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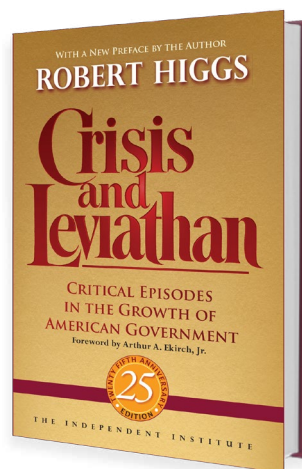
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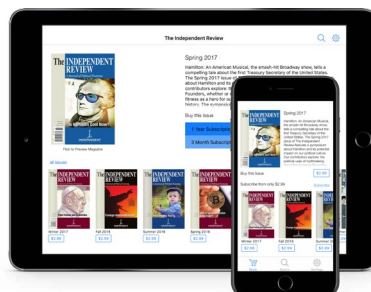
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# Cronyism

## *Necessary for the Minimal, Protective State*

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CHRISTOPHER J. COYNE AND ABIGAIL R. HALL

**T**he provocative lead essay by Michael Munger and Mario Villarreal-Diaz, “The Road to Crony Capitalism,” in this symposium forces readers to wrestle with the oft-neglected but crucial distinction between “ideal” capitalism, which is immune from cronyism by definition, and “real” capitalism, which is not. Our paper is motivated by their claim that “it is at least possible that cronyism is *intrinsic to* and not *separable from* capitalism” (emphasis in the original). We make a stronger claim and argue that to the extent that capitalism requires the existence of a state, even a minimal state, it also requires some degree of cronyism. Cronyism is inherent in state activities, so where the state exists, so too does cronyism. The question is not whether cronyism exists or whether there is a tendency for cronyism to emerge but instead the magnitude of cronyism given that the existence of the state is its very cause.

In discussions of a minimal state, the analogy of a referee is often employed (see, for instance, Buchanan 1975, 95–97). The idea is that the referee stands outside of the game and serves purely as an enforcer of predetermined rules. As an enforcer of the rules, a referee is not an active player in the game and does not intervene to shape outcomes. Those who embrace this analogy typically conclude that if the state remains purely protective, like the hypothetical referee, cronyism will be a nonissue. Players in

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the game will have no incentive to curry government favor because the referee cannot influence outcomes.

There are two reasons, however, why 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 in private economic life to extract resources. In doing so, it shapes and manipulates economic life and creates an environment conducive to cronyism by relying on political power to determine resource transfers and allocations. 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. As Friedrich Hayek noted, a government planning authority “cannot tie itself down in advance to general and formal rules which prevent arbitrariness.” The reason why is that planners require the power to address “circumstances which cannot be foreseen in detail” ([1944] 1994, 82, 83). This applies not just to comprehensive economic planning but also to noncomprehensive planning wherein government exerts authority over specific industries or sectors of the economy (see Lavoie [1985] 2016; Coyne and Hall forthcoming).

By modeling the state as an exogenous referee that remains entirely outside of the capitalist system, advocates of a minimal state understate or entirely neglect these realities. Despite their use of the term *minimal* to describe the core functions of the protective state, in reality the state contains significant space for cronyism. Advocates of the minimal state tend to be vehemently against corporatist cronyism and view it as destructive to the dynamic aspects of capitalism. At the same time, however, many of these advocates argue that the state *must* provide national security because it is a public good that will be undersupplied by private parties. Rarely do they appreciate the tension between these two claims. The state provision of defense fosters cronyism just like any other state activity. In fact, we should expect the problem of cronyism to be especially severe in matters of national security given the state’s monopoly control over all aspects of military activities, which are vast in both scale and scope.

In the next section, we discuss the U.S. military sector as one illustration of how cronyism can infect protective-state functions. This is an insightful example because the U.S. military sector influences nearly all aspects of the U.S. economy and represents peak cronyism. Indeed, one would have a difficult time identifying a sector in the United States that better illuminates the operations of cronyism and its deleterious effects. This case study is also useful because it illustrates that even *if* government were limited solely to providing core protective functions, cronyism would still be rampant. The concluding section considers some potential modes of response regarding the necessity of cronyism for capitalism.

## Peak Cronyism: The U.S. Military Sector

### *The Foundations of Cronyism*

The current U.S. military sector is a product of the two world wars. Prior to the U.S. entry into these wars, state-led military production would ebb and flow sporadically based on conflicts that emerged. During the world wars, this pattern changed. The state's massive war effort required the participation—whether voluntarily or through the threat of force—of the private sector. This requirement dramatically increased government intervention into the U.S. economy and created the foundations of the crony system that persists to this day.

