CRONY CAPITALISM

The Tea Party and Occupy movements can find common ground in opposing crony capitalism, says **Adam Creighton**

You can spend your own money on yourself, [then] you really watch out for what you're doing ... You can spend your own money on somebody else. For example, I buy a birthday present for someone. Well then, I'm not so careful about the content of the present, but I'm very careful about the cost. I can spend somebody else's money on myself ... [then] I'm going to have a good lunch! Finally, I can spend somebody else's money on somebody else. [Then] I'm not concerned about how much it costs, and I'm not concerned about what I get.

— Milton Friedman

Milton Friedman's pithy classification of the four ways to spend money is a salutary reminder of the economic and moral superiority of freedom over coercion. The first two ways, freely spending one's own money, produce the most satisfactory results. The owner of resources is in the best position to expend them efficiently, and has the most right to do so.

The incentives underlying these two ways of spending are also those that underpin capitalism. One's right and ability to spend the resources one rightfully acquires promotes effort, creativity and prosperity. Indeed, the 'welfare theorems' of economic theory that formalise the superior efficiency of the free market economy assume that households rationally allocate their incomes according to their own preferences.[1]

The other two ways to spend money, freely spending someone else's money, produce poorer outcomes because they result in waste, excess and even folly—either by dint of force (government) or institutional design (limited liability companies). Spending other's resources is the hallmark of socialism, that naive idea that wise, altruistic planners can distribute the fruits of individual efforts and endowments for the betterment of society.

The global financial crisis and the ensuing public debt crises in Europe and the United States are sapping confidence in the West's economic system and undermining its economic dominance. Both crises are born of equally malign incentives; in fact, they have arisen from the 'socialist' ways of spending that Friedman identified above. Recognising this and reforming the economic incentives that key social institutions face should be a public priority.

Public protests

The economic fallout of the global financial crisis sparked widespread anger, particularly in the second half of 2011. The protests' scope and durability were remarkable. Almost every Western city—from Vienna to New York, from Sydney to London—witnessed disruptive 'occupations' of some sort for days, often weeks. Protestors

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ranged from Tea Party activists to socialists, from young people to old. No particular event or person provoked these rancorous ructions; rather, they appeared to be animated by a collective disdain for the status quo that seemingly took about three years to manifest.

To be sure, it was easy to mock the protestors. Protesting about greed and inequality is akin to complaining about human nature. Moreover, they had no coherent alternative. Many of the budding *sans-culottes* were better termed *avec-ipods*: relatively well-off, educated and accessorised with the clothes and gadgets produced by the economic system they damned.

Nevertheless, their anger was understandable.

In OECD countries alone, the credit crunch and economic stagnation prompted by the financial crisis has thrown 15 million people out of work. Overwhelmingly, these job losses have occurred in industries far removed from the financial services and government sectors, which were in their own ways responsible for fostering and causing the crisis through their involvement in the US sub-prime securitised mortgage market. Moreover, government attempts to revive economic growth have proved largely ineffective.

Yet government financial regulators and politicians, who were paid to prevent such conflagrations, gained from the crisis with bigger budgets, more staff, and increased gravitas attached to their public statements.

Banks continue to gamble and profit on the back of state-guaranteed deposits, and enjoy improved access to cheap credit from central banks. Indeed, innovative monetary policies in Europe and the United States, known as 'quantitative easing,' appear to entail creating money out of nothing and handing it to large financial institutions hoping they will lend some of it—whatever the theoretical merits, it is not a policy likely to attract public support.

Recall Henry Ford's quip: 'It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.' The intense reporting of the global financial crisis is increasing the public's understanding of the banking and monetary systems. Meanwhile, the steady drip of 'bonuses' for directors in the banking and wider corporate world is Chinese water torture for taxpayers and shareholders.

Public support for financial institutions has also exacerbated the public debt crises in the United States and Europe. Take the United Kingdom. Its public debt has surged to £1 trillion since it started rescuing its banks in 2007; GDP per person there is now 13% lower than its pre-crisis trajectory. Only penal inflation, substantial tax hikes, or massive cuts to state welfare (the latter not necessarily a bad thing in itself) will be able to alleviate the fiscal burden. Even in countries with no immediate exposure to the crisis, such as Australia, government debt has leapt dramatically.

