Stephen Haber

Introduction: The Political Economy of Crony Capitalism

Since the Asian economic collapse of 1997 scholars and policy-makers have grown increasingly interested in the phenomenon of crony capitalism. Indeed, much of the surprisingly rapid meltdown of the East Asian economies is often attributed to widespread cronyism.

Yet although crony capitalism is frequently offered as a description or explanation of the inefficient economic systems of much of the developing world, the phenomenon remains poorly understood. Why do crony economic systems come into being? Why, exactly, are such systems bad for growth? If crony systems are bad for growth, then why do they survive for so long? Finally, under what conditions can crony capitalism be reformed?

This volume does not seek to offer definitive answers to these questions. The state of our knowledge is not yet well enough developed. This volume does, however, advance a set of tentative answers to these questions that we hope will motivate and guide future research.

Although crony systems can be found in a broad range of countries, we focus primarily (although not exclusively) on Latin America. We do so for the following reasons. First, an overlap in our empirical studies brings a degree of coherence to the chapters that would be more difficult to accomplish otherwise. Second, Latin

America provides an ideal natural laboratory to study the causes and consequences of cronyism. Indeed, there is perhaps no region of the world in which crony arrangements have been as fundamental a feature of the economy as in Latin America.

Crony capitalism is usually thought of as a system in which those close to the political authorities who make and enforce policies receive favors that have large economic value. These favors allow politically connected economic agents to earn returns above those that would prevail in an economy in which the factors of production were priced by the market. Frequently, the factor of production that is provided cheaply to cronies is capital. Cheap credit is funneled to the enterprises of cronies through government-controlled banks. This type of entitlement does not, incidentally, require a state-run banking system. Under crony systems, even private bankers can be induced to provide credit to insiders so long as the bankers themselves receive some form of economic entitlement from the government in exchange. Cronies may also be rewarded with the ability to charge higher prices for their output than would prevail in a competitive market. Indeed, one very common form of entitlement is to award a favored economic group with an official or quasi-official monopoly, thus allowing that group to earn monopoly rents. Even if it is not possible to create a monopoly, however, cronies can still be protected from international competition by high levels of trade protection. This allows cronies to earn rents through the ability to charge prices well above those that prevail internationally. In fact, if the trade regime requires that firms obtain licenses to import certain key inputs, governments may use the selective award of these licenses to create monopolies in industries that otherwise would be characterized by more competitive markets.

Why do governments grant such favors and create such entitlements? The answer is that crony capitalism is a solution, albeit a second-best one, to a fundamental problem faced by all governments: Any government strong enough to protect and arbitrate property rights is also strong enough to abrogate them. The ability of the government to arbitrarily predate on asset holders creates a dilemma. Unless the government can find a way to tie its hands, asset holders will not invest. If asset holders do not invest, there will be no economic growth. And if there is no economic growth, the government will be unable to finance its needs because there will be insufficient tax revenue.

How can a government create a credible commitment that it will not use its powers either to tax away all of the rent created by property rights or completely abrogate those rights? Simply promising to do so is not enough. The government can always break the promise at some later point. Indeed, the government may have strong reason to break the promise later because it faces some dire emergency or threat.

The question of how governments tie their hands has motivated a great deal of research by political scientists and has spawned a broad literature on what has come to be known as the *commitment problem*. That research, however, has focused principally on countries such as the United States. These countries solve the commitment problem through the creation of limited governments. Limited governments are understood as those that respect due process and universal individual political and economic rights—and that are bound to respect these rights through sets of self-enforcing institutions. The exact structure of these institutions varies across states. In general, however, they take the form of multiple, overlapping veto points in the decision structure of the government. Individual political actors cannot implement policies without the approval of other actors. The system is set up in such a way that the benefits to any individual actor from staying within the constitutional structure exceed those from going outside it. In the United States, for example, the president is limited by a bicameral legislature, an independent judiciary, state and local governments, and a set of independent federal agencies with professionalized civil service staffs. Thus, the U.S. president cannot arbitrarily renege on an agreement with a private individual because he or she would be blocked by (or subject to sanctions from) other branches and levels of the government. The self-enforcing nature of the institutions that underlie limited governments solves the commitment problem. Precisely because the government cannot act in an arbitrary manner, asset holders will invest.[1]

Most countries do not, however, have limited governments. They must solve the commitment problem in some other way. That is, they must find a way to tie their hands but cannot or will not create the mechanisms of limited government. We would argue that, absent limited government, a common solution to the commitment problem is crony capitalism. Essentially, crony capitalism allows government to guarantee a subset of asset holders that their property rights will be protected. From the individual asset holder's point of view, whether property rights are universal or particular is irrelevant. As long as their assets are protected, these asset holders will continue to invest as if there were universal protection of property rights. Thus, economic growth can occur, even though the government is not limited.

