

Cronyism, Economic Freedom, and Human Flourishing

By Joseph Connors

There is a common misperception in economic and political debates that needs to be dispelled. The corrupt relationship that often exists between government and favored businesses is not capitalism or economic freedom; it is cronyism. Politicians often claim the free market mantle by legislating regulations, tax incentives, and subsidies in support of certain businesses. These policies are antithetical to economic freedom. A free market system is one in which the role of government in markets is limited. The task of government is not to favor certain businesses over others but to evenhandedly enforce private property rights and provide a court system for adjudicating disputes. When a government goes beyond these fundamental tasks, the opportunity for cronyism begins. These interventions may be noble and come from the best of intentions, but they create the apparatus that allows business interests to bias markets in their favor.

A simple yet thorough way to define economic freedom is that each person has: 1) personal choice 2) the ability to engage in voluntary exchange coordinated by markets 3) the freedom to enter and compete in markets 4) and their lives and property are protected from aggression by others.¹ Cronyism is a type of system where people with power modify these precepts in order to favor themselves and their cronies. Holcombe and Castillo state that, "Cronyism is a system in which people receive benefits from personal connections—benefits that are not available to individuals who are outside that group of cronies."² A more succinct definition is legal corruption.

Cronyism of Politicians

The first method of cronyism is that carried out by politicians. Many politicians use their office to enrich themselves. There are some who are wealthy before they are elected to Congress.

However, most politicians enter congress with little money and leave wealthy.³ In his book *Throw Them All Out*, Peter Schweizer documents example after example of politicians using their office to enrich themselves. They accomplish this in three ways.

First, they pass legislation that enriches their private assets. If the politician owns real estate, then earmarks are sometimes used to channel funds to infrastructure projects near their property, increasing its value. Or, politicians buy up land near where they know legislation will provide funds to build a new road. The value of the property increases significantly after the legislation is passed and becomes known publicly. At that point they sell the land to developers and pocket a pretty return on the investment.

The second is accomplished through privileged access to initial public offerings (IPOs). An IPO occurs when a company decides to allow shares of their company to be bought and sold on a public stock exchange. When this happens the vast majority of the shares are sold on the stock exchange the day of the IPO. However, a certain percentage of the shares are kept by the company and distributed how they see fit. Usually, these shares are allocated in various proportions to employees of the company and their friends and families. These shares are often called "friends and family shares." It is a way for the company to reward their employees and their families by allowing them to purchase the stock at the initial listing price before the price gets bid up during the IPO.

I know from personal experience that these shares are difficult to acquire. Several years ago, when I worked in Silicon Valley, a friend's company was about to have a very profitable IPO. I asked if he still had any friends and family shares left. He politely said, no, and mentioned those shares had been snapped up long ago. On the day of the IPO my friend's net worth went from a modest amount for someone in their 20s to well over a hundred million dollars. This helps one to understand why access to these friends and

family shares is coveted and why politicians love to get privileged access.

The third way politicians act as cronies and enrich themselves is through campaign contributions. Companies and interest groups attempting to influence legislation channel campaign contributions toward key members of Congress. It's not a mystery that key members of the Committee on Financial Services receive significant campaign contributions from companies in the financial sector. The same goes for healthcare, transportation, defense, and any other key sectors. It is a pay to play system. If companies want legislation that favors them, they must tithes their politicians' campaign accounts. This keeps the politicians in office where they can enrich themselves and their cronies.

Cronyism of Business

Being supportive of businesses and their interests is not the same thing as being supportive of economic freedom. Businesses often use government to distort the prevailing market rules in their favor. Typically this is done by large businesses as they are the only ones with enough money to hire lobbyists to press their case in state capitals and Washington.

When businesses engage in cronyism they do so in three ways. 1) They influence the regulations that pertain to their industry in order to gain an advantage. 2) They lobby for favorable loans or grants. 3) If they are well connected, they lobby for government bailouts when financial trouble occurs.

Controlling and Capturing Regulations

A business can influence regulations in one of two ways. They can influence and help write the legislation that creates the regulations, or they can "capture" the existing regulatory body that regulates the business. This second concept is an economic phenomenon known as regulatory capture.⁴ Both means of cronyism occur because businesses have the upper hand when it

comes to regulations. This is true for one simple reason: they know their industry. If the government wants to regulate an industry, they need people with knowledge of that industry. Not surprisingly, the most knowledgeable people are industry insiders.

