

SCRATCH OUT THE “CAPITALISM”; “CRONY” SUFFICES

Yi Zona Xu and Katina Zheng

High School essay contest 1st place winner

Following the automotive and banking industry bailouts in America after the 2008 financial crisis, fingers have been pointed at the Obama for favoring “cronies” over quicker economic recovery. Expansionary monetary policy is not unheard of, nor is government intervention. However, with one-time global economic strongholds Europe and America flailing under socio-economic forces, the public needs someone to blame. The culprit: crony capitalism.

Guilty verdict

“Crony capitalism” is by no means a newly-observed phenomenon and its undertones trace back to the 1624 *Darcy v. Allein* case that prohibited English monarchies from granting exclusive rights to produce goods (Calabresi and Price, 2014: 8). The term “crony capitalism” itself takes on a variety of nuanced interpretations. Commonly, it is seen as collusion between businesses and government, with firms getting help from high places. However, arguably just as prevalent is a form

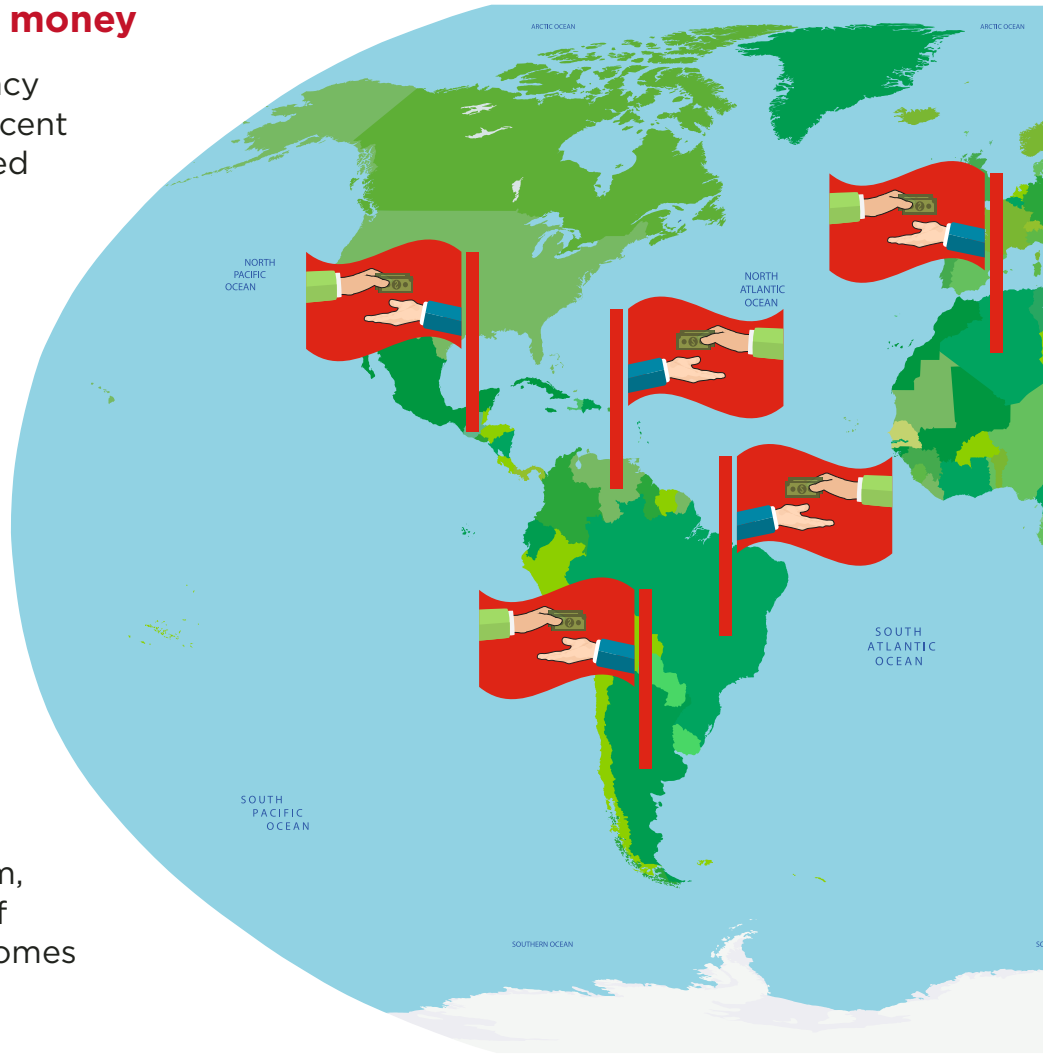
of “implicit cronyism,” where firms manipulate regulatory systems already in place to advance their goals.