1. See Douglass C. North, *Structure and Change in Economic History* (New York: Norton, 1981), pp. 146–57. Also see Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988); Barry R. Weingast, "The Political Foundations of Limited Government: Parliament and Sovereign Debt in 17th- and 18th-Century England," in John N. Drobak and John V.C. Nye, eds., *The Frontiers of the New Institutional Economics* (San Diego: Academic Press, 1997), pp. 213–46; Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History* 49, no. 4 (December 1989): 803–32; Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge, England: Cambridge University Press, 1990); Barry R. Weingast, "The Political Foundations of Democracy and the Rule of Law," *American Political Science Review* 91 (1997): 245–63; Kenneth Shepsle, "Discretion, Institutions, and the Problem of Government Commitment," mimeo, 1991; and Hilton L. Root, "Tying the King's Hands: Credible Commitments and Royal Fiscal Policy during the Old Regime," *Rationality and Society* 1: no. 2 (October 1989): 240–58.

How are such arrangements made credible? What keeps the government from unilaterally changing the rules once the asset holders have invested their wealth in productive assets? More extremely, what keeps the government from confiscating these productive assets?

The answer is that members of the government itself, or at least members of their families, must share in the rents generated by the asset holders. This may take the form of jobs, coinvestments, or even transfers of stock. It is why crony capitalism goes hand in hand with corruption. What matters is that any attempt by the government to change the economic policies that benefit the asset holders will have a negative effect on the wealth and happiness of crucial members of the political elite that support the government. The activities of Suharto's family in Indonesia are a classic example of this phenomenon: the dictator's own family received rents from just about every enterprise in the country, which constrained the dictator from seizing private assets. In short, the intermingling of economic and political elites means that it is extremely difficult to break the implicit contract between government and the privileged asset holders.

Crony capitalism is not, however, as good a solution to the commitment problem as limited government. From the point of view of economic growth and distribution, crony capitalism has three major drawbacks. First, it encourages the misallocation of resources. The whole point of crony capitalism is that the government designates a set of economic policies that provides some privileged group of asset holders with a high-enough rate of return to induce them to invest without the security of limited government. Without these special entitlements, asset holders would not invest. Thus, crony capitalism not only permits rent seeking, it requires rents to be earned and distributed. Once rent seeking becomes a fundamental part of economic life, however, rent seeking above and beyond the minimum needed to induce investment will almost inevitably occur. In fact, asset holders must share some of the rents with crucial members of the political elite (in order to secure the implicit contract between the asset holders and the government). The level of rent seeking must therefore be even higher still. Industries will exist that would not exist otherwise, monopolies and oligopolies will exist in industries that should be characterized by more perfect competition, and opportunities will be denied to entrepreneurs who have the required skills and assets but not the political access or protection required. In short, crony capitalism is economically inefficient.

Second, the fact that crony systems ultimately depend on the personal connections of particular asset holders and government actors means that the commitments of the government are credible only so long as that particular government is in power. This stands in stark contrast to limited government, in which government commitments are made credible by the fundamental institutions of the polity, regardless of the identity of the individuals exercising power. Under a crony system, if the government is replaced, those personal connections vanish and with them the protection of the property rights of even privileged economic groups. For this reason, economic agents under crony systems, including the politically connected, will operate with short time horizons. This causes cronies to demand high rates of return even for projects that have short maturities. It may, in fact, completely discourage long-term investing.

Third, crony capitalism has negative consequences for the distribution of income. In a crony system, some privileged asset holders must be able to earn rents in order to induce them to invest. These rents must come from somewhere: usually everyone else in the society. Imagine, for example, that a group of cronies has obtained from the government a monopoly on some important line of economic activity, such as banking or telecommunications. Its politically created monopoly will allow it to charge prices for services well above what would prevail under conditions of free entry. Essentially, then, there will be a transfer of income from everyone using telecommunications or banking services to the managers and shareholders of those firms.

The economics of crony capitalism are taken up at length in the first chapter of this book, "Why Is Crony Capitalism Bad for Growth?" In this chapter, Anne Krueger examines the efficiency effects of crony systems by drawing parallels between the economic arrangements of cronyism and those of state-owned enterprises. This allows her to solve a crucial problem in the economic analysis of cronyism; by definition, crony arrangements are not transparent and the costs of cronyism are hidden as profits. She argues, however, that state-owned enterprises are almost exactly the same in their effects as cronyism—and for exactly the same reasons. She is therefore able to draw on evidence about the performance of state-owned enterprises to provide her with a window with which to view the performance of crony enterprises. She then extends this analysis to the study of the how cronyism can take place through the trade regime, focusing in particular on the use of import licenses in import-substituting countries and inexpensive domestic credit in export-oriented countries.

If crony systems are bad for growth, then why do they persist for so long? Why and how do crony systems get re-created over time, even in the face of dramatic regime changes? The answer is that every government that comes to power, regardless of its stated ideology, faces exactly the same commitment problem as the government it replaced. Unless it can make the very difficult transition to limited government, it will find itself confronting the same dilemma as the crony system that replaced it; if it does not create entitlements for a select group of asset holders, there will be no investment and economic growth, and if there is no investment and economic growth, the government's ability to tax will be constrained.