An event from 2007 provides a classic example of this phenomenon. In 2007, the toy company Mattel had a crisis on its hands. Random testing revealed that many of their toys manufactured in China contained lead paint. Mattel's quality control had failed and they were forced to recall 1.5 million toys manufactured in China.⁵ This was a serious blow to Mattel's reputation. In response Mattel invested money and developed a rigorous quality control system to prevent this from ever happening again. To repair their reputation they had to guarantee the highest quality for their toys.

Something else happened in the midst of this crisis. Many parents demanded of their politicians that something be done to prevent tainted toys from ever entering this country again. Congress, as it so often does, sprang into action and began crafting legislation. The solution? Require all toy companies to use a rigorous testing system. And who helped Congress write the bill? Why, Mattel of course! You see, they had become experts in toy quality control.

Mattel had deep pockets and could afford an expensive testing system. This put smaller toy companies at a disadvantage as they were less able to afford the new testing system now required by law. Moreover, Mattel was the only company with an "approved" system. Many smaller toy companies suffered as a result of this legislation. Their costs were increased significantly. The irony is that these smaller toy companies were already making safe toys. It was Mattel that had lead-tainted toys. After it was all said and done, Mattel came out on top.

Grants and Loan Guarantees

The second form of business cronyism occurs through grants and loan guarantees, the largest of which come from the federal government. These grants and loan guarantees are given to companies that have difficulty securing loans or investment funds in the usual private credit markets. The rationale is that these companies are engaged in fields that are deemed important by the general public. When grants are given, the company promises to use the money for certain purposes. Periodically the grants are monitored to make sure the money is spent as the company indicated on its grant application. The money does not have to be paid back to the government.

Loan guarantees, on the other hand, are different. When the federal government issues a loan guarantee they are agreeing to pay back all or a portion of a loan if the company defaults. This enables a company to secure a private loan that they otherwise would not have received without the guarantee. In both cases the market process is replaced by the political process. Regardless of how well intentioned this process might be, it creates the opportunity for cronyism.

When the federal government provides grants and loan guarantees political connections become extremely important. If this were a market process then companies would have to convince investors or banks that they are a viable company and expect to make a profit from an investment or loan. In short, there is a risk, but there is an expectation of a return on the investment. This is not the case for grants and loan guarantees. The intent might be to have a rigorous screening process, however, the reality is that political connections determines who gets what. The author Peter Schweizer noted that a recent Government Accountability Office report on loan applications handled by the Department of Energy "had treated applicants inconsistently in the application review process, favoring some applicants and disadvantaging others." And that "contracts had been steered to 'friends and family'."⁶

American taxpayers foot the bill when companies receiving loan guarantees go bust. A recent well-known example was the solar panel manufacturer Solyndra. The company received a guaranteed loan of \$573 million from the federal government. Not surprisingly, Solyndra had connections in the executive branch and was able to secure the loan, despite not being able to return a profit on the manufacture of solar panels. In 2011 the company declared bankruptcy. The executives and initial investors did well as their intent all along was to "get the loan... go public and cash out."⁷ As usual, taxpayers were left to pick up the \$573 million tab.

Bailouts

Markets are about profit and loss. If one finds a way to use resources and create an even greater value for customers then profits reward the effort. Losses on the other hand are the market's way of stopping businesses that are wasting resources and not creating value for customers. In today's market there exists an exception to this market rule. If you are politically connected you can avoid losses by securing a bailout from the federal government. This was the mode of operation for many large companies on the verge of bankruptcy during the financial crisis. In fact, one of the first uses of money from the Troubled Asset Relief Program (TARP) was not to deal with troubled assets at all. Rather, it was used in an early, and unsuccessful, attempt to bail out a very politically connected firm, General Motors.

Warren Buffet, the world's most famous investor, is an expert in this type of cronyism. During the financial crisis he appeared as a knight in shining armor helping to rescue the financial system. He invested \$5 billion in Goldman Sachs in September of 2008 as a gesture to calm markets and restore financial stability to an important financial firm.

Buffet was making a shrewd investment based upon a political calculation. He could buy low and then use the government to help him sell high. His \$5 billion dollar investment was made at the

nadir of the financial crisis when shares of Goldman were trading for less than half their value earlier that year. Buffet did the same with GE, purchasing a \$3 billion stake in the midst of the financial crisis. He then became a cheerleader for TARP and other bailout measures which would be used to bailout failing firms like Goldman Sachs and GE. After the dust of the financial crisis settled, Buffet's investment company, Berkshire Hathaway, had invested in firms that received up to \$95 billion in TARP money in addition to the \$140 billion GE received in taxpayer money.⁸

Bailing out companies in which wealthy connected individuals like Warren Buffet have financial interests hardly seems fair or egalitarian. But that is the essence of cronyism.

What's So Bad About Cronyism?