Once cronyism takes hold, businesses are no longer rewarded based on quality of output, but rather on how many government strings they can pull.

In either case, once cronyism takes hold, businesses are no longer rewarded based on quality of output, but rather on how many strings they can pull in the seat of government. Meritocracy yields to kleptocracy, and efficiency is lost with the erection of regulatory barriers that distort the price mechanism. Ultimately, a market with asymmetric information results, along with the gradual degradation of the quality of goods and services produced. Cronyism-led growth is fundamentally unsustainable, often leading to social unrest and waste of resources in unproductive rent-seeking behaviour. What can be affirmed is that free markets are not to be blamed for stagnating economic figures; cronyism is.

Explicitly getting the money

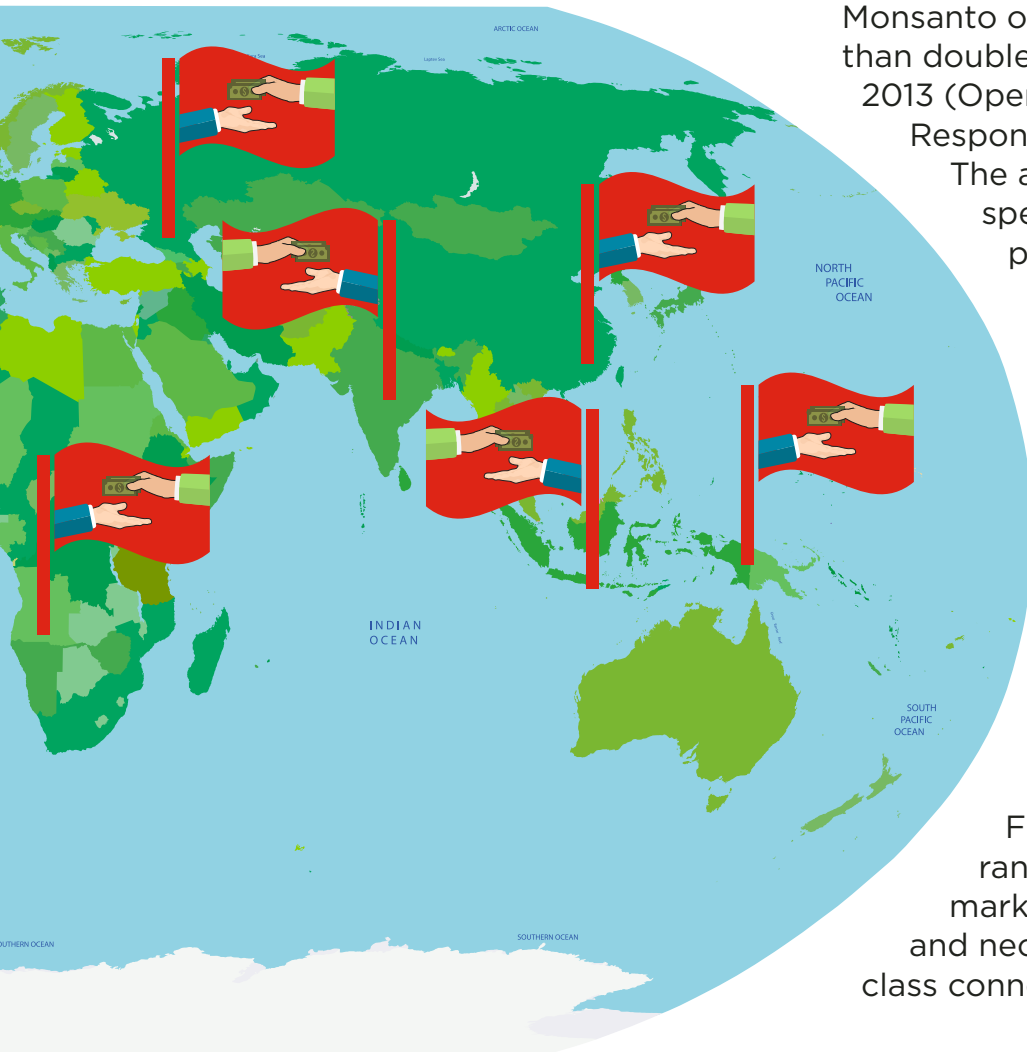
In a survey by Transparency International, over 54 percent of India's residents claimed to have paid a bribe in 2013 alone (Hardoon and Heinrich, 2013). Lack of accountability has led to corporate indecision and incompetency in often vital construction and development projects, slowing India's private sector and stunting GDP growth to 5 percent in 2013 (The Economist, 2014). Government corruption is normalized and propagated through a persistent lack of reform, and as a result, paying off government officials becomes routine procedure.



