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Crony Capitalism: Caricature or Category?

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CONTENTS

<i>Abstract</i>	1
1. Introduction	1
2. Crony Capitalism as a Concept	2
3. Crony Capitalism and Arm's-length Capitalism in the 'Theory' of Crony Capitalism	7
4. Crony Capitalism and 'Relationships'	13
5. Crony Capitalism and the Financial System	19
6. Cronyism and the Business-State Relationship	25
7. Crony Capitalism and the Internationalization of Capitalism	31
8. American Capitalism and Crony Capitalism: Polar Opposites or Synonymous?	34
9. Conclusion	43
References	46

List of Boxes

<i>BOX I</i>	The Diagnosis...	7
<i>BOX II</i>	Crony Capitalism: Some Recent Definitions	8
<i>Box III</i>	The Impersonality of the Market	15
<i>Box IV</i>		41
<i>Box V</i>	Whose Crony Capitalism?	43
<i>Box VI</i>	The Wall-Street Treasury Nexus and Free Capital Mobility	44

List of Tables

<i>Table-1</i>	Distribution of US Net Private Savings, 1950–2006 (Percentage Shares in Period Averages and Annual Values)	38
<i>Appendix Table</i>	Illustrative List of Financial Fraud Cases Settled by the US Securities Exchange Commission, FY 2003 to FY 2006	52

CRONY CAPITALISM: Caricature or Category?

*Surajit Mazumdar**

[Abstract: This paper, the first in a series on Crony Capitalism and Contemporary India, examines the conceptual meaning of the term crony capitalism, which has acquired considerable popularity since it was used as an explanation for the East Asian crisis. The paper argues that the conception of crony capitalism as a description of a distinct kind of capitalism associated with the State playing a key role in the allocation process suffers from serious deficiencies and therefore does not provide a suitable framework for understanding the business-state interaction. While the phenomenon that is called cronyism is very real, it is widespread in modern capitalism and not a peculiar feature of capitalism characterized by a particular economic policy regime. In fact, crony capitalism may lie at the very heart of the contemporary global capitalist order, and this crony capitalism may explain why the concept of crony capitalism has acquired such prominence in recent times.]

1. Introduction

Any search for the possible existence, and manifestations, of crony capitalism in the contemporary Indian economy must be premised on some degree of clarity on the basic question: What precisely constitutes *crony capitalism*? This essay is an attempt to come to grips with this term (the companion essay that follows will then turn to specifically the Indian context, past and present). Crony capitalism is not part of the standard set of concepts derived from economic theory that find use in the analysis of the real world. It is relatively recently, over the decade or so since the East Asian crisis, that it has found a place for itself in the official lexicon of economists, along with its many aliases. Its use

* The author is Professor at the Institute. This paper and its sequel are revised and extended written versions of a presentation made at the ISID Symposium on Crony Capitalism and Contemporary India held on 4 October 2007. Each of our presentations was a product of a semi-collective effort involving also my colleagues Prof. K.S. Chalapati Rao and Prof. K.V.K. Ranganathan. I am grateful to them for their inputs, empirical and theoretical, that I have taken the liberty of using in preparing these papers. I am also indebted to the guest speakers at the symposium—Prof. C.P. Chandrasekhar, Prof. Nasir Tyabji and Shri Jay Bhattacharjee—and all other participants at the symposium whom I am unable to name individually, for their suggestions and comments. For different kinds of editorial and technical support, I received the generous help of the ISID staff. It bears emphasizing, however, that none whom I have acknowledged here can be held responsible for either my conclusions or any errors of fact and logic in these essays. *E-mail:* surajit@vidur.delhi.nic.in

may have been mainly in relation to a set of overlapping groups of economies—developing, Asian, emerging market, transition, etc.—of many of which India is a member. Yet in the vast literature on the Indian economy, the expression crony capitalism is rarely found. Hence there is a need to clarify its meaning preceding any application to the Indian economy of the present.

This clarity about the conceptual meaning of crony capitalism—its content, its origins, and its consequences—is not, however, easily obtained from the existing literature. Most of the debates on crony capitalism that have accompanied its significant appearance in the economic literature have been less about the concept itself and more about its importance in explaining the East Asian crisis (and sometimes even the ‘miracle’ that stretched over a long period prior to the crisis)¹. The merits or demerits of the different views on that crisis will not be, however, our primary concern. Rather our focus will be more on the “theory” of crony capitalism that emerged in its background. We shall try to demonstrate that even though the phenomena that it apparently seeks to capture may be very much real, the status of crony capitalism as a rigorously defined and meaningful theoretical concept is far from clear. Ironically, even the social origins of its own rise to prominence in the realm of ideas can be attributed to the very same phenomenon called crony capitalism. This points towards the need to focus on underlying structural factors and the multitude of forces they give rise to, rather than merely on some selective epiphenomena.

2. Crony Capitalism as a Concept

The use of the expression crony capitalism is of course not the exclusive preserve of economists, who instead have appropriated something that was in general usage and remains so². Crony means a friend, a pal, a chum, or a buddy, and cronyism originally simply meant friendship. Cronyism eventually acquired a negative connotation in general discourse as a description of the phenomenon of the exercising of authority in a manner that favours friends or associates at the expense of merit (whatever is merit in the relevant context). Crony capitalism emerged then as a derogatory or derisive

¹ East Asian crony capitalism and the inherent instabilities of volatile capital flows have been rival explanations of this crisis. Proponents of the latter explanation saw crony capitalism as a mere smokescreen to cover for the main cause, necessary to continue justifying the absence of capital controls and financial liberalization in general: [Lee (1999), Bello (1998/99), Johnson (1999), Ghosh (2005)]. A third view has tried to relate the two rival explanations [Wei (2001)]. More generally, the relationship between the ‘quality’ of governance institutions and development has also come into the debate [Goldsmith (2005)].

² See Kahn & Formosa (2002) for an etymology of cronyism and crony capitalism.

description of the illegitimate use (or abuse) of public authority to favour businessmen or business firms who have close relations with those exercising that public authority.