Regarding World War I, Robert Higgs notes that “[w]hile many viewed the mobilization of the economy as having established both the possibility and desirability of extended government control of economic life, hardly anyone came away from the crisis with an enhanced understanding or appreciation of the market system or greater insight into the inherent cost-imposing, cost-concealing character of the command economy” (1987, 156). Similarly, Higgs states, World War II “moved the prevailing ideology [of the U.S. citizenry] markedly toward acceptance of an enlarged government presence in the economy” (236). As these statements suggest, it was not just the establishment of a massive bureaucracy that fostered cronyism but also an ideological shift that normalized entanglements between the private and public sector as a regular part of life.

During World War II, changes to defense contracting created the foundations for peak cronyism (see Higgs 2012, 214–18). Procurement laws were changed to allow for the widespread use of noncompete, cost-plus-fixed-fee contracts in place of sealed competitive bids. The purpose of this change was to incentivize businesses to enter the military sector, which led to a change in the relationship between government and private business (Higgs 2006, 36–40).

As R. Elberton Smith notes, there was a change “from an ‘arm’s length’ relationship between two more or less equal parties in a business transaction [to] an undefined but intimate relationship” ([1959] 1991, 312). The result, Higgs states, was that “deals came to turn not on price, but on technical and scientific capabilities, size, experience, and established reputations as a military supplier—vaguer attributes that are easier to fudge for one’s friends” (2012, 217–18). Further, “the newly established ‘intimate relationship’ opened up a whole new world for wheeling and dealing on both sides [government and private business] of the transaction” (217). This arrangement persisted in the post–World War II period with the creation of a “permanent war economy” to engage in constant preparation and production for future wars (see Duncan and Coyne 2013a, 2013b).

The permanent war economy, which continues to thrive today, is the epitome of crony capitalism. The U.S. government has a monopoly on final defense provision at the national level. In order to deliver defense, the U.S. government purchases a significant

amount of defense-related inputs from private firms. These purchases include civilian goods that are used by the government for military activities—for example, clothing, housing, health care, and so on—and defense-specific goods and services that are not legally available to the public—for example, military technologies, weapons, and so on. In order to secure contracts from the U.S. government, private firms must participate in and successfully navigate the political and bureaucratic process that defines the sector. Both firms and political actors attempt to influence and manipulate this process in pursuit of their own interests. The cumulative result is an entanglement of private firms with the federal government that results in the well-known “military-industrial-congressional complex” (see Higgs 2012, 204–24; Duncan and Coyne 2013a, 2013b; Coyne, Michaluk, and Reese 2016).

This entanglement has important implications for treatments of the minimal state. The language of “minimal” or “limited” government conflates the number of general, aggregate functions that the state engages in, on the one hand, with the scope of the activities that constitute each of those broad functions, on the other. To many, indicating that the state should be limited to providing “defense” or “security” from internal and external threats suggests that the state is doing very little. This characterization of the limited state, however, masks the true reach of the state’s military activities in domestic economic life (see Higgs 1987, 2012, 204–24; Duncan and Coyne 2013b; Coyne and Hall forthcoming).

Consider, for example, that the U.S. Department of Defense is the country’s largest employer, with 1.4 million men and women on active duty, 850,000 civilian employees, 836,000 Select Reserves, and 245,000 Individual Ready Reserve forces (U.S. Department of Defense 2015, 6). These numbers do not include the significant number of people who work in jobs that supply the U.S. military with various goods and services, which is estimated to total more than 1.5 million (Reich 2010). Beyond the labor market, the U.S. military also influences a wide range of industries (Coyne and Hall forthcoming). A review of the top-one-hundred defense contractors for fiscal year 2016 finds participants in the following industries: aerospace, computer and technology, accounting and professional services, courier services, engineering and construction, finance and private equity, health care, higher education, and telecommunications (“Top-100” n.d.). As this list suggests, the reach of state military activities into the private economy is anything but “minimal.”

The military sector is instead a prime example of noncomprehensive planning, which is characterized by a tight relationship between private firms and a state apparatus that governs the relationship and hence the profitability of firms through bureaucratic rules and mandates (see Lavoie [1985] 2016; Coyne and Hall forthcoming). The U.S. defense sector’s public–private arrangements are more reminiscent of fascist economic systems than of a competitive, private market (see Higgs 2012, 204–24). There is private ownership over the means of production, but the evolution and actions of the private owners are dictated by government mandates established by political authorities.