In the 2014 Sochi Winter Games, the largest contracts often went to Putin's childhood friends

Cronyism took another heavy toll in the 2014 Sochi Winter Games, with the massive US\$50 billion price tag dwarfing Vancouver's mere \$7 billion (Murray, 2014). As much as one-third of the sum was lost to bureaucracy; the largest contracts often went to Putin's childhood friends, like former judo partner Arkady Rotenberg, now a construction mogul (Murray, 2014).

Financial rewards from holding political office create a positive feedback loop, wherein power is followed closely by money, and money by power. Approximately 90 percent of the richest 1000 individuals in China identified by the Hurun Report in 2011 were officials or members of the communist party (Lee, 2014), and in 2011, the *Harvard Business Review* found that worker deaths from unsafe workplace conditions were over 10 times higher in "connected" companies, where at least one executive member had previously held a high-level



Monsanto on lobbying has more than doubled between 2006 and 2013 (OpenSecrets.org, Center for Responsive Politics (2014a).

The agricultural superpower spent \$654,000 in political contributions to Republicans and Democrats in 2012 alone (OpenSecrets.org, Center for Responsive Politics (2014b). Monsanto's lobbying has been costly, but at the end of the day Monsanto leaves courtrooms happy, trapping low-scale farmers in a net of patented GMO seeds.

Friends in high political ranks have disrupted the free market, creating inefficiencies and necessitating political and class connections.

post (Fisman and Wang, 2014). "Connections" allow companies to circumvent health and safety regulations at the cost of employee and customer welfare. Systems characterized by decision-making power concentrated in a group of elites are prone to corruption, manifesting in poorly maintained yet expensive infrastructure that hinders development.

Firms directly pushing for favourable legislation are not unheard of in the developed world, either. Money spent by the biotechnology firm

Money spent by the biotechnology firm Monsanto on lobbying has more than doubled between 2006 and 2013

Comedy of implicit errors

In 2013, Microsoft, along with some 16 other firms in the FairSearch coalition, accused Google of unjustly pushing its services through the Android mobile device platform (BBC News, April 9, 2013). FairSearch, which includes Google rivals from Expedia to Nokia, is taking on a course of action that benefits itself. Unlike in explicit cronyism, FairSearch

was not actively pushing for new bills to be passed or for new subsidy checks to be written. FairSearch was making the most of established social institutions; in other words, when firms are not actively erecting barriers to entry or lobbying for their removal, they are manipulating their environment. Echoed in ongoing Apple vs. Samsung patent feuds, instead of innovating, big businesses are engaging in a war of legal suits (Newman, 2014).

Likewise, the 1800s marked a period of massive subsidies for a handful of steamboat operators. Large firms continued using wooden hulls due to high iron costs, leaving smaller unsubsidized firms afraid to move forward. Cornelius Vanderbilt was the first to switch to iron and was so successful that competitors paid him 75 percent of their annual subsidy to not run his ships in their waters; only after the subsidy expired did iron

hulls take off (Weingarten, 2014). When dominant firms are protected, they are complacent, and competitors are unable to innovate. The result: poor quality and higher prices for the consumer.

