Chapter 6

Crony Capitalism: Rent-creating *versus* Profit-sharing Corruption

February 2000

Absolute power corrupts absolutely. Corruption is little better. Yet this statement is too gross. There is corruption, and then there is corruption.

The distinctions that we must make, and which I will now make, are prompted by the denunciations of “crony capitalism” in Asia following the devastating financial crisis there. These reflected, to some extent, a corruption of public dialogue. They constituted scapegoating by the true culprits, on Wall Street and in Washington, who would rather point the accusing finger to the victims themselves. Yet they raise questions that can be answered with illumination on how corruption must be analyzed.

Crony Capitalism

So, at the outset, we must ask: can we think of politics anywhere without “cronies?” Political cronies are, of course, the politicians’ friends and supporters. We call them friends here and cronies over there. After all, we write the script and the check. But that does not alter the facts as we find them.

Thus, does President Clinton not have his cronies? Surely they include Barbara Streisand, Alec Baldwin, Kim Basinger and Steven Spielberg in Hollywood. There are others he befriends on Wall Street. His new home in Chappaqua was to be financed , until public exposure and outcry threw a spanner in the works, by an indirect loan from a well-known crony, Mr. Terry MacAuliffe. One can therefore well imagine that an Asian intellectual, looking at Washington, would find our politicians with cronies just the way we find politicians with cronies in Asia. The play is the same; only the actors differ.

Cost of Cronyism: Asymmetry between Us and Them

But the production of the play does vary enormously. Here we do have a major advantage, so that our cronies cost much less than others' cronies. Our cronies, who must be rewarded reciprocally here as elsewhere for the loyalty and cash they provide to the politicians, are given their compensation in ways that for the most part do not have social costs of the magnitude that obtain in Asia. Our institutions have evolved so as to give us a vigilant press, democratic practices and a rule of law, all adding up to a firewall against rewarding cronies in expensive ways.

Thus, the Streisands and the Spielbergs are rewarded by giving them access to White House events. Their industry, Hollywood, rather than they themselves directly, is rewarded through pressuring others into greater market access and greater intellectual property protection: these are options that a superpower can deploy. To many economists, the demands for intellectual property protection are not conducive to advancing economic welfare worldwide, contrary to the self-serving propaganda of our industries and our campaign-contributions-purchased politicians. But they do amount to an income transfer from the other, intellectual-property-using, countries to us. So, we reward our cronies in such cases as the expense of others, not ourselves.

Rent-creating versus Profit-sharing Corruption

But if we can thus keep our cronies in comfort without hurting our economies in the process, this is not quite true in the newly-independent countries, often without the historical evolution of institutions such as ours and also at times without even democratic governance.

But we need to distinguish between two types of corruption in these regimes: between rent-creating and profit-sharing corruption. Under rent-creating corruption, President Suharto rewards his cronies, including the members of his extended family, with monopolies in production or distributive activity. These create what economists call "rents," and the laymen call windfall profits, based on artificial scarcity. These create, in turn, significant efficiency losses. Good examples are the creation of car-production privileges by Prime Minister Mrs. Gandhi of India and by President Suharto for their sons. Indonesia, before the financial crisis, appears to have had a fair share of such rent-creating corruption.

But consider the alternative form of corruption where, in profit-making enterprises, the cronies are given a share. With their fingers in the pie, the cronies have an incentive to make the pie as big as they can. Thus, efficiency is not impaired; instead, the incentive is to enhance it. This seems to have been the case partly with Indonesia where, along with rent-creating examples, one also reads of profit-sharing examples. Indeed the rapid growth of the Indonesian economy over nearly two decades prior to Suharto's downfall was with Indonesia embracing economic reforms, including general openness to trade and equity investments, often ahead of World Bank schedules (for such reforms) laid down under conditional aid inflows. It is also the story, I suspect, in the burgeoning openness of China on the east coast where rapid growth took off.

But profit-sharing corruption, in the end, is not without cost. Profits, so siphoned off by cronies could well cut into tax revenues that build useful infrastructure. On the other hand, they may be reinvested productively by the cronies whereas tax revenues may have been wasted. But the certain drawback of such corruption is political, though ultimately with deleterious economic consequences as well. Thus, as the people see the cronies siphoning off the profits and fattening on this undeserved largesse, they get cynical and the regime begins to lose legitimacy. When this happens on a large scale, with the passage of time, respect for the law disintegrates and political chaos may break out. It may also become difficult for the state then to do efficaciously elementary tasks such as the enforcement of taxation. The economic costs, if such a state is reached, can be substantial.

Possibly, Indonesia, just before the financial crisis hit it, was beginning to enter this phase. The crisis tore the ship of state apart, making it difficult to judge what might have happened in the course of normal evolution. But I would not be sanguine.