People might be forgiven for seeing socialism for the elites, and capitalism for everyone else.

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Pernicious incentives

The global financial crisis was undoubtedly a consequence of the third and fourth types of spending that Friedman outlined. The employees of large financial institutions (including the directors) were spending shareholders' funds (quite rationally) for their own short-term purposes: boost the stock price, meet short-term bonus thresholds, outbid other banks for staff who would likely leave soon after, etc. These firms were run like partnerships, but unlike partnerships, the managers had no personal liability.

Meanwhile, government officials sanctioned increased public debts and contingent liabilities without permission from taxpayers, the ultimate paymasters. And it shielded the biggest firms and their most senior staff from the bracing winds of 'creative destruction,' what Joseph Schumpeter considered the hallmark of genuine capitalism.

As Kevin Dowd has argued, the world's financial system was—and still is—riven with pernicious incentives that made a mockery of the sort of capitalism envisaged by thinkers from Smith to Hayek.[2] Bank shareholders, let alone their employees, could profit substantially from behaviour that ultimately put taxpayers at risk.

Besmirched capitalism

The response from the public to recent economic events has been a disaster for classical liberals.[3] Both the causes of the economic crisis and the unedifying aftermath are being blamed on capitalism.

The protestors should be agitating for more capitalism. Capitalism is animated by the first two ways of spending in Friedman's schema—being able to spend one's money on whatever one sees fit. It rewards talent and effort, and leaves the biggest rewards for those who risk their own money and time to bring goods or services to market that consumers can voluntarily buy. Think Henry Ford or Lang Hancock, Steve Jobs or John Symonds.

Capitalism is not about corporations being able to transfer their losses to taxpayers, as financial institutions and even car manufacturers and insurers have done in Europe and the United States. It is not about allowing senior employees to scrape off the profits of capital simply because they can—capital that has been supplied by others. Nor is it about armies of bureaucrats, corporate welfare, implicit guarantees for banks, or welfare states so pervasive and meddling they have dulled citizens' appetite for individual responsibility—all of which characterise Western economic systems.

The ubiquitous state

In fact, it is laughable that so many people still believe we live in an unbridled capitalist economic system, yet the belief is widespread. Whatever measures one takes—volume of legislation, quantity of government spending, quantity of regulations, the size of the bureaucracy—the state is more pervasive than it has ever been outside wartime. Through direct spending and creeping regulation, Western governments have permeated almost every facet of the economy.[4] The absolutist monarchs of seventeenth and eighteenth century Europe would be amazed if they could see the extent to which executive government permeates twenty-first century life.

Yet misguided essays like former Prime Minister Kevin Rudd's[5] perpetuate the ludicrous notion that Western countries exhibit unbridled capitalism, and that financial markets are unregulated.

Take the financial sector itself. No part of the economy had more highly paid, educated bureaucrats watching over it. It was far from 'unregulated'; on the contrary, a very detailed code of behaviour placing limits on banks' behaviour—know as the Basel capital accord—was designed and enforced by government. Central banks, and domestic and international financial and corporate regulators by the thousands, were watching over and analysing financial institutions, routinely liaising with them and their 'risk managers.' In fact, most central banks had financial stability reports that expressed little alarm in the lead up to 2008.[6]

An ideological rut

For too many years advocates of small government, both official and academic, have ignored the serious structural perversions in our economic institutions. Perhaps while the West competed with dictatorial socialism in Russia, any such problems were quite reasonably confined to academic discussion. But 'the end of history' in the early 1990s should have ushered in more economic introspection among Western liberals. Western democracy no longer had viable economic competitors.

Countless books lauding globalisation demonstrated how 'capitalism' was lifting millions out of poverty in the Third World.[7] Indeed, they were right that freer trade and growing consumer demand in the West were helping poorer counties develop. And they were right to point out that living standards in the West were rising inexorably.

