the publication of his book *Mass Flourishing* (2013). By the time he wrote and published this book, however, he no longer viewed the Anglo-Saxon countries as particularly dynamic because most of the Western world was still reeling from the after effects of the global financial crisis. His book describes an overall decline in dynamism in many if not all Western countries. Indeed, he asks: "What happened in the 19th century that caused people in some countries to have—for the first time in human history—unbounded growth of their wages, expansion of employment in the market economy, and widespread satisfaction with their work? And what happened to cause many of these nations—by now, all of them, or so it would appear—to lose all that in the 20th century?" (2013, vii).

Dynamism, then, affects more than employment and economic growth. It also leads to general human flourishing, which is gained through individuals' engagement in challenging and rewarding work. Yes, material wealth matters, but so does the non-material part of life.

The Rise of Corporatism and the Decline of Dynamism

Phelps warns about the dangers of corporatism. Corporatism leads to corruption and rent seeking, which are inefficient. "[C]ontracts are won and resources allocated on the basis of connections and bribes rather than price competition" (2006, 62). Munger and Villarreal-Diaz also examine these two dangers of corruption and rent seeking. Unlike them, however, Phelps does not make the explicit case that the combination of democracy and capitalism has a tendency to lead to the development of cronyism.

Both Munger and Villarreal-Diaz and Phelps link cronyism to innovation and hence to prosperity. As Phelps puts it,

> What may be the worst cost by far, however, is that corporatism may cost the economy a great deal of its potential dynamism. In operating almost intentionally to slow or resist change except when there is a consensus for it, corporatism is very poor at providing the adventure, the mental stimulus, and the succession of challenges at work on which business people will depend for their intellectual development and personal growth. And if jobs are less compelling and engaging as a result, there may result collateral damage in reduced labor force participation and diminished employee morale, leading to increased unemployment. In a very literal sense corporatism prevents the economy from being as developed as it would be under an operating system hospitable to innovation. The corporatist economy is stultifying. (2006, 62)

As this statement illustrates, Phelps links the decline of dynamism to the individual. Although Munger and Villarreal-Diaz point to the self-interested nature of heads of corporations who, rationally so, turn to rent seeking, Phelps adds in the analysis of the effect of corporatism on the entrepreneurial nature of individuals working in the corporatist firms. In fact, the subtitle of *Mass Flourishing* refers to "grass roots innovation" (Phelps 2013). Corporatism, because of its resistance to change, leads to less innovation and, hence, to fewer challenges in the workplace as well as to decreased intellectual stimulation and human flourishing. Because the decline in dynamism appears at the individual level, turning things around needs to happen at the grassroots level, according to Phelps (2013).

Rent Extraction and Transitional Gains

Munger and Villarreal-Diaz explain the tendency for rent seeking to emerge in capitalist, democratic countries. Phelps (2006, 2013) refers to the insulation from competition garnered by rent seekers as "social protection," which can include things such as subsidies to support domestic artists to reduce competition from foreign culture and regulations making it difficult to fire employees. "Social protection," therefore, differs from "social insurance," by which Phelps means the welfare state, but expansion of the welfare state also leads to reduced dynamism because it devalues work (Phelps 2013, 230). Both Munger and Villarreal-Diaz and Phelps conclude that protection from competition reduces innovation in an economy.

The analysis of social protection can be extended by adding in the concepts of rent extraction and the transitional-gains trap. Fred McChesney (1987) introduced rent extraction into the economic theory of regulation, explaining that politicians are not merely passive brokers in political markets, as Robert Tollison (1982) described them. Rather, to gain part of the monopoly rent, politicians can threaten either to impose costly regulation or to remove regulations that help firms. Munger and Villarreal-Diaz hint at this phenomenon when they explain why politicians predictably facilitate collusion among firms. "Monopolies are much easier to deal with than disparate, complicated, competitive market structures. If a little less competition is the price regulators pay for much better control, well, that's a price politicians are willing to pay." Phelps presents a similar sentiment when he states, "We know that corporatist governments find it more convenient to deal with an industry populated by a few giant corporations than one with a great many small enterprises" (2013, 255). He describes the United States as having a "[c]orporatist complex between government and the private sector" (253). Munger and Villarreal-Diaz point out that "[e]ncouraging corporate dependence on the state and collecting revenues from running artificial rent-seeking contests are primary money-making enterprises of successful politicians." This is exactly the type of rent extraction that McChesney (1987) models.