Crony capitalism in general use is thus a means of caricaturising the relations between actors in the two different spheres in a capitalist society. One is the sphere of the economy, or the **market**. In this operate businessmen or capitalists—those who own or manage business firms engaged in a variety of activities with the object of making profits. The other is the realm of public authority, the **State**, in and through which public policies, rules, regulations, and laws are made and enforced. The key actors in this sphere are politicians, bureaucrats and other public officials, the judiciary, etc. Intrinsic to the working of the economic mechanism of capitalism is a role for the state because that mechanism has a variety of requirements that either cannot be completely met from within itself or cannot be ensured by its spontaneous operation. The very existence of the capitalist state in turn automatically implies its influence on the working of the capitalist economy³.

There can be no doubt that the study of the mutual interaction between the State and the economy or the market must always occupy an important place in the economic analysis of capitalism. If crony capitalism serves as a useful category for that purpose, then its appropriation by the discipline would be perfectly legitimate. But we know that the meaning of many words in general use do get substantially modified, amended, or at least more narrowly specified in the process of their conversion into theoretical concepts in Economics. Moreover, it is not always the case that a unique and universally accepted theoretical meaning emerges from such conversion. Efficiency, capital, or even capitalism can be put forward as examples of such concepts that are understood differently in different theoretical perspectives. It cannot, therefore, be *a priori* assumed that because there exists a generally understood meaning of crony capitalism, it is a readymade concept that can be simply borrowed of the shelf and put to use in economic analysis. Yet its meaning is often treated as being so obvious and well established as to not require a clear theoretical specification⁴. But apart from this general reason, there are also four

³ At the minimum this is due to the fact that it implies taxation and state expenditures. An inevitable economic role of the state also arises from the congruence of the international nature of the economic mechanism of capitalism and national states.

⁴ A prime example of this is the following. Nowhere in the 200 odd pages of David C. Kang's book that had the title "Crony Capitalism" [with a subtitle: Corruption and Development in South Korea and the Philippines] can be found a clear statement that would explain the choice of the title, its specific meaning, and the relationship of crony capitalism with the phenomenon of corruption [Kang (2002)]. Kang, however, is not the only one to have treated crony capitalism and corruption as being more or less synonymous.

reasons particularly associated with the term crony capitalism why a more careful approach is warranted regarding its conceptual use.

Firstly, crony capitalism encapsulates a loose collection of phenomena rather than one very specific one. Even those who treat its meaning as obvious admit this.

“...cronyism – a blanket term to refer to a number of related concepts: family and personal relations, bribery and corruption, patron-client relations, and collusion. In some cases cronyism involves political factions, groups, or informal networks, while in other cases it involves actual clans, families, or social groups.”⁵

Secondly, crony capitalism is one of those expressions that have the special quality of being amenable to be moulded to suit diametrically opposite and mutually exclusive perspectives on capitalism and the capitalist state. The use of public authority to favour selected businessmen can be considered by some to be nothing more than a specific expression of the essential role that the state plays in capitalism as a defender of the interests of capitalists. At the other end, the same thing can be seen as a consequence of the state extending its role beyond what is appropriate for capitalism to work efficiently. So is crony capitalism a quintessentially capitalist phenomenon or does it represent a deviation from ‘pure’ capitalism?

Thirdly, somewhat parallel to the above is the source of the clearly negative connotation attached to crony capitalism. Crony relationships between private businesses and those wielding public authority can and has been a subject of concern from two, not necessarily mutually exclusive, but also not necessarily equivalent, perspectives.

One kind of concern with cronyism emanates from its perceived implications for the functioning of markets and the competition process. From this perspective, cronyism is seen as something that can undermine the processes through which the market mechanism serves as an efficient allocator of resources and as an engine of growth. One of the necessary conditions for it to play such a role (the way in which **the market is said to serve the public interest or the general good**) is that capitalists/business firms are subject to the **discipline of the market**. Close ties between privileged businessmen/firms and public officials would, however, mean that public authority could be brought into play to strengthen the position of the former and protect them from the discipline of the market or competition.

⁵ Kang (2003)

An alternative concern with cronyism is related to its tendency to undermine the **public character of the functioning of any public authority** and the **disciplining of private capital by the state**. This requires no presumption that the market mechanism would spontaneously generate results in the general good. Rather, it presumes a definite role for the state in ensuring such results without however assuming that such a role would be automatically forthcoming. This role can take the form of regulation necessary to correct for any 'market failures' that may occur if the market mechanism is left to operate on its own. A more general disciplining role of the state is necessitated by the fact that the capitalist economy requires for its working a disciplining of private capital that cannot be enforced by competition—compliance with tax laws, environment regulations, labour regulations, etc.—and which also includes basic things like property rights since competing capitalists will always have an incentive to predate on each other's property rights. An even wider role for the State, one that is of particular relevance to countries seeking to overcome a legacy of economic backwardness, is as a developmental state. In this avatar, the state has to guide the dynamics of the capitalist economy towards the attainment of definite social goals that are not directly the goals of private capital itself. Whether the State can play each of these roles effectively depends among other things on its ability to insulate its functioning from the influence of sectional interests within private capital.

How different these two kinds of concerns can be may be illustrated with how differently regulation and its "capture" can be understood. On the one hand is the view held by a group of theories that have been clubbed under the broad head of "Interest Group Theories of Regulation"⁶. These see regulation to be always in practice to a greater or lesser degree captured by different interests so that cronyism inevitably goes hand in hand with regulation. The other kind of view is that held by the originator of the concept of the developmental state.

*"The possibility of a state being able to implement a successful industrial policy depends upon some precise political arrangements. In attempting to forge an industrial structure that the state believes is necessary for the good of the society as a whole—one that market forces alone will not produce—it must prevent what in the jargon of bureaucratic studies is called "agency capture." This refers to the tendency for special interests to bribe, disable, or dominate—in short, to capture—the state organs set up to control and direct them in ways that they do not want to go but that the state believes they must. "*⁷

⁶ Boehm (2007)

⁷ Johnson (2001)

Fourthly, the meaning of crony capitalism in the economic literature appears to have been actually modified from what is implied in the general sense of the term.