Isn't cronyism just business as usual in Washington? Haven't markets and politics always operated this way? It is tempting to think that the current situation is the norm. And for many of us, it seems that Washington has always operated this way. There was a time in our history when most people recognized cronyism for what it is, legal corruption. In fact the term "lobbyist" comes from President Grant who liked to spend time in the lobby of the Washington Hotel smoking cigars. Businesses and other interest groups knew this and would wait in the hotel lobby hoping to grab the President's ear for a moment to press their case. This annoyed the President to no end. He despised them and so began to call them lobbyists. Today, unfortunately, most politicians prefer the company of a lobbyist to that of a fine cigar.

Even if Washington and business hasn't always operated this way, isn't cronyism economically efficient? Wouldn't wealthy businesses still gain an advantage in the market another way? The answer is, no. Businesses engage in cronyism precisely because they seek to use government to give themselves an advantage in the market. Without cronyism businesses would be forced to compete with other businesses to serve their customers better than their

competitors. And the fact that many crony businesses sought bailouts during the financial crisis indicates that these firms are not as good as others in serving their customers. Cronyism becomes the lifeline of failing businesses.

William Baumol described the harm of cronyism in a simple way. The rules and environment surrounding entrepreneurial activity will determine whether human ingenuity is channeled in a productive, unproductive, or destructive fashion.⁹ If markets are governed by voluntary exchange, if property rights are respected and enforced, and if people are free to exchange with one another, then entrepreneurs will channel their efforts in ways that are beneficial to everyone. In markets guided by economic freedom, entrepreneurs will attempt to make money by serving their customers. Steve Jobs, Bill Gates, and Fred Smith are all examples of this type of entrepreneurship. The innovations and products they created have transformed our world.

If on the other hand, an economy is dominated by wealthy firms cooperating with politicians to enrich themselves, then entrepreneurs will channel their talents in unproductive and often destructive ways. Instead of innovative new products, entrepreneurs will find innovative ways to use government to enrich themselves and their cronies. These entrepreneurs will engage in win-lose activities inherent in the political process rather than win-win market transactions. Their creativity is channeled in an unproductive direction. A classic example of this comes from *Liberalism and Cronyism: Two Rival Political and Economic Systems*, a book written by Randall Holcombe and Andrea Castillo.

[The] electric car manufacturer Aptera Motors laid off 25 percent of its workforce so that it would have the resources to focus on procuring a DOE loan. The remaining employees spent the bulk of their time navigating the myriad forms and processes that were necessary to procure government support. The incentives

produced by government loan guarantees, grants, and subsidies remove resources from productive activities and direct them toward unproductive cronyism.¹⁰

Some may go even further and engage in destructive activities. Cronyism allows wealthy firms to use government power to change rules and regulations to gain an advantage. This makes it harder for smaller, less politically connected firms to do business. It destroys the underlying rules needed for economic freedom. It encourages creative individuals to destroy a system in which creativity is channeled to serve others.

An Injustice

Cronyism is much more than a purely economic problem. It is a moral problem. Politicians using their office to enrich themselves is permissible according to the House and Senate ethics standards, but it is still wrong. Businesses using the power of government to benefit themselves might be the norm in Washington, but that does not make it right. Cronyism is legal corruption. Nothing can make it morally acceptable.

How is cronyism unjust? And what standard of justice should be applied? There are two dominant views of justice in markets, and cronyism is a violation of both. The first view holds that an outcome is just if the process is just. When people interact in markets and everyone is treated equally, fairly, and rights are respected and enforced then the resulting outcome must be just. As long as there is no coercion, a just process leads to a just outcome, even if the outcome is unequal.

The second view is an outcome-based notion of justice. The outcome of the process must be equal for all and fair. The rules and procedures are less important than the outcome. This view is known as the distributive view of justice.

The first view is consistent with economic freedom. An economically free system is just because all are treated equally and

rights are respected throughout the market process. The second view is inconsistent with economic freedom as it necessarily involves the redistribution of outcomes.

While these two views of justice conflict as it pertains to economic matters, they are both inconsistent with cronyism. Cronyism is a violation of all notions of justice and as such should be condemned by all.