Of course, all good rents must come to an end, as Gordon Tullock explains with his concept of the transitional-gains trap:

> Many government programs which appear to be designed to help some particular industry or group do not seem to be succeeding. The explanation offered here is that the program, when inaugurated, generated transitional gains for the individuals or companies in the industry, but that these have been fully capitalized, with the result that the people in the industry now are doing no better than normal. On the other hand, the termination of the particular scheme would, in general, lead to large losses for the entrenched interests. (1975, 671)

One example Tullock offers is the use of taxi medallions in New York to limit the number of taxicabs. Yes, the first recipients of the medallions earned monopoly rents, but Tullock explains that over time the value of these medallions is "fully taken into account" (1975, 672). In order to enter the industry, one must buy a medallion, so only normal profit is earned by new entrants. Even the incumbent firms earn only normal profits at that point because they face the opportunity cost of selling the medallion. Tullock sees no politically feasible way out of the trap without some compensation for the incumbents who sunk costs into the medallions. His insights are all too relevant today as ride-sharing services such as Uber and Lyft battle with the taxi industry in city after city.

Nikolai Wenzel (2012) finds a possible way out of the transitional-gains trap in his analysis of the French wine industry and the Appellation d'origine contrôlée (AOC). This regulation system is part of the overall geographic indication system governing wines and spirits in Europe. Wines receiving the AOC designation must meet very strict criteria regarding where the grapes are grown and how the wine is produced. Wenzel finds that the AOC stifles innovation relative to New World wines that are free from the restrictions. He notes that the French wine industry is declining in world-market share in part due to the transitional-gains trap resulting from the AOC. According to Wenzel, the industry is tiered as follows: "The top producers capture rents while excluding domestic competitors and using the AOC as an international marketing brand. Mid-market producers hide behind an AOC system that is overly generous to insiders at the expense of outsiders. And lower-end producers fall back on state subsidies, thus not having to compete with more cheaply and efficiently produced foreign wines" (2012, 73–74).

None of the producers in these tiers has an incentive to get rid of the AOC and subsidy system even though the industry as a whole and consumers would benefit from the AOC's demise, as Tullock (1975) would predict. Nonetheless, Wenzel (2012) identifies a fourth—entrepreneurial—tier in Languedoc, long known for producing lower-quality wines, that may offer some hope. In Languedoc, Wenzel says, there is "1. a need for an entrepreneurial approach to face the economic reality of New World wines; 2. [an] embracing of the need for change through dynamism and innovation; and 3. experimentation grounded in the lessons of the past, i.e., pushing the envelope from within the AOC and tradition . . . or accepting temporary loss of AOC, in favor of a lesser designation" (2012, 75–76). It remains to be seen whether the Languedoc producers can continue to find it in their own self-interest to profit from innovation or whether they, too, will find the lure of the AOC system too hard to resist. The French wine industry, then, may be an example of the "constant influx of creative individuals who demand adequate conditions to advance their productive efforts" that Munger and Villarreal-Diaz describe as a tendency of capitalism.

Is There Dynamism in the United States?

Munger and Villarreal-Diaz point to the dominance of the "too big to fail" syndicates in the United States as evidence of the corporatist nature of the U.S. economy. They liken these syndicates to the *chaebol* of Korea, the *keiretsu* of Japan, and the social planning in Europe. How entrenched are these top U.S firms? Table 1 shows the top-twenty Fortune 500 companies for selected years.

As shown in table 1, 20 percent of the top-twenty firms in 1955 (the first year the list was available) are still entrenched at the top today. The other 80 percent show the churn in the economy as we shifted from a manufacturing base to services. Comparing today to a couple of decades ago (1995), we see that 40 percent of the firms remain in the top twenty. One firm that has remained on the list since the beginning is General Electric; however, it has dropped in rank over the years. Its fall in stature is further illustrated by its recent deletion from the Dow Jones Industrial Average after a century and its replacement by Walgreens (Wursthorn and Gryta 2018). If firms move in and out of favor, perhaps that is a sign of dynamism, at least over the long term. Nonetheless, the firms that remain ensconced in the top twenty represent the corporatist nature of the U.S economy that Munger and Villarreal-Diaz describe.