When dominant firms are protected, they are complacent, and competitors are unable to innovate

In China, and in many developing countries, vague and lax legislation and enforcement leave the door open for corruption and skewed interpretations and applications of law. Apart from granting firms the ability to exploit resources, this social structure inherently promotes collusive behaviour between firms and high-ranking officials, lest firms wish to find themselves suddenly punished under a law never previously enforced (Kumar, 2010: 77). Businesses' behaviours reflect legislations and interventions in what should be a free market.

In India, the government's decision to create "mandis," or marketplaces where prices are determined through auctions to protect farmers from moneylenders and traders, shows how problematic intervention can prove. In these mandis, traders need licenses to function, generating revenue through farmer and retailer commission. Because of an immature enforcement system, auctions have not been held regularly, nor has tax from



transactions been used in developing mandi infrastructure (Chand, 2012: 54). The government's intervention led to further exploitation of farmers by middlemen.

In Malaysia, politically connected firms were found to have greater profit margins than unconnected rivals, despite lower returns on assets

In reacting to governments and social institutions that prevent markets from clearing, firms are now highly incentivized to pursue rent-seeking behaviour rather than innovate, resulting in loss of social welfare due to productive inefficiencies and the perpetuation of wealth and power concentration in a social elite class.

Much ado about institutions

All being said, the focus of reform and debate should not be criticism of business leaders. Big business isn't evil: in cases like TransCanada Rail where high infrastructure costs exist, it might be more efficient for one firm to supply to an entire market. Likewise, larger firms can attain scale economies, enhancing profits and thus the capacity to innovate. In practice, an uncompetitive firm relying solely on cronyism will not succeed for long. Innovation should be celebrated, and business leaders like Bill Gates and Steve Jobs who are contributing both domestically and globally should be recognized. What needs to go is government

intervention in what should be a free market.

With cronyism proliferating, consumers are unable to satisfy their own needs and wants, leading to the rise of parallel markets. Following the implementation of the medallion regulation system for taxi cabs in early 20th Century New York, the high costs of taxi leasing cut into the income of cab drivers and raised prices for consumers. The result? Underground economies in underserved areas (VanDoren, 2014). Under-the-table agreements favour those who are able to pay, ignoring those who aren't.

When the government picks winners and losers, disparity is perpetuated. In Malaysia, politically connected firms were found to have greater profit margins than unconnected rivals, despite lower returns on assets (Johnson and Mitton, 2003). Power, wealth, and influence is concentrated more and more within an upper class. The middle and lower classes are disenfranchised, having less opportunity and willingness to participate in economic activity, thus contracting output and productivity in the long run.

Positive means to an end

Further government regulations cannot resolve crony capitalism. In a modern context, businesses facing cronyism are conditioned to curry favours and manipulate their environment, not necessarily operating efficiently, but making use of available resources. From Putin's Sochi to the failed Kyoto Protocol,

the “government knows best” approach is clearly unreasonable and ineffective at best. In India, government spending on the provision of basic humanitarian services rose 11% faster than GDP in real terms between 2005 and 2012; half of the sum did not translate to improved living conditions. It was lost to inefficiency and corruption (Gupta et al., 2014: 5).

When dealing with implicit cronyism, the key is to liberate both markets and trade

One could look to Hong Kong as a beacon as it works to curb explicit cronyism and corruption. Hong Kong established the Independent Commission Against Corruption (ICAC) in 1974 with power to make arrests and prosecutions in conjunction with the Department of Justice, apprehending 245 individuals in 2012 alone. The ICAC also protects whistleblowers by providing them with new identities and relocating them. Through community outreach programs like exhibitions and e-learning workshops, Hong Kong has established a culture of integrity in both the private and public sectors (Gupta et al., 2014: 119).

When dealing with implicit cronyism, the key is to liberate both markets and trade. In doing so, firms can seek to maximize efficiency rather than connections, leading to more optimal allocation of resources and a society better integrated across all social strata. Governments have

a responsibility to protect taxpayers and citizens, not through more regulation, but through pro-market reforms.

It’s not the “capitalism” that makes “crony capitalism” an issue—it’s the “crony” part. 