The various parties involved in the defense sector—both private and public—seek to take advantage of gaps in bureaucratic rules that allow them to pursue their own interests. These gaps are often significant, as illustrated by dysfunctional internal accountability mechanisms for tracking the location and allocation of defense-related resources (on this point, see Paltrow 2013; Coyne, Michaluk, and Reese 2016, 229–30). According to a recent report by the U.S. Government Accountability Office, “[t]he Department of Defense (DOD) is responsible for more than half of the federal government’s discretionary spending. Significant financial and related business management systems and control weaknesses have adversely affected DOD’s ability to control costs; ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent and detect fraud, waste, and abuse; address pressing management issues; and prepare auditable financial statements” (2015, 172).

Further, consider that according to the Government Management Reform Act of 1994, starting in 1997 the Government Accountability Office has been legally required to audit the financial statements of federal agencies. Despite this law, the office was unable to begin to audit the financial statements of the Department of Defense until 2017 (the audit is still ongoing as of September 2018). This means that *for two decades* the Department of Defense operated in violation of federal law.

A former Pentagon cost analyst nicely captured the implications: “[T]he combination of loose procurement rules and government acquiescence in rip-offs leaves many a crook untouched” (Fitzgerald 1989, 290). Similarly, retired air force colonel James Burton bluntly captured the essence of the arrangement when he noted that “[t]he business of buying weapons that takes place in the Pentagon is a corrupt business—ethically and morally corrupt from top to bottom. The process is dominated by advocacy, with few if any checks and balances” (1993, 232). This corruption extends beyond the purchase of weapons to the other activities undertaken by the Pentagon, which often equally reek of cronyism (see Fitzgerald 1972, 1989; Burton 1993; McCartney 2015).

In sum, the defense sector is characterized by government control of resources, reliance on public–private partnerships for production, and the absence of effective mechanisms for accounting and accountability. This leaves significant space for opportunism by both private firms and those within government, who are able to pursue their own interests under the guise of “protecting the nation.” The resulting cronyism manifests itself in several ways.

### *Rent Seeking and Rent Extraction*

In order to influence political actors, private firms in the military sector engage in rent seeking, which involves the expenditure of resources to build, maintain, and use beneficial connections with government to curry favor (see Tullock 1967; Buchanan

1980). This behavior is predictable because private-sector defense firms receive income through government contracts that are determined by the political process rather than through the competitive market process. Along these lines, Seymour Melman notes that although “military-industry firms compete, often in much the same fashion as division managers under a central corporation, in their Pentagon-dominated world ‘competence,’ including political clout, is the coin of competition rather than the price–quantity contest that is more characteristic of civilian firms” (1985, 35). Rent seeking is one form of establishing and extending this “political clout.”

Rent-seeking expenditures are best understood as legal bribes whereby donors seek to establish or maintain favorable terms with political actors in exchange for future benefits. As Higgs notes, “Both the givers and receivers understand these payments in exactly the same way that they understand illegal forms of bribery, even though they never admit this understanding in public” (2012, 214). Payments can consist of direct campaign contributions, monetary contributions to elected representatives’ favored charitable organizations, or payments in kind to elected officials or Pentagon bureaucrats. To provide one example of such payments in kind, a report indicated in 1975 that “Senate investigators have found evidence that at least 10 major defense contractors, in addition to the Northrop Corp., have operated lush entertainment facilities for Pentagon brass. They include quail and pheasant shooting preserves, yachts and ‘recreational’ facilities in exotic warm climates” (McCartney 1975). Private firms used these facilities to build relationships with the gatekeepers who control access to government funds. This is but one illustration of the culture of rent seeking that permeates the defense sector (see also Choi and Storr forthcoming).

Whereas private firms engage in rent seeking, political actors who control defense-related resources engage in rent extraction. The underlying idea behind rent extraction is that discretionary control over rule enforcement and resource allocation creates a property right. Politicians who possess this property right can extract payments from those subject to their control (see McChesney 1987, 1989).

The national government’s monopoly over defense provision creates property rights for the political gatekeepers who control the flow of funds and make decisions regarding contracts with private firms. These gatekeepers can extract rents from private defense firms who are dependent on government funding. For example, the U.S. House of Representatives Subcommittee on Defense, which is a permanent subcommittee of the House Committee on Appropriations, controls the flow of military-related funding and is therefore central to the profitability of private defense firms. As such, the members of this committee are able to extract rents from private firms for their own narrow benefit. As Peter Schweizer notes, the subcommittee’s final report is “the sort of document that can make or break the programs of defense contractors, both large and small” (2013, 37). This control over the budget allows the gatekeepers to seek favors from firms that are incentivized to comply.