Another way to measure dynamism (or lack thereof) is to examine rates at which new businesses have been started and rates of entrepreneurship. Phelps, citing data from the *Financial Times* on the number of start-up firms, reports that 550,000 businesses were born in 2006, but that number dropped to 400,000 in 2009 (2013, 257). Another source reporting a decline in entrepreneurship and dynamism is a recent report by the

Table 1
Top-Twenty Fortune 500 Companies

1955	1995	2018
1. General Motors	1. General Motors	1. Walmart
2. Exxon Mobil	2. Ford Motor	2. Exxon Mobil
3. U.S. Steel	3. Exxon Mobil	3. Berkshire Hathaway
4. General Electric	4. Wal-Mart Stores	4. Apple
5. Esmark	5. AT&T	5. UnitedHealth Group
6. Chrysler	6. General Electric	6. McKesson
7. Armour	7. International Business Machines	7. CVS Health
8. Gulf Oil	8. Mobil	8. Amazon.com
9. Mobil	9. Sears Roebuck	9. AT&T
10. DuPont	10. Altria Group	10. General Motors
11. Amoco	11. Chrysler	11. Ford Motor
12. Bethlehem Steel	12. State Farm Insurance	12. AmerisourceBergen
13. CBS	13. Prudential Insurance	13. Chevron
14. Texaco	14. DuPont	14. Cardinal Health
15. AT&T Technologies	15. Kmart Holding	15. Costco
16. Shell Oil	16. Texaco	16. Verizon
17. Kraft	17. Citicorp	17. Kroger
18. Chevron Texaco	18. Chevron Texaco	18. General Electric
19. Goodyear Tire & Rubber	19. Proctor & Gamble	19. Walgreens
20. Boeing	20. PepsiCo	20. JPMorgan Chase

Source: Compiled from issues of *Fortune* magazine.

Brookings Institute. Jay Shambaugh and his colleagues (2018) find that the U.S. economy has become more concentrated and less dynamic over the past few decades. Specifically, start-up rates in all industries declined from 1979 to 2014, and entrepreneurship rates fell in the period from 1992 to 2017. Note that this decline in dynamism is not limited to the post–financial crisis years. Rather, U.S. dynamism has been in decline for decades. These authors make a case similar to the one Munger and Villarreal-Diaz make for the dangers of this decline: "Entrenched incumbent firms with market power hire fewer workers, produce less output, and earn higher profits than would otherwise be the case in a competitive market. In attempting to secure and maintain their market power, firms can spend substantial resources that produce no value for the overall economy but simply allow the firm to maintain high profits" (Shambaugh et al. 2018, 1).

The most recent Startup Activity Index produced by the Kauffman Foundation for 2016 shows a glimmer of hope. "In 2013, the Startup Activity Index was at its lowest point in the last twenty years. Today it has gone up three years in a row, reaching close to the peak before the Great Recession drop" (Kauffman Foundation 2017, 10). Furthermore, the index is "now above the U.S. average from the last twenty years." (10). Things are not so rosy for the rate of entrepreneurship, though: this measure is "still in a long-term decline compared to levels in the 1980s" (4).

The data presented in this section attempt to measure dynamism, but an index created by the *Economist* magazine attempts to measure cronyism. According to its "crony capitalism index," the United States fares pretty well compared to the other countries measured and is seen as less "cronyist" in 2016 than it was in 2014 (*Economist* 2016). The reduced crony percentage of our economy and the recent increase in the Kauffman Startup Index offer two bright spots in an otherwise dismal record.

Can We Recapture Our Dynamism?

Most of the data on U.S. economic dynamism provided in this essay support Munger and Villarreal-Diaz's prediction that capitalist economies in democracies can find themselves on the road to crony capitalism. The term *crony capitalism* has seen increased use in the United States since the bailouts after the recent financial crisis. Similarly, the economies stricken by the earlier Asian financial crisis were labeled with the term. However, crony capitalism has been alive and well throughout U.S. history. Cozy relationships between the federal government and well-connected businesses in the years after the Civil War are described in *The Gilded Age* by Mark Twain and Charles Dudley Warner, a novel inspired by real-world events of the day (Vachris 2014). Luigi Zingales describes how crony capitalism led President Andrew Jackson to end the Second Bank of the United States in 1832 (2012, 50). Cronyism, then, has always been present in our capitalist, democratic system, so Munger and Villarreal-Diaz appear to be correct that "[t]he road to cronyism leads directly through capitalism."