The use of public authority to favour selected businessmen always remains potentially possible in a capitalist context. Such favouritism may characterize some particular individual decisions or actions, which are then dubbed as symptoms of crony capitalism. For example, we can say that crony capitalism is at work when a government contract is given to a business firm with a close association with the decision-makers. Such use of the expression crony capitalism does not, however, imply that all or most of the important actions of the same authority share that feature nor even that all its actions can be completely explained solely or primarily in such terms⁸. This also holds even if such favouritism towards some businessmen is rampant for a period of time.

But from a description of a concrete phenomenon whose possibility always exists in capitalism, and which may exhibit itself to a greater or lesser degree in particular capitalist societies in particular periods of time, crony capitalism as a concept is converted into a description of a particular *type* of capitalism. This is the sense in which 'East Asian crony capitalism' was advanced as the cause for the Asian financial crisis, and it was suggested that the afflicted countries would be better off adopting an alternative model of capitalism, the American one to be precise (See Box I).

Crony capitalism has thus come to be counterposed to other kinds of capitalism to which that prefix crony is inapplicable. This metamorphosis of crony capitalism represents a big leap—which at one level broadens what crony capitalism as a generalization captures, while simultaneously restricting the applicability of that generalization. It is this concept of crony capitalism, and the “theory” behind it, that we now examine.

⁸ In the example previously mentioned, cronyism may explain who gets the contract but not why the contract exists to be awarded in the first place.

BOX I
The Diagnosis...

...weak financial systems and opaque relationships between government and the private sector greatly enhance the risks of crises in a more globalized world. Lack of transparency, too much lending on the basis of too many implicit public guarantees - the risks of these and other micro-economic distortions that are associated with the phrase "crony capitalism" were all brought home in a much more dramatic way in the financial crises in Thailand, Indonesia and elsewhere.

-US Treasury Secretary Lawrence Summers (1999)

And the Prescription...

Every country is unique, and deserves its own institutions. Nevertheless, I would have to say at this point that emulating the American brand of capitalism looks like a pretty good strategy.

- Jeffrey A. Frankel (1997)

Member of the Council of Economic Advisers in the second Clinton Administration

3. Crony Capitalism and Arm's-length Capitalism in the 'Theory' of Crony Capitalism

One of the reflections of the relative vagueness of the concept of crony capitalism is the lack of a clear outline of it that can serve as a reference point for discussion. The few formal definitions of crony capitalism that can be found in the economic literature (See Box II) bear a strong family resemblance to the general meaning of the term in as much as they focus on special relationships between the State and business. But they are inadequate for capturing what crony capitalism signifies as a system. For one, it would be odd if crony capitalism as a type of capitalism completely ignored crony relations that may exist between purely private parties. In practice the literature on crony capitalism does often refer to such connections or linkages between private agents in the economic sphere, even if they are related to the acts of commission or omission of the State.

Typologies of capitalism that incorporate the nature of relations between private economic agents do in fact exist. There are variations amongst them, and crony capitalism is not found in all of them as one of the types. Nor are conceptions of a performance-based hierarchy between the types universal⁹. Nevertheless, features that exhibit a strong resemblance to "cronyism" usually define types of capitalism described by expressions like 'relation-based' capitalism, oligarchic capitalism, or "co-ordinated market economy". Some of these are clearly aliases for crony capitalism, and East Asian

⁹ Hall and Soskice (2001) in fact argue quite assertively that their typology involves no hierarchy between the two extreme types, both of whom have demonstrated their capacities to "perform". In the view of others, the effectivity of the form is often related to the level of development.

BOX II

Crony Capitalism: Some Recent Definitions

A description of capitalist society as being based on the close relationships between businessmen and the state. Instead of success being determined by a free market and the rule of law, the success of a business is dependent on the favoritism that is shown to it by the ruling government in the form of tax breaks, government grants and other incentives.

- *Investopedia*

Crony capitalism is a pejorative term describing an allegedly capitalist economy in which success in business depends on an extremely close relationship between the businessman and the state institutions of politics and government, rather than on the free market competition, and economic liberalism. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks, and so forth.

- *Wikipedia*

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.

- *Stephen Haber*

...a crony capitalist system—a distinct institutional order characterized by the domination of informal elite groups that I refer to as economic-political elite networks (EPNs). Under crony capitalism selected economic elites receive preferential treatment and privileges, thus making support from the state rather than market forces a crucial factor for maintaining and accruing wealth.

- *Gulnaz Sharafutdinova*

and Latin American capitalisms often serve as the common examples¹⁰. Moreover, the characteristics of the opposite type to which these are counterposed, 'rule-based capitalism', 'diffuse capitalism', or 'liberal market economy' respectively, are also similar, and common to all these typologies is that the Anglo-American or Anglo-Saxon model of capitalism is cited as the archetypal historical example of this other type.

From these different typologies and the general discussion on crony capitalism, it is possible to construct that missing outline of what appears to be understood as a crony capitalist system, and also of its binary opposite¹¹. The central notion around which the distinction between the two is organized is the following: that the two capitalisms work

¹⁰ However, one of the prime examples given of a co-ordinated market economy, namely Germany, is not one with whom crony capitalism is usually associated.

¹¹ Li (2003), Morck, Wolfenzon and Yeung (2005), Haber (2002), Berglof (1999), Rajan and Zingales (1998), Hall & Soskice (2001), Allen (1999, 2005)

fundamentally differently because one is characterized by depersonalised arm's-length relationships, between market transactors and between those exercising public authority and businessmen, while these same relations are more 'personalised' in the other. The latter is a crony capitalist system, while the former may be called *Arm's-length Capitalism*.

It is easier to first outline the distinctive and mutually related features of the "ideal" arm's-length capitalism and then to bring out the departures from arm's-length interactions that take place in many directions and convert it into a crony system. These features could be summarised as follows.