Together, rent seeking and rent extraction have important implications for understanding the U.S. military sector. Decisions are not made based on the “national

interest” or to provide for the “common defense” of the nation. The foundation and operation of the industry are instead based on political relationships, favors, and privilege.

### *The Revolving Door*

The term *revolving door* “refers to the back-and-forth movement of personnel between the government and private sector” (Duncan and Coyne 2015, 391). To many, the idea of the revolving door sounds conspiratorial, but in practice it is the logical result of the structure of the defense sector. On the private-sector side, firms have an incentive to hire experts who understand the bureaucracy—organization structure and procedural rules—associated with the government’s defense operations. Former government employees are likely to possess the necessary human capital based on their past experience. In discussing the revolving door in the military sector, Gordon Adams notes that former government employees “are knowledgeable in the ways of Government [*sic*], aerospace technology, and procurement strategies. . . . The expertise brought by these individuals is not only technical but political” (1982, 79). As one investigative journalist noted, “When a general-turned-businessman arrives at the Pentagon, he is often treated with extraordinary deference—as if still in uniform—which can greatly increase his effectiveness as a rainmaker for industry. The military even has a name for it—the ‘bobblehead effect’” (Bender 2010). This effect enhances private firms’ ability to secure profits through political means.

The logic of the revolving door is prevalent in the U.S. defense sector. According to one study, “[f]rom 2004 through 2008, 80 percent of retiring three- and four-star officers went to work as consultants or defense executives” (Bender 2010). A separate report revealed a “mentorship program” in which retired officers, many of whom now worked for defense contractors, were hired by the military as “consultants” to serve as advisers and guides to active-duty officers (Brook, Dilanian, and Locker 2009). This program allows these mentors insider access to represent their current private employers.

The revolving door also operates in the other direction, with people flowing from private industry to state agencies. Government bureaus need people to create and enforce regulations and to make decisions regarding resource allocation to private firms. Those who have gained human capital in the private defense sector are well suited to this role because they have firsthand knowledge of the operations and capabilities of private firms as well as an understanding of the broader interplay between the private and public actors in the sector. To provide but one example of this dynamic, consider the case of William Lynn. In 2010, Lynn was confirmed as the top deputy for the Department of Defense, despite serious concerns about his close connections to top defense contractor Raytheon, for whom he had worked as a lobbyist over the previous decade (Griffin and Bronstein 2010). His experience in the private defense sector prepared him for the role in government, which is based on entanglements with the private defense industry.



### *Local Politics versus the “National Interest”*

In the ideal model of democratic politics, elected representatives work together to provide common defense and security for the entire nation. Reality deviates sharply from this ideal model, with elected representatives pursuing their own narrow interests as dictated by local politics. This pursuit is entirely predictable because local politics determines whether the representative will be reelected.

The pursuit of local political interests is evident in elected officials’ efforts to channel military funds to private firms and labor unions in their home states, which often leads to the production of goods and services that are, from the perspective of those running government defense agencies, wasteful and unnecessary for national defense. Elected officials pursue these resource allocations because they deliver funds and resources, much of which are paid by other taxpayers, to their constituents.

To provide one illustration, in 2008 Secretary of Defense Robert Gates informed Congress that the current planned order of 205 C-17 cargo jets for the U.S. Air Force was sufficient to meet the branch’s current needs (Gates 2008). Ignoring Gates, members of Congress ordered a further expansion of the fleet in order to direct benefits to their constituencies. Boeing, which manufactured the C-17, estimated that the program supported 650 suppliers and more than thirty thousand jobs across forty-four states (McCartney 2015, 41). Although the production of the C-17 was undertaken in the name of contributing to the nation’s security, the reality is that it became a “welfare program, offering profits for companies, jobs for workers and unions, and political support for cooperative lawmakers. Planes the Pentagon has not thought necessary have been built to promote the reelection of congressman and senators” (McCartney 2015, 41). A significant number of other activities in the defense sector follow a similar pattern, which amounts to nothing more than a grand corporate-welfare scheme that redistributes wealth from taxpayers to crony corporations under the cover of national security.

Private firms are aware of the incentives tempting elected officials and actively structure their operations accordingly. One example of this is the spreading of the production of Lockheed Martin’s F-35 Joint Strike Fighter over forty-five states (Miller, Capaccio, and Ivory 2013). This means that elected officials in those states have a shared interest in continuing to fund the program to ensure that resources are channeled to their local constituents even though the project has been plagued by numerous cost overruns and failures. By strategically allocating the production of the aircraft across geographic space, Lockheed Martin has created a too-big-to-fail scenario in which elected officials have a vested interest in the continuation of the project (Berr 2015).