Is there anything that can be done in the United States to ensure "a constant influx of creative individuals who demand adequate conditions to advance their productive efforts," which Munger and Villarreal-Diaz maintain is a "feature[] of free-market capitalism"? Can the United States regain its dynamism?

Munger and Villarreal-Diaz conclude that "[t]he solution, if there is one, is to empower entrepreneurs not to want to become rent seekers and to constrain state actors not to sell off rents in the first place." The second part of the solution refers to the idea that if government has fewer favors to award, there will be less point in rent seeking. Munger and Villarreal-Diaz admit, however, that "this second part is the more arduous, perhaps." Here they affirm the long-standing conclusion of public-choice literature that it is extremely difficult to restrain government due to the vested interests of the bureaucracy and politicians. This difficulty in cutting back on the powers of government has also been noted in popular culture. For example, humorist Dave Barry wrote in 1996 about the possibility of Congress merely simplifying the tax code. To answer how a flat tax would work, he responds: "If Congress were to pass a 'flat' tax, you'd simply pay a fixed percentage of your income, and you wouldn't have to fill out any complicated forms, and there would be no loopholes for politically connected groups, and normal people would actually understand the tax laws, and giant talking broccoli stalks would come around and mow your lawn for free, because Congress is NOT going to pass a flat tax, you pathetic fool" (emphasis in the original).

As Barry indicates, there are no incentives for politicians to enact reforms that would curtail their power to bestow favors. Given the difficulty of political reform, the first part of Munger and Villarreal-Diaz's solution, "empower entrepreneurs not to want to become rent seekers," may be our only hope. The catch is that we have to make it in entrepreneurs' self-interest not to seek rents. Phelps (2013) argues that, yes, we need institutional and policy reform to regain our dynamism, but this reform will be possible only if we can reignite the values of the modern era. According to Phelps, these values include "a desire for self-expression through the exercise of imagination and creativity" and "the right of individuals to pursue this search unchained from traditionalism: obligations to family, community, country, and religion" (211). This modern Enlightenment way of thinking fueled the American economy for most of its history. Phelps (2013) maintains that during the past century the United States reverted to more traditional values (as defined by the World Values Survey) and that this is a main reason why our economy has become less dynamic. Phelps's argument that our values have changed may explain why even though cronyism has been present throughout U.S. history, it only recently led to reduced innovation and dynamism. He concludes that we need to infuse our educational systems with appreciation of these modern values. "The genius of high dynamism was a restless spirit of conceiving, experimenting, and exploring throughout the economy from the bottom up—leading, with insight and luck, to innovation. This grassroots spirit was driven by the new attitudes and beliefs that defined the modern era, and a full return to high dynamism will require that those modern values prevail again over traditional ones" (2013, 324).

Deirdre McCloskey explores the importance of adopting modern virtues in depth in the *Bourgeois* trilogy: *The Bourgeois Virtues* (2006), *Bourgeois Dignity* (2010), and *Bourgeois Equality* (2016). McCloskey (2006) argues that, contrary to popular opinion, the commercial class embodies virtues and that these virtues are in turn encouraged by capitalism. The second installment of the series explains that mainstream economic growth theory cannot fully explain the Great Enrichment that took place in the 1800s. Rather, McCloskey (2010) attributes the birth of the modern era to a change in ideas, specifically increased respect for business. The third book further examines how the adoption of "liberalism" has enriched the world. McCloskey maintains that this change of values happened at both the societal level—that is, with a general respect for the commercial class—and the individual level as entrepreneurs felt free to "have a go in business" (2016, xvi). Change at both of these levels needs to happen in the United States for the country to regain its dynamism.

By a change in values at both levels, I do not mean an improvement in the character of CEOs so that they resist rent seeking out of principle. As Munger and Villarreal-Diaz point out, that "would . . . violate the essential 'public-choice' axiom of *behavioral symmetry*" (emphasis in the original). Rather, what is needed is a revival of the general appreciation of liberalism in the classical sense.

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