- a) It has a strong **individualistic** character. The drivers of its economic mechanism, the centres of initiative and dynamism, are **self-interested** atomistic individuals rather than centralizing or collectivizing organizations or communities to which individuals are affiliated or tied. Interaction between individuals in markets is of an **impersonal arm's-length nature**, with transactions typically having a "one-off deal" character. When the nature of the transaction necessitates an ongoing relationship for some duration of time, **third party enforced formal contracts** are the norm. Organizations like firms are nothing but a nexus for a set of contracting relations between individuals. Individuals are not restricted either by external forces or their own norms of loyalty from pursuing their self-interest and giving rein to their initiative, which is subject ultimately to the test of the market. That is, their influence on the outcomes of relations they enter into based on the 'exit' option rather than their 'voice', and option whose exercise can also be the means of initiating new projects and innovations.
- b) The financial system too reflects the above kind of pattern with arm's-length transactions between the owners and the users of funds. The primary focus of the owners of funds is on maximising the return that they earn from advancing their funds to others. Stock markets play an important role in this system, through which "investors" provide finance for business activities. Business activities are organized through **widely-held free-standing corporations** run by "managers". The problem of the potential misalignment of the interests of these two groups of individuals (the agency problem of corporate governance) is kept in check by a mutually reinforcing combination of market and non-market mechanisms, ensuring that corporations are run to maximize shareholder value. Effective legal protection of the property rights of shareholders, transparency and disclosure requirements, and appropriate contracts linking managerial compensation to pursuit of shareholders interests allow corporate insiders to be monitored by investors, a task that can be made more effective and less costly by the pooling of funds with institutional investors. Product

market competition, the managerial labour market and its important component, the market for corporate control, provide the market based mechanisms of disciplining managers, which work through the price of shares reflecting the “true value” of firms. The protection of the interests of creditors in general in this system rests on a strong third party enforcement of contracts rather than any control being exercised by lenders over borrowers—the separation of ownership and control of capital being therefore its distinctive hallmark.

- c) An effective set of governance institutions that facilitate the market interaction of individuals and at the same time prevent private parties from using (or abusing) public authority to distort the process of private exchange in their favour. For this the State ensures effective protection of property rights of individuals and enforces contracts, blind to the identities of the concerned individuals, which requires among other things the exercise of public authority be based on rules rather than on discretion (**Arm’s-length principles in Governance**). This “hard” role of the State is institutionally constrained through “limited government” from extending itself to the abrogation of the property rights of individuals by the State itself (the commitment problem). In other words, the role of the state in the economy is a minimalist one.

In contrast to the above, crony capitalism is seen as being characterized by a double violation of arm’s-length principles—in market interaction and in governance.

In markets, transaction decisions—who to transact with and at what price—are linked to non-market and durable relationships and networks rather than being purely self-interest guided and price-determined. Instead of third-party enforced formal contracts, largely self-governed implicit contracts based on mutual trust are the norm. The pursuit of individual self-interest in the form of seeking the best deal is constrained by ‘relationships’ that individuals are tied into. The reliance on networks of personal relations in the conduct of economic activity are either constraints that individuals impose on themselves for historical and ‘cultural’ reasons or constraints that are externally imposed by inability of the State to be impartial or to create an appropriate legal framework where property rights are protected and contracts enforced. Business firms too in such a context gravitate away from being a nexus for market mediated contracts between individuals towards becoming organizations involving firm-specific internal structures based on networks of non-market ties. These are built around some notions of the firm as a collective venture and loyalty of individuals to it—with family control over firms often contributing to imparting this character to it.

Cronyism also finds its reflection in the financial system where “relationship-banking” or state control over the financial sector plays a key role in providing some favoured businesses a privileged access to funds, without a rigorous scrutiny of competing demands for funds. Corporate ownership tends to be heavily concentrated, with a few business families using pyramiding and other such mechanisms to acquire dominant equity stakes in a number of corporate entities without themselves providing the resources. This leads to the problem of *entrenchment* whereby these business families enjoy the benefits of control without ownership but are not subject to discipline and monitoring by the providers of funds, either directly, or indirectly through the market for corporate control¹². A weak property rights regime also suits these families.

The absence of arm's-length principles in governance is part a problem of institutional development and part a consequence of state intervention in the economy. Cronyism tends to thrive, it is argued, in an environment of discretionary decision-making, typically the case whenever limited government is not institutionally ensured and government plays an important role in regulating economic activity. Such state regulation creates enormous opportunities for granting favours to selected business elites who in turn develop a vested interest in such regulation and are prepared to devote resources towards that end—resulting in what is called ‘state capture’, the subservience of the legal, regulatory and policy environment to the interests of these elites. Crony capitalism, some argue, therefore, finds a congenial home when the political structure is more authoritarian, while electoral democracy creates the scope for the losers to organize in defence of their interests¹³.

A vicious circle thus exists whereby a closed circle of business elites can use their connections with those exercising public authority to earn large and exceptional returns, and then use a part of these returns to maintain such influence. This compels other firms also to devote resources towards buying influence¹⁴. Corruption thus tends to go hand in hand with crony capitalism. More fundamentally, cronyism is seen as a second-best solution to the commitment problem, the necessary assurance that has to be given to subset of asset holders that their property rights would not be violated by the state when a general assurance cannot be given to all asset holders by institutionally ensured limited government.

¹² Morck et al. (2005)

¹³ Haber (2002)

¹⁴ Desai (2007) emphasizes that this can be often completely wasteful in the sense that it may not even succeed in its objective.

The differences between arm's-length capitalism and crony capitalism are thus part behavioural, how economic agents behave in their interaction with each other, and part circumstantial-cum-institutional, the context in which economic agents act. The emphasis is usually on the latter in the shaping of which the State has a key role. But in crony capitalism this also means strong endogenous tendencies for the perpetuation of that context. Crisis is consequently considered by some to be necessary to trigger reform or correction of a crony system because of the need to overcome the endogenous tendencies for perpetuation¹⁵.

The differences between the two kinds of capitalism are also causally connected to their relative economic performance. It is contended that in arm's-length capitalism the price mechanism performs the co-ordination and resource allocation functions and works towards the attainment of maximum economic performance—in both the neoclassical resource allocation sense as well as the Schumpeterian innovation driven growth sense¹⁶. Competing transacting parties responding to price data, effectively ignoring the identities of their transacting partners, and seeking to maximize their individual benefit from every transaction, ensure that resources flow towards their best uses. The financial system is also 'efficient' in this sense, channelizing capital to its highest value uses and to the best managers and entrepreneurs. In crony capitalism, however, non-price factors and non-market co-ordination enter the equation in an important way, and firms are not subject to the rigours of market competition to the same extent as in arm's-length capitalism. Neither is price-data based decision making universal and nor are the prices emerging in such a context appropriate for guiding resources to their best uses. Resource allocation instead bears the imprint of the 'personalised' networks of relationships involving both market actors and public officials.