Yi Zong Xu and Katina Zheng recently graduated from Glenforest Secondary School in 2014. They are currently studying business and health sciences at New York University and McMaster University respectively.

WORKS CITED

- BBC News (2013, April 9). Microsoft accuses Google of pushing services to Android. <<http://www.bbc.com/news/technology-22078746>>, as of February 9, 2015.
- Calabresi, Steven, and Larissa Price (2012). *Monopolies and the Constitution: A History of Crony Capitalism*. Northwestern University School of Law Scholarly Commons. <<http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1213&context=facultyworkingpapers>>, as of February 9, 2015.
- Chand, Ramesh (2012). Development policies and agricultural markets. *Economic and Political Weekly* 47. *Economic and Political Weekly* 52. <<http://www.indiaenvironmentportal.org.in/files/file/Agricultural%20Markets.pdf>>, as of February 16, 2015.
- The Economist (2014a, March 15). A bad boom. *The Economist*. <<http://www.economist.com/news/briefing/21598967-graft-india-damaging-economy-country-needs-get-serious-about-dealing-it>>, as of May 28, 2014.
- The Economist (2014b, March 15). The new age of crony capitalism. *The Economist* <<http://www.economist.com/news/leaders/21598996-political-connections-have-made-many-people-hugely-rich-recent-years-crony-capitalism-may>>, as of May 29, 2014.
- Fisman, Raymond, and Yongxiang Wang (2013). The unsafe side of Chinese crony capitalism. *Harvard Business Review* (Jan. 1).
- Gupta, Rajat, Shirish Sankhe, Richard Dobbs, Jonathan Woetzel, Anu Madgavkar, and Ashwin Hasyagar (2014). *From Poverty to Empowerment: India's Imperative for Jobs, Growth, and Effective Basic Services* (February). McKinsey Global Institute. McKinsey & Company. <http://www.mckinsey.com/insights/asia-pacific/indias_path_from_poverty_to_empowerment>, as of February 9, 2015.
- Hardoon, Deborah, and Finn Heinrich Heinrich (2013). *Global Corruption Barometer 2013*. Transparency International. <http://www.transparency.hu/uploads/docs/GCB2013_Report_Embargo.pdf>, as of May 19, 2014.
- Johnson, Simon, and Todd Mitton (2003). Cronyism and capital controls: evidence from Malaysia. *Journal of Financial Economics* 67, 2: 351-382.
- Kumar, Swapn (2010). *Globalization in India: New Frontiers and Emerging Challenges*. Eastern Economy ed. PHI Learning Private Ltd.
- Lee, John 2011, September 14). China's rich lists riddled with Communist Party members. *Forbes Magazine*. <<http://www.forbes.com/2011/09/14/china-rich-lists-opinions-contributors-john-lee.html>>, as of May 21, 2014.
- Murray, Don (2014, February 4). The costly distraction that is Vladimir Putin's Sochi Olympics. CBC News. <<http://www.cbc.ca/news/world/the-costly-distraction-that-is-vladimir-putin-s-sochi-olympics-1.2521816>>, as of May 28, 2014.
- Newman, Jared (2014, March 31). The Apple vs. Samsung patent war continues, but the stakes are lower. *Time*. <<http://time.com/44353/the-apple-vs-samsung-patent-war-continues-but-the-stakes-are-lower/>>, as of May 19, 2014.
- OpenSecrets.org, Center for Responsive Politics (2014a). Monsanto Co: Annual Lobbying by Monsanto Co. Web table. <<https://www.opensecrets.org/lobby/clientsum.php?id=D000000055&year=2014>>, as of May 23, 2014.
- OpenSecrets.org, Center for Responsive Politics (2014b). Monsanto Co: 2014 PAC Summary Data. Web table. <<http://www.opensecrets.org/pacs/lookup2.php?strID=C00042069>>, as of May 27, 2014.
- VanDoren, Peter (1997). Transitional losses. *Regulation* (Winter). Cato Institute.
- Weingarten, Benjamin (2014, April 18). New book asks: Did 'crony capitalism' prolong the Civil War? *The Blaze*. <<http://www.theblaze.com/blog/2014/04/18/book-government-subsidies-may-have-prolonged-the-civil-war/>>, as of May 27, 2014.