But they failed to critically evaluate the nexus between finance and government. Commentators on the Right were quick to deplore public subsidies to individuals, but they were less contemptuous of direct and indirect government support for business. They appeared to be unaware of the behavioural consequences of permitting large corporations to operate with implicit state guarantees. Some commentators expressed reservations[8] but were drowned out by more triumphant analyses; in any case, such voices had no effect on financial regulation.

As John Kay has written, the 'subtle but important distinction between policies that support a market economy and that support the

interests of established large firms was not widely appreciated.'[9] Too many equated gargantuan growth and outsized remuneration in financial services (much of which entailed trading and dealing among financial firms themselves, as opposed to interaction with the real economy) with capitalism.

An economic tragedy

The attribution of the financial crisis to capitalism is worse than just a public relations disaster for liberals. It is an economic disaster for everyone, as it has fanned and promoted anti-capitalist interventions from government. The best way to promote prosperity and equity is to curtail government, limit regulation, and entrench institutions that permit individuals to profit (and fail) from taking risks with their own funds.

The 'solutions' to the crisis have entrenched bigger government and exacerbated the links between government and financial services. For instance, in the United States the *Dodd-Frank Act* has tightened financial regulation and designated a list of banks that are 'too big to fail,' exacerbating the very implicit guarantee that encouraged the crisis in the first place.[10] Although the new Basel III regulations, which are set to apply to all major banks, are an improvement, they suffer from the same problems the first two incarnations of those rules exhibited: arbitrary rules applied to diverse institutions which in turn feel less obliged to oversee their own risk profile.

Regulators have always had sufficient powers. But they naturally lack the ability to foresee the source of the next financial crisis. Take the International Monetary Fund. Its flagship *World Economic Outlook* noted as late as 2007 that the global economic outlook looked 'very favorable' and 'world growth will continue to be strong.' Even in July 2008, as the crisis was beginning to unfold it noted that the 'risks of a financial tail event have eased.'

Moreover, many regulators were and still are captured by the financial services sector. Many public service employees themselves hanker for the incomes and (supposed) prestige that senior 'bankers' command,[11] and are therefore reluctant to disrupt or crimp the industry in any meaningful way.[12]

The macroeconomic response has been just as bad. Most economists have agitated for Keynesian pump priming and artificially low interest rates to revive lacklustre economies. Yet Keynesian economic demand management had been widely discredited in the economic literature.[13] And low interest rates are considered by many to be responsible for prompting the crisis in the first place.[14]

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The limited liability company

If genuine liberals want to maintain credibility, they need to distance themselves from corporatist and managerial rent-seeking as much as from the labour and bureaucratic kind. They need to continually highlight that the financial crisis was borne of incentives that have nothing to do with free markets and capitalism.

One constructive way forward for liberals is to question whether the limited liability company is an appropriate legal form for companies with potentially massive systemic importance. Arguing for a greater role for owners of capital in our economy—shareholders—is an important way to encourage enduring support for capitalism. Adam Smith railed against the avarice and waste of the managers of the British East India Company, and he recognised how limited liability companies are a perversion of the capitalist system:

> The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private company frequently watch over their own ... Negligence and profusion, therefore, must always prevail, more or

> less, in the management of the affairs of such a company.[15]

Limited liability companies are a gift and construction of the state. They are clearly a contingent as opposed to a natural form of business organisation. These forms of business organisation promote risky business ventures because the maximum loss the owners can incur is the value of their investment.

They have been a boon for Western economies. Contemporary authors rightly consider them 'the most important organisational form in the world and the basis of the prosperity of the West in the modern world.'[16] Because owners have limited liability, companies foster economic activity that would not otherwise have occurred. They allow capital to come together from different sources to create large business enterprises, which in turn can enjoy economies of scale and scope that are passed onto consumers.

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But the separation of ownership and control is a source of inefficiency, as Smith recognised above.[17] Companies were not universally welcomed when they became more common in the late nineteenth century. At the beginning of Queen Victoria's reign, for instance, conservatives considered the company a disputed, legally suspect, and morally dubious organisational form.