The intellectual lineage of the contemporary concept of crony capitalism should be obvious from the above. Shorn of all detail and put simply, crony capitalism in this worldview is capitalism where the free market does not rule completely, and arm's-length capitalism is that where it does, and the latter has a superior economic performance precisely on that count. For many, this would be sufficient basis for determining their standpoint on the concept of crony capitalism because the essential points of dispute between the "free-market" view and its opposing perspectives are clear and established even without this new animal being brought into the picture. But we shall not leave the matter at that but instead engage with the concept of crony capitalism

¹⁵ Tornell (2002), Haber (2002)

¹⁶ We ignore here the possibility that the attainment of maximum economic performance in both senses may not be compatible with each other.

outlined above on its specifics. Does a capitalism that conforms to the image of arm's-length capitalism outlined above actually exist in the contemporary world? Are the differences between it and crony capitalism more of form than of substance? Or, do the really important differences between these two lie elsewhere and not in the relative roles of prices and non-market relationships? These are questions that we shall attempt to answer in the next few sections.

4. Crony Capitalism and 'Relationships'

Obviously it would be absurd to talk of capitalism sans relationships. Any society and its associated economy involve relationships between individuals, and capitalism is no exception. In fact, as was pointed out by Marx long ago, capitalism develops the most extensive network of relationships even while making every relationship individuals enter into appear to them as the means towards a private purpose, leaving "no other nexus between man and man than naked self-interest, than callous 'cash payment'"¹⁷. The tendency for individuals to adopt such a *subjective* attitude towards their relations with others is, however, intrinsic to capitalism, produced by its conditions. How can crony capitalism be then different from arm's-length capitalism on this count?

In fact, a careful reading of the features of both arm's-length capitalism and crony capitalism outlined earlier would show that neither is characterized exclusively by one kind of behaviour. Rather both exhibit a co-existence of purely self-interested behaviour with behaviour that reflects their attachments to some larger social grouping. The difference between them is actually in the pattern of that co-existence. In arm's-length capitalism, the deviation of at least some individuals from pure self-interest driven behaviour is the essential condition for the State to play its due role and for arm's-length rule-based governance to exist, because such governance cannot itself result from the interaction of purely self-interested atomistic individuals. In crony capitalism on the other hand, so much of the behaviour is actually the use of personalised relations for the pursuit of self-interest, with some of the 'personalised relations' (for example, between the bribe giver and the taker) being potentially entirely a product of self-interested mutual interaction. The theory of crony capitalism thus throws up a paradox. On the one side we have a capitalism where in the economic domain individuals are by nature highly individualist, self-oriented, and calculating, but dramatically change character when they become personnel in the institutions of governance such that they are immune to the influences of self-interested capitalists. On the other side is a capitalism where family, community, the organization, and other kind of collectivities are attached

¹⁷ Marx & Engels (1999), p. 91

value by individuals when they operate in the economic domain, but self-interested bribe-taking by individuals completely corrode the decision-making processes of the institutions of governance.

Three related problems with the theory of crony capitalism underlie this paradox. The first is that the only relationships it recognises as essential or inherent to the economic mechanism of capitalism are the transaction relations between individuals in the market. Business firms thus disappear from the picture as individual actors of any significance in a capitalist economy, even though a large number of market transactions in *any* capitalist economy are entered into by capitalist firms and not by individuals. The significance of this omission lies in the fact that while individuals may be too numerous for either co-ordination of their actions or self-consciousness about their mutual effects on each other to affect their behaviour, the situation is different with the comparably fewer number of firms. This in turn contributes to the second problem, namely the creation of a false dichotomy between depersonalised self-interest driven and 'personalised' 'relation-based' market interaction by ignoring the essential connection between depersonalisation and self-interested behaviour. The third problem is that though the theory of crony capitalism is not about the purely economic processes of capitalist society isolated from the realm of politics and the State, missing from it is any conception of the processes and the dynamic of that parallel realm and of its mutual interaction with the economic realm. In that context a particularly important omission is the lack of recognition of the fact that though their members may participate in market interaction as individuals and such market interaction may often be between those who are members of *different* rather than the same group, there do exist different and conflicting social groups in capitalism¹⁸. In this section, we shall concentrate on primarily the first two problems and only briefly touch upon the third, which is the subject matter of a later section.

To begin with, let us consider the meaning of the impersonality of the market with reference to Weber's description of it in the accompanying passage (see Box III). Three separate dimensions of the depersonalisation of market interaction are identifiable in that passage. In each case, however, depersonalisation may not in all circumstances be consistent with the pursuit of self-interest.

¹⁸ By these one is referring not merely to social groups that are case-specific additional elements of a concrete capitalist reality but to those—capitalists, workers, national communities—that are creations of the conditions of capitalism itself and therefore general.

Box III
The Impersonality of the Market

“The reason for the impartiality of the market is its matter-of-factness, its orientation to the commodity and only that. Where the market is allowed to follow its own autonomous tendencies, its participants do not look toward the person of each other but only towards the commodity; there are no obligations of brotherliness or reverence, and none of those spontaneous human relations that are sustained by personal unions....Market behaviour is influenced by rational, purposeful pursuit of interests. The partner to a transaction is expected to behave according to rational legality and, quite particularly, to respect the formal inviolability of a promise once given. These are the qualities which form the content of market ethics. In this latter respect the market inculcates, indeed, particularly rigorous conceptions. Violations of agreements, even though they may be concluded by mere signs, entirely unrecorded, and devoid of evidence, are almost unheard of in the annals of the stock exchange. Such absolute depersonalization is contrary to all the elementary forms of human relationship.

...