In general, an elected representative is highly unlikely to vote against a defense project that brings jobs and money to his or her constituents, even if that project contributes little or nothing to the country’s actual security. Representative Jamie L. Whitten (D–Miss.) summed up the problem nicely when he stated during congressional testimony, “I am convinced that defense is only of the factors that enter into our

[Congress's] determination for defense spending. The others are pump priming, spreading the immediate benefits of defense spending, taking care of all of the services, giving defense contractors a fair share, spreading the military bases to include all sections" (quoted in McCartney 2015, 41). As this statement suggests, cronyism, not some mythical economic concept of the "optimal production of a public good," is what drives the provision of what falls under the overly broad category of "defense."

### Conclusion: Three Modes of Response

Most discussions of cronyism take a basic set of state functions as given and then ask whether there is a tendency for capitalism to devolve into crony capitalism. This approach neglects the fact that the minimal, protective state is an inherently crony-capitalistic entity. This inherent cronyism is not due to the number of functions carried out by the government; rather, the state itself is the cause of cronyism. This relationship has an important implication that is typically neglected: to the extent that the state is necessary for capitalism, so too is cronyism. Where the state exists, the issue is not whether there is a tendency toward cronyism because cronyism is inherent in state activities. The issue is instead the magnitude of cronyism, given its existence. There are three potential modes of response to this implication. We consider each of these potential responses in terms of the state's protective function.

The first is the "Jedi mind trick," which involves pretending via assumption that there is no tension. This is the preferred response among many economists and political scientists, as indicated by their treatments of state-provided defense (see Coyne 2015). As J. Paul Dunne notes, "[T]he neoclassical approach to military expenditure . . . is based on the notion of a state with a well defined social welfare function, reflecting some form of social democratic consensus, recognizing some well defined national interest, and threatened by some real or apparent potential enemy" (1995, 409). More broadly, James Buchanan (1949) highlighted that many public-finance scholars treat all activities of the state as if the state were an all-knowing "fiscal brain." In the fiscal-brain model, there is no concern for cronyism by assumption. The state does exactly what is necessary to maximize social welfare, no more and no less. Most social scientists invoke a similar notion of the "defense brain," wherein it is assumed that the state is purely protective and that there is no cronyism associated with its security activities, thus making the concern irrelevant (see Coyne 2015; Coyne and Lucas 2016).

The second mode of response is to "bite the bullet," which involves accepting that cronyism is inherent in all state activities, including the functions of the minimal state. This response requires a more nuanced analysis of cronyism along the lines offered by Munger and Villarreal-Diaz in their essay. This position admits that not all cronyism is bad. From this perspective, what one might call "foundational cronyism" is beneficial and even desirable because it allows the protective state to operate and provide the foundations of a capitalist system. To our knowledge, the only economists to explicitly

recognize this point in the context of the defense sector are Tyler Cowen and Dwight Lee (1992), who argue that the inefficient rents inherent in the military sector can be beneficial because they incentivize politicians and defense contractors to produce defense-related goods that, standard models of defense provision assume, would be undersupplied on the market.

The burden on those who adopt this mode of response is to develop a general theory of “foundational cronyism” and to identify the mechanisms that limit cronyism so that the system does not devolve into full-blown crony capitalism. Such a response would need to address the large literature that analyzes the deleterious effects of cronyism and provide arguments for how these effects can be avoided so that society experiences only the beneficial effects of foundational cronyism. In doing so, the proponent of this mode of response would also have to engage the extensive scholarship in public choice literature, which finds that limiting cronyism is extremely difficult due to the pathologies of democratic politics.

Finally, one might adopt a “root cause” mode of response grounded in two arguments. First, cronyism is a result of state action, so that wherever the state exists, so too will cronyism. Second, cronyism cannot be sufficiently contained through state-provided and enforced rules, resulting in a genuine threat to the foundations of capitalism and a free society. This mode of response holds that the only way to resolve the issue is to remove the root cause—the state.

The burden on those who select this mode of response is to make a convincing case that the protective state’s activities can be provided through alternatives that do not rely on government. These alternatives, no doubt, will sound radical to many. However, they may not be any more radical than the belief that cronyism can be limited in the presence of the state. At the end of the day, removing the root cause of cronyism—the state—may very well be the only way for capitalism to ultimately sustain.

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