Cronyism: The Dominant Economic System of Biblical Times and Poor Countries

Cronyism is not new. In fact looking back through history one realizes that mankind has lived in a crony world much longer than he has lived in an economically free world. It is still the dominant economic system in poor countries. As Schweizer notes, cronyism "is a term that used to be applied almost exclusively to developing countries that were rife with corruption."¹¹ Unfortunately, it has made its way to our shores as "the label can be applied to many sectors of our economy."¹²

The increase of cronyism in markets and politics should be a cause for concern. In biblical times and for much of history, people lived in corrupt economic and political systems. Many of the people in jail were innocent but had fallen afoul of the current cronies in power. It was not uncommon for people to be in debtors' prison as a result of not paying back a loan that was probably made under onerous terms. In the Bible, the parable of the unforgiving servant in Matthew is a good example of how unpaid debt was dealt (Matthew 18:21-35). The parable is ultimately about forgiveness, or lack thereof on the part of the servant. It also illustrates that falling on hard times was enough to land one in jail or sold into slavery.

The story of Zacchaeus the tax collector in the New Testament is another illustration of the cronyism that existed at that time. Tax collectors worked with the occupying Roman forces. Each tax collector was in charge of a certain area and paid the

Romans an agreed upon amount. The tax collector then went out and collected the taxes as he saw fit. Usually they incorporated a very large "middleman mark-up" as compensation for their troubles. This is why the tax collectors were so hated by the Jews. They collaborated with the occupying Romans and padded their accounts with much of the taxes collected.

This type of cronyism is not unlike the cronyism of today. Politicians and businesses use their positions of power to increase their wealth at the taxpayer's expense. Today, our failing is that we don't recognize how big of an injustice cronyism truly is. The people living in Palestine during the first century clearly did, hence, the outcry when in the biblical story, Jesus decides to dine with Zacchaeus. The people can't believe that Jesus would condone the cronyism of his day. Zacchaeus, much to his credit, repents of his crony ways and promises to make amends.

Reducing Opportunities for Cronyism

The cronyism of historical times and poor countries has unfortunately become an accepted part of life in Washington and our state capitals. When people with wealth and connections use government power and taxpayer money to enrich themselves, our society suffers. It does not matter what form of government one has. As long as the capacity exists for governments to dictate and coerce the economic outcomes of people, cronyism will dominate the affairs of mankind.

For some this may seem counterintuitive. Instinctively we often look to the political process for solutions. When we see problems in our world we want to do something about them and we use the political process to implement these good intentions. But even the best of intentions are usually sidetracked to serve the interests of cronies.

The solution to cronyism is not to use the political process to rectify economic wrongs, but to dismantle the capability of those with power to affect our economic lives. A coral reef cannot exist

without attaching to a rocky underwater structure. Remove that structure and the reef cannot exist. To undue cronyism we must work toward a system with less structure for cronies to use and abuse.

Therefore, it is helpful to consider the principles of economic freedom. An economically free environment limits the opportunities for cronyism because there is little power for others to control our economic lives. The enforcement of private property rights and the use of courts to ensure justice lead to human flourishing and less cronyism.

Most importantly, economic freedom and cronyism are incompatible. The power structure that cronyism needs to control our economic choices doesn't exist with economic freedom. There is a wide space between the workings of families, communities, and churches, and that of the state. This space is ideally suited to be filled with ordinary people, living out their lives with meaning and purpose. Cronyism relies on the power of government. Take that away and you have a space that people can fill with justice, mercy, and charity.

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This article is an abridged version of "Cronyism, Capitalism, and Human Flourishing," a research paper from The Institute for Faith, Work, and Economics.

¹ James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: Annual Report*, (Vancouver, B.C.: Fraser Institute, 2013), 1.

² Randall Holcombe, and Andrea Castillo, *Liberalism and Cronyism*, (Arlington, VA: Mercatus Center, 2013), 8.

³ Peter Schweizer, *Throw Them All Out: How Politicians and Their Friends Get Rich Off Insider Stock Tips, Land Deals, and Cronyism That Would Send the Rest of Us to Prison*, (New York: Houghton Mifflin Harcourt, 2011), 40.

⁴ George Stigler, “The Theory of Economic Regulation,” *The Bell Journal of Economics and Management Science* 2 (1971), 3-21.

⁵ Louise Story, *The New York Times*, “Mattel shifts into crisis mode after quality problems,” August 28, 2007 online:
http://www.nytimes.com/2007/08/28/business/worldbusiness/28iht-mattel.4.7289869.html?pagewanted=all&_r=1&_r=1&.

⁶ Schweizer, *Throw Them All Out*, 82.

⁷ *Ibid.*, 86.

⁸ *Ibid.*, 110-112.

⁹ William J. Baumol, “Entrepreneurship: Productive, Unproductive, and Destructive,” *Journal of Business Venturing* 11 (1996): 3-22.

¹⁰ Holcombe and Castillo, *Liberalism and Cronyism*, 70.

¹¹ Schweizer, *Throw Them All Out*, XX.

¹² *Ibid.*