It is normally assumed by both partners to an exchange that each will be interested in the future continuation of the exchange relationship, be it with this particular partner or with some other, and that he will adhere to his promises for this reason and avoid at least striking infringements of the rules of good faith and fair dealing. It is only this assumption which guarantees the law abidingness of the exchange partners. Insofar as that interest exists, “honesty is the best policy”. The proposition, however, is by no means universally applicable, and its empirical validity is irregular; naturally, it is highest in the case of rational enterprises with a stable clientele. For, on the basis of such a stable relationship, which generates the possibility of mutual personal appraisal with regard to market ethics, trading may free itself most successfully from illimited dickering and return, in the interest of the parties, to a relative limitation of fluctuation in prices and exploitation of momentary interest constellations.”

-Weber (1978), pp. 636–637

The first of these dimensions is the *lack of awareness or concern with the identity of the other party being transacted with*. This is related to the notion that self-interested individuals would be concerned with what is the commodity or price being offered and not who offers it. But what happens when the commodity being offered by different potential sellers cannot be assumed to be homogeneous—and perceptions of the 'quality', of the commodity being offered are linked to the identity of its seller/maker? What happens when the value attached by individuals to a particular commodity is related to the identity of the seller (expressed through things like brand name)? Is not in each of these cases knowledge of the identity of the transacting partner and choices based on such knowledge central to the pursuit of 'self-interest'?

The second element of depersonalisation that Weber highlights, which is actually at odds with the notion of depersonalisation underlying the theory of crony capitalism, is the

uniform *adherence to a market ethic* by all transactors regardless of who they are transacting with. It involves eschewing short-run opportunistic behaviour, and the only incentive individual transactors have for observing it is that it allows them to keep participating fruitfully in the market. Such eschewing, however, is incompatible with the 'one-off' deal approach. Weber himself recognised that adherence to market ethics cannot be guaranteed when transactors are driven by self-interest, and that a stable and more personalised adherence to this market ethic may be necessary in some circumstances. But in either of these circumstances, when transactors eschew short-run opportunistic behaviour to continue participating in the market or when they hope to continue the relationship beyond the immediate transaction, can such eschewing be considered as going against self-interest given the reasons behind it? In other words, either possibility can be related to essentially the same motivation.

Moreover, whether the eschewing of short-run opportunistic behaviour is self-enforcing in nature or prevented by entering into appropriate contracts enforced by a third party, it is incompatible with lack of awareness of the identity of the one being transacted with. The penalty of non-adherence to the market ethics cannot be imposed unless the identity of the violator is known.

The final aspect of depersonalisation is that in market interaction the actions of the transactors are *not motivated by the idea of favouring the other party* in a transaction. Such favours again would be impossible with a one-off deal approach. But if the provider of the favour expects receiving some return on that in the future or over the long-run through repeated transactions with the same party, then such behaviour can neither be deemed to be going against one's interest nor even to be motivated by the idea of doing a favour.

What emerges from these then is the following. The depersonalisation of market interaction in capitalism has a one-sided partial character. The primary subjective motive with which economic agents enter into market transactions is self-interest, and not any other personal relationships that may exist between the parties. But whether the persona of the other party in any *individual* transaction will be considered entirely irrelevant, and whether the transaction will be approached as a one-off deal or not, is contingent, and contingent not despite but because of self-interest.

Even in theoretical work that does not fundamentally challenge the micro-theoretic tradition of neoclassical economics, there is recognition that 'social relations' and self-interested behaviour can go together, that social relations between individuals other than impersonal market relations may actually be deeply involved in economic activity. It has

been argued that even while conforming to the rational choice calculus, economic agents leverage and use their networks of social relations that may exist independent of economic interaction, may be the result of repeated economic interaction, or may be consciously cultivated for furthering that very purpose, and some economic transactions result from or become possible only because of such relations¹⁹. It has also been argued that such personal relations may facilitate the “efficient” working of the capitalist market in a number of overlapping ways—by reducing transaction and information costs; by generating trust and normative pressures to eschew opportunistic behaviour that could solve problems associated with asymmetric information or reduce agency costs; by facilitating efficiency enhancing coordination, etc. Indeed, the currently fashionable idea of “social capital” is built on precisely such notions and one might be excused for experiencing some difficulty in distinguishing between social capital and crony capitalism²⁰.

Shifting attention from individuals to the mutual interaction of business firms would further highlight the limits of depersonalisation of the market. In the case of firms, however, the focus cannot entirely be only on the exchange transactions between firms, because firms are also potential competitors and collaborators. While all that has been said previously about the limits of depersonalisation in market interaction apply equally to transactions where firms are involved, there are in addition other elements of ‘personalisation’, which are more likely when firms are involved. There are certain kinds of such relations possible for which the adjective crony would be eminently suitable, and which would have similar consequences as those between public officials and businessmen. For example, the formation of a cartel by a group of firms is similar to the grant of a monopoly to a favoured businessman by the state. In general, it is well recognised that in any contemporary context the completely depersonalised and atomistic one-off deal approach is unlikely to be observed by firms in their relationship to each other. Oligopolistic rivalry is based on awareness of the existence of rival firms, and collusion between oligopolistic firms represents an alternative potential response to the same market situation. Like collusion, mergers and strategic alliances between firms, the replacement of impersonal market exchange with internal transactions through vertical integration, or long-term contracts between firms, are all commonly found responses of profit-seeking firms to competition and uncertainty, and each of them involves ‘relationships’.

¹⁹ See Biggart and Castanias (2001), Uzzi (1997, 1999), Granovetter (1992), Piore (2002), McGinn and Keros (2002), and Cetina (2006)

²⁰ ‘It is not what you know but who you know which matters’—this is the simple definition of social capital. See Harris (2001) and Fine and Lapavistas (2004) for critical commentaries and Fukuyama (1999) and World Bank for more sympathetic treatments of social capital.

The entry of an element of 'personalisation' into the economic interaction between self-interested agents is therefore not something inherently contradictory. Rather, such personalisation must be considered in many instances a normal counterpart of that interaction, and the kind of instances that have been highlighted here would make it obvious that it is quite prevalent in any contemporary context. That personalisation may be at times effected or facilitated through a variety of non-market relationships that may exist independently, without those other relationships being either the principal *cause* of that personalisation or even its necessity. Indeed, such non-market relationships can also be formed and even be weakened by forces generated from the economic interaction between individuals and individual entities—business associates can develop friendships with each other while family relations within business families can break down. It is in fact intriguing that the theory of crony capitalism does not usually highlight that the tendency for splitting up of firms, the breaking up of a single individual market entity into many such entities, tends to go hand in hand with family control of firms, while the opposite tendency characterizes the situation where managerial control is prevalent and an active corporate control market exists.