The persistence of crony systems is taken up at length by Stephen Haber, Noel Maurer, and Armando Razo in the second chapter of this volume, "Sustaining Economic Performance under Political Instability: Political Integration in Revolutionary Mexico." Drawing on the economics literature on industrial organization, Haber, Maurer, and Razo develop a model of the economics of crony systems. They then use an archetypal case of a crony system, the Porfirio Díaz dictatorship in Mexico (the period 1876–1910), to show how, as a practical matter, governments make credible commitments to protect property rights by providing small groups of asset holders with special entitlements. Finally, they show how this crony system was re-created after Díaz was overthrown and a new government came to power. They argue that even though Mexico fought a violent revolution that brought to power a government with a radically different ideology than that of Díaz, all the postrevolutionary governments engaged in precisely the kinds of cronyism that Díaz had. In fact, many of the cronies before and after the revolution of 1910–1920 were exactly the same people.

Crony capitalism is not solely an economic phenomenon. It is a political creation and has political consequences. Crony systems require that special economic entitlements be granted to some subset of asset holders. These entitlements then allow those asset holders to extract rents from other members of society. Electoral democracy, however, would rapidly erode these entitlements: the losers from rent seeking would presumably mobilize and defend their interests. Under crony capitalism, therefore, the government must be able to make deals in smoke-filled rooms without public review and approval; crony systems are not consistent with high levels of political democracy. Indeed, the more authoritarian the government, the more efficiently the system can work.

The connection between political institutions and crony capitalism is discussed at length in the chapters by Kenneth Sokoloff and William Summerhill. Sokoloff's point of departure is that the rules of political organization have a fundamental impact on the policy choices of governments. He therefore focuses on the conduct of elections under crony systems, paying particular attention to the question of who holds the right to vote. His chapter, "The Evolution of Suffrage Institutions in the New World: A Preliminary Look," compares the experiences of Latin America with those of the United States from the time of independence to the present day. His findings are striking. Where there was extreme economic inequality, the proportion of the population that had the right to vote at the time of political independence was generally low. Moreover, in areas characterized by extreme inequality, the timing of the extension of the right to vote from elites to a broader population generally occurred later. In fact, even though most New World polities were at least nominally democratic by the middle of the nineteenth century, only a few had electoral laws allowing universal male suffrage before the twentieth century. In some extreme cases, such as Brazil, literacy and property restrictions on suffrage were not dropped until recently.

The chapter by William Summerhill, "Party and Faction in the Imperial Brazilian Parliament," pursues the issue of the relationship between political organization and crony systems through a detailed analysis of a single case: nineteenth-century Brazil. Brazil is perhaps an ideal case with which to study the political consequences of a crony economic system—political authority was highly centralized and suffrage was tightly restricted. Summerhill notes, however, that well-developed party systems would have mitigated some of the effects of political centralization; by forcing legislators to act in concert, parties can override narrow constituent interests and thereby curtail pork-barrel politics. His major findings for the Brazilian case can be summarized as follows. Contrary to what scholars have long believed, political parties mattered a great deal in nineteenth-century Brazil. Parties commanded considerable electoral resources that were valued by federal deputies. The Brazilian Chamber of Deputies therefore adopted policies that were less distortionary than would have existed otherwise. The magnitude of this party effect cannot be estimated with precision, but the general result is clear: political parties gave rise to economic policies that mitigated the negative consequences of Brazil's highly centralized political system.

One of the implications of the Sokoloff and Summerhill chapters is that crony systems can be reformed. In the long run, changes in the rules concerning suffrage and the development of strong political parties should erode the discretionary power of the government to grant lucrative (and economically distortionary) entitlements. The chapter by Haber, Maurer, and Razo, however, suggests that such reforms might not be easy to accomplish; any government that comes to power will still confront the commitment problem.

The issue of reformability of crony systems is pursued by Aaron Tornell in the final chapter of this volume, "Economic Crises and Reform in Mexico." Tornell begins his analysis by noting that Mexico carried out a series of fundamental economic reforms during the 1980s and 1990s. These reforms, which deregulated much of the Mexican economy and opened it up to foreign trade and investment, had a negative effect on a politically powerful groups of cronies. Why is it that these power holders, to use Tornell's phrase, did not block the reforms, even though all or most of these reforms resulted in conditions that made the power holders worse off? Tornell argues that reforms occurred in Mexico because the economic crisis generated by cronyism itself produced conflict among the powerful economic groups. Some groups unilaterally relinquished their privileges because they sought to prevent other groups from introducing changes that would harm them even more or because they sought to neutralize the harmful effects of changes already introduced by other groups. Once this process began, it proved difficult to stop.

One of the implications of Tornell's chapter is that fundamental economic reforms to crony systems may only be possible during a period of severe economic crisis. When the economy is doing well, every politically powerful economic group finds that the short-run diversion of resources that would be necessitated by economic reform exceeds the benefits that the group might attain. It is only during an economic crisis, when the opportunity costs of diverting resources fall, and when groups fear reforms induced unilaterally by other groups, that the implicit coalition between the cronies breaks down.

These essays do not, of course, exhaust all the issues related to the political economy of crony capitalism. Indeed, it is our sense that we have only begun to scratch the surface, in terms of both theory and empirical research. Our hope, however, is that the case studies and presented here will provide a point of departure from which further research can be developed.