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To Fight Cronyism, We Need a Separation of Business and State

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In my 30-plus years in Washington, I've lived through some very bad pieces of legislation.

- George H.W. Bush's betrayal of his "read my lips" promise with the 1990s tax increase.
- Bill Clinton's 1993 tax hike, which OMB admitted 18 months later was a failure.
- All sorts of bad policies under George W. Bush, starting with the no-bureaucrat-left-behind education bill.
- A blizzard of bad policy in Obama's first two years, including the fake stimulus, Dodd-Frank, and Obamacare.

But the most depressing experience was probably the TARP bailout. In part, it was depressing because bad government policy created the conditions for the crisis, so it was frustrating to see the crowd in Washington blame capitalism (in effect, a repeat of what happened in the 1930s).

Far more depressing, however, was the policy response. Thanks largely to the influence of Treasury Secretary Hank Paulson, the Bush Administration decided to bail out the big firms on Wall Street rather than use "FDIC resolution," which would have bailed out depositors but at least shut down big institutions that were insolvent.

Creative Destruction

In other words, TARP was pure cronyism. Wall Street firms had "invested" in Washington by giving lots of contributions to politicians and TARP was their payoff.

With this background, you'll understand why I asserted in this interview that the dissolution of two business advisory councils is the silver lining to the black cloud of Charlottesville.

Since that was just one segment of a longer interview and I didn't get a chance to elaborate, here are some excerpts from an article in Harvard Business Review by Robert Litan and Ian Hathaway about the connection between anemic productivity numbers (which I wrote about last week) and cronyism.

Baumol's writing raises the possibility that U.S. productivity is low because would-be entrepreneurs are focused on the wrong kind of work. In a 1990 paper, "Entrepreneurship: Productive, Unproductive, and Destructive," Baumol argued that the level of entrepreneurial ambition in a country is essentially fixed over time, and that what determines a nation's entrepreneurial output is the incentive structure that governs and directs entrepreneurial efforts between “productive” and “unproductive” endeavors. Most people think of entrepreneurship as being the “productive” kind, as Baumol referred to it, where the companies that founders launch commercialize something new or better, benefiting society and themselves in the process.

A sizable body of research establishes that these “Schumpeterian” entrepreneurs, those that are “creatively destroying” the old in favor of the new, are critical for breakthrough innovations and rapid advances in productivity and standards of living. Baumol was worried, however, by a very different sort of entrepreneur: the “unproductive” ones, who exploit special relationships with the government to construct regulatory moats, secure public spending for their own benefit, or bend specific rules to their will, in the process stifling competition to create advantage for their firms. Economists call this rent-seeking behavior.

That’s the theory.

What about Evidence?

Well, Obamacare could be considered a case study since it basically was a giveaway to big pharmaceutical firms and big health insurance companies.

But the authors look at the issue more broadly to see if there is an economy-wide problem.

Do we…see a rise in unproductive entrepreneurship, as Baumol theorized? …James Bessen of Boston University has provided suggestive evidence that rent-seeking behavior has been increasing.

In a 2016 paper Bessen demonstrates that, since 2000, “political factors” account for a substantial part of the increase in corporate profits. This occurs through expanded regulation that favors incumbent firms. Similarly, economists Jeffrey Brown and Jiekun Huang of the University of Illinois have found that companies that have executives with close ties to key policy makers have abnormally high stock returns.

This is very depressing.

I don’t want companies to do well because the CEOs cozy up to politicians. If entrepreneurs and corporations are going to be rolling in money, I want that to happen because they are providing valued goods and services to consumers.

I wrote about Bessen’s research last year. It’s very unsettling to think that companies make more money because of political connections than they do from research and development.

There are two reasons this is troubling.

First, it means slower growth because government intervention is undermining the efficient allocation of labor and capital that occurs with productive entrepreneurship.

Second, cronyism is very corrosive because people equate business with capitalism, so their support for capitalism declines when they see companies getting special favors.

I wish ordinary people understood that big business and free enterprise are not the same thing.

Though I fully understand their disdain for certain big companies. Consider the way a select handful of big companies use the Export-Import Bank to obtain undeserved profits. How about the way big agri-businesses rip off consumers with the ethanol scam. Don't forget H&R Block is trying to get the IRS to drive competitors out of the market.

Big Sugar also gets a sweet deal by investing in politicians. Another example is the way major electronics firms enriched themselves by getting Washington to ban incandescent light bulbs. Needless to say, we can't overlook Obama's corrupt green-energy programs that fattened the wallets of well-connected donors. And General Motors became Government Motors thanks to politicians fleecing ordinary Americans.

The bottom line is that it's time to save capitalism from the rent seekers in the business community.

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