Indeed, British economist Alfred Marshall believed honesty and uprightness on the part of senior employees can sustain the efficiency of companies. He might have added public support. Stellar growth in executive salaries since the 1980s, which in many cases have appeared to be limited only by the personal greed of directors themselves, reflect erosion of that moral code.

The global financial crisis and its aftermath have raised questions about whether the limited liability company is an appropriate organisational form for businesses whose failure could have economy-wide ramifications. One must wonder if, starting from scratch, society would have chosen to grant (at practically no charge) the shareholders of large financial firms limited liability and their employees no liability. Without a strong moral code fostering prudence and restraint among managers, the incentive for staff to gouge shareholders is strong.

I am under no illusions about how difficult it would be to alter these fundamental characteristics of our financial and corporate architecture. Nevertheless, it is incumbent on classical liberals to think about how to reform our economic and financial systems to ensure the best incentives are fostered. Certainly, moves to give shareholders greater voting power, especially in relation to remuneration, is a good idea. Perhaps shareholders of financial firms should also have liability that extends somewhat beyond their investment to better protect taxpayers for having to make up any losses of firms with implicit state guarantees.

Conclusion

The economic crises that have bedevilled the west since 2008 have drawn attention to the major defects of our economic system. Even if the distribution of income and wealth is of no concern to a classical liberal, *how* it comes to manifest itself is. If the current trend continues, whereby ever-increasing rent-seeking and bureaucratic and corporate parasitism contribute to ever greater disparities of wealth, Western democracies will leave themselves open to extreme elements that could remove the freedoms and liberties we still have.

The protestors struggle to articulate it. But they are not angry about inequality *per se*—they deplore an economic system that appears to allocate rewards arbitrarily and unfairly. And they are depressed by a political class that is too timid to acknowledge that the financial crisis was born of deep-seated and pervasive flaws in economic incentives—not by a lack of 'regulation,' or more laughably, inadequate government spending.

Endnotes

1 Gareth Miles, *Public Economics* (Cambridge University Press, 1995), 18
2 Kevin Dowd, 'Moral Hazard and the Financial Crisis,' *Cato Journal* 29:1 (Winter 2009), 141–166. In the economics literature, the term 'moral hazard' is used to describe changes in behaviour that can arise when individuals do not bear the full costs of their actions.
3 Whenever I use the term 'liberal,' I use it in the classical sense of belief in limited government and personal freedom.
4 Chris Berg, *The Growth of Australia's Regulatory State* (Institute of Public Affairs, 2008).
5 Kevin Rudd, 'The Global financial Crisis,' *The Monthly* (February 2009).
6 It is important to note that the Bank for International Settlements, an international body that coordinates central banks, was more sceptical about the soundness of the financial system than most other institutions, for which it deserves credit.
7 For instance Johan Norberg, *In Defense of Global Capitalism* (Cato, 2003).
8 Richard Bookstaber, *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* (John Wiley and Sons, 2007).
9 John Kay, 'A Good Crisis Gone to Waste,' *Prospect* (August 2011).
10 Peter Wallison, 'The Error at the Heart of the Dodd-Frank Act,' *Financial Services Outlook* (American Enterprise Institute, 2001).
11 I use inverted commas to reflect the range of jobs within banks that have very little to do with prudently lending out depositors' funds to households and businesses.
12 For example, the Reserve Bank governor's outsized salary is justified to avoid his being lured into lucrative financial sector roles.
13 John Taylor, et al. 'New Keynesian versus Old Keynesian Government Spending Multipliers,' *Journal of Economic Dynamics and Control* 34 (2010), 281–295.
14 William White, 'Ultra Easy Monetary Policy and the Law of Unintended Consequences,' *Working Paper 126* (Dallas Federal Reserve, 2012).
15 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edwin Cannan ed.) [1776] (London: Methuen, 1904), The Online Library of Liberty.
16 John Micklethwait and Adrian Wooldridge, *The Company—A Short History of a Revolutionary Idea* (Modern Library, 2003).
17 The 'principal-agent' problem is how economists describe the problems that emerge when ownership and control are severed.