If interaction that is not impersonal in the extreme sense required for pure “arm’s-length capitalism” to exist is so intrinsic to the working of the economic mechanism of modern capitalism, particularly when the relations between firms are taken into account, where does this leave the conception of crony capitalism as the opposite of arm’s-length capitalism? One possible conclusion is “*cronyism*” in the economic domain is inherent to capitalism. If such a conclusion has to be avoided, then one requirement at least is that some basis other than the feature of mere personalisation has to be found for separating out those relationships whose operation may be deemed as “cronyism”.

Even on other more general grounds, the use of cronyism as a catch-all term for the influence on decision-making of a diverse set of personal connections may be questioned. The origins of these relations, the nature of their mutual interaction with the capitalist economy, their modes of operation, and conditions of entry into, and their operational consequences, can be different in important ways. In fact, the extent of individualisation or personalisation associated with the influence of these on social interaction can itself vary. In the Indian context, for example, caste identities can come into play (to favour or exclude) in many situations without a direct prior personal connection between the relevant parties, something which cannot be said to be true for family connections²¹. True that the differences between these different kinds of social relations are not important

²¹ Social status of the individual concerned, and not merely personal connections, can operate even in a purely capitalist context

when they are entirely incidental to the process working through them. But in such cases the relations are also not explanatory factors of that process. Where these relations become important as independent or additional factors, their differences could be important. One such area where they are important is when they act as influences on the decisions and actions of public officials. It would be absurd, for example, to treat the phenomenon of corruption influencing such decisions as equivalent to the influence of economic nationalism, even though for different reasons both of these could qualify as instances of 'cronyism'²².

5. Crony Capitalism and the Financial System

In the theory of crony capitalism, the differences in the nature of their respective financial systems are of such critical significance in shaping the differences between crony and arm's-length capitalism that they can virtually serve as proxies for the entire systems. This is not surprising given that in one it is the price-mechanism that is supposed to work in allocating savings, while non-price factors matter in the other.

As is well known, capital markets are different from standard commodity markets because all credit transactions are characterized by the problems of asymmetric information and the risk of default²³. Therefore the price (interest) rate cannot play the same role in loan markets as prices do in spot exchange markets for homogeneous commodities, and an element of rationing always characterizes such markets. Stock issues may not involve either any fixed commitment to pay a return, or any repayment of the principal. But the investor advances funds by acquiring equity only on expectation of a return in the form of dividends and/or capital gains, which in turn depend on how the controller of these funds utilises them. The so-called agency problem of corporate governance is the form in which equity financing also faces the same problems as loan financing. Further, in case of equity financing the rate of return to the advancer of funds has only a partial direct relationship with the rate of return on the real assets acquired with these funds. Partly the former return is dependent on the movement of expectations influenced asset prices in the secondary market.

In fact, transactions involving transfer of funds are classic cases of exchange transactions where it is impossible for at least one party to ignore the identity of the other transacting party. They are not spot exchanges but involve transactions over time whereby one party, the advancer of funds, can only exercise his/her subsequent claim on the other by

²² Nationalism, an ideology that is very much a product of capitalist conditions, involves a sense of a community.

²³ Greenwald & Stiglitz (1991)

knowing his/her identity. The reassurances that their owners need to part with their funds, have to always work through a clear knowledge of the identity of the borrower—whether that reassurance comes from ‘trust’ in or ‘reputation’ of the receiver, or by being able to legally enforce the contract. In general, if it includes finding the ‘right people’ to provide funds to, the ‘efficiency’ of the financial system is incompatible with credit market transactions where transactors ignore the identities of those in whose command they place their funds.

So what is it about the architecture of the two kinds of financial systems that enables price guided allocation in one despite the problems outlined above, but prevents it in the other? Financial systems can of course be categorised on different bases related to their different features²⁴. But it is argued that there tends to be a clustering and apparent complementarity of features that makes for financial systems being broadly of two types, with the basic distinction between them lying in “the extent to which investors get involved in investment decisions in individual firms, the degree of separation of ownership and control”²⁵. An arm’s-length financial system and its ‘relational’ or ‘control oriented’ opposite type are distinguished by the specific methods through which these two systems deal with the problem of information asymmetries and divergences of interest between the providers and users of funds.

According to such a classification, control oriented systems are those where the problems of monitoring and information are resolved or dealt with through some form of direct control being exercised by the lenders over the borrowing firm’s decision-making. This being contingent on the lender accounting for a large part of the funds received by the firm, concentration in the ownership of debt and equity is associated with this system. Such concentration in turn typically has to be achieved through pooling of funds in the hands of financial intermediaries, who therefore occupy an important position in this system. In contrast, an arm’s-length system relies on third party enforced contracts, information disclosure requirements, and the market for corporate control, for dealing with same problems that are resolved in control oriented systems through retention of partial control with the owner of funds. The important requirement here is that funds have to be advanced through an asset that is marketable and linked to control and hence the importance of the stock-market and equity financing in this system. The role of the investors or providers of funds is deemed to be relatively passive—with their main focus

²⁴ Typically classifications are in terms of binary opposites of the following kind: Bank-based versus Market-based or Relational versus Arm’s-length or Control oriented versus Market oriented systems

²⁵ Berglof (1999). Fohlin (2000), however, makes the argument that there is great diversity between the financial systems of countries.

being on the return to them for making available their funds, in the form of interest (in loan markets); or expected dividends and capital gains from holding equity. Even in the market for corporate control, their role is passive and limited to making the equity shares held by them available to the highest bidder. In other words, while the interests of investors exercise a direct influence on the users of their funds through 'voice' in a control-oriented system, in arm's-length systems the same influence is indirectly exercised through the availability of, and willingness to exercise, the 'exit' option.

From this kind of reasoning, a linkage is drawn between control oriented or relational financial systems and crony capitalism, the link being a two-way one²⁶. Relation-based or crony financial systems are at one level seen as a response to the absence of a proper third party contract enforcement mechanism; at the other end, control oriented finance also tends to breed crony 'relationships' because the provider of funds develops an interest in ensuring that the recipient business firm stays afloat. As both lenders and creditors are restricted in such a system in their choice of market partners, price signals play little role in guiding allocation decisions. In contrast, in arm's-length financial systems, the primary focus of investors is supposed to be on risk and return, and they provide their funds to whoever can offer them the highest risk adjusted rate of return. Price signals therefore guide decisions and ensure that resources flow towards their most productive uses.

But is the story of a purely price-guided allocation of resources in an arm's-length financial system a plausible one? Before accepting such a conclusion, one may note that not one but a number of problems characterize the theorising that is the basis for this conclusion.

Firstly, it is almost an assertion rather than an established fact that if there exists a strong third party contract enforcement mechanism and a market for corporate control, the intrinsic differences between transactions in capital markets and those in standard commodity markets basically disappear. But do they?

Considering loan markets first, the protection of the interests of the saver-lender through an enforceable contract would itself involve conditions being imposed on the borrower like provision of secondary collaterals and margin requirements, the ability to meet which would not be possessed in the same degree by different potential borrowers. Moreover, even if opportunistic behaviour is entirely preventable by enforceable contracts, the lender would need further reassurances that the funds provided are likely

²⁶ Rajan and Zingales (1998)

to be used judiciously. This is because of the dependence of the ability of the borrowing firm to meet its obligations to lenders on the returns earned from the use of funds borrowed. These returns are subject to the inherent uncertainties associated with investment process in a capitalist economy. Further, if the ability to pay the price for funds (interest) depends on returns earned from their use, no borrower's demand is subject to a 'budget-constraint'. More than one borrower may seek the same funds for the same purpose and at the same price. In other words, lenders have to discriminate between the 'quality' of the managements of different firms, including the quality of their 'judgements' regarding the potential returns from their planned investments.

These problems are further aggravated by the fact that all investments in any period are not independent investment projects. A large part of investment derives its rationale and its prospects of earning a return from being expansions or additions to existing investments of firms, from whom they cannot be detached. In addition, if firms have substantial market power, which could also be gained through crony connections with each other or with state officials, then that would increase the rates of return and reduce the riskiness of their investments. Unless other factors prevent it, a return oriented financial system would direct resources towards such firms.

Thus, even if contracts are enforceable, the credit allocation process will involve a screening whereby a host of non-price factors such as own assets and resources of the borrowers, their track-records and reputations, their existing business position, etc., will come into play. Most of these factors have no direct relationship with the intrinsic rates of return of the investments that the credit provided would finance. These factors play an even greater role in the case of equity finance where the transfer of funds is permanent while the discretion enjoyed by the recipient in determining the return in the form of dividend is much greater, as is the uncertainty about the return in the form of capital gains. The market for corporate control can hardly play the role of guarantor, its operation in the manner required belonging itself to the realm of uncertain future outcomes. These make equity financing impossible to use at times, and the widespread observance of the empirical phenomenon of equity financing being both highly concentrated and accounting for a very small proportion of investment financing is therefore not surprising.

What these suggest is that irrespective of the nature of the financial system, there is an inherent bias in the finance allocation process that favours older, established, and dominant firms. If such selectivity and favouritism is deemed 'cronyism', then cronyism is inherent to the working of the capitalist financial system, and not peculiar to the relational one. The difference between the two systems may only lie in the degree to

which this cronyism assumes an *apparent* personalised or depersonalised form. The inherent bias against new firms in such a situation in fact can only be moderated by 'relationships' of some form because these have to compensate for the absence of other impersonal qualifications and strengths that can only be acquired over time. Even venture capital is a form of relationship financing that is prominent even in arm's-length financial systems²⁷.

A second problem is that the bias in the allocation process referred to above is actually only part of the story because it is limited to the bias that affects the allocation of funds that actually enter market supply. If focus is centred on firms rather than individuals, it is immediately clear that there is another part of savings, retained earnings of firms, which are allocated on a pure 'relationship' basis whereby they are the exclusive monopoly of the firms whose retained earnings they are. This bias in fact tends to be greater in an equity-oriented system than in a debt-oriented one for two reasons. For one, equity financing involves a permanent transfer of funds so that the finance for replacing assets used up need not be accessed again from the market. And every successive round of equity financing keeps on increasing the amount permanently transferred from the realm of individual decision-making to the control of corporate managements. In the case of debt-financing, however, there has to be a repayment of the principal which has to be recovered by fresh borrowing. But that process also means that funds once accessed from the market return to the market and are potentially therefore mobile across firms, and are not structurally inhibited from flowing even to new firms. Secondly, if all production activity is undertaken by firms, the relative importance of external to internal financing of investment will depend on the distribution of savings between personal savings and corporate savings. The greater the proportion of equity financing, the greater would be the tendency for this distribution too shift increasingly towards corporate savings with each successive round of equity financing, if the returns to investors are more in the form of capital gains rather than dividend so that the dividend per unit of equity capital raised is lower than the interest rate applicable to debt financing.

Finally, there is an additional problem with centring the classification of financial systems around the degree of separation of ownership and control. A distinction needs to be made between the separation of ownership and control of *capital* and that of corporations. The former would result from the capital agglomeration process, irrespective of whether such agglomeration is done initially by intermediaries or by

²⁷ Rajan & Zingales (1999) argue that venture capital works well only because the parallel existence of markets offers an eventual exit option for the venture capitalist. But venture capital is not inconsistent with a bank-based system either.

business corporations directly and irrespective of whether debt or equity instruments are used to achieve agglomeration. In either of these cases, managements, of financial intermediaries or of corporations that undertake real investments, would exercise effective control over the agglomerations of capital and not the many *individual owners* of that capital. If so, separation of ownership and control of capital could equally be associated with a context of concentrated ownership of equity and debt of corporations and intermediary-based financing²⁸.

Should such great significance be then attached to the fact that control over the capital owned by others in one kind of financial system is vested in managements of financial firms and in the other with managements of real sector firms? Both intermediaries as well as investing corporations are business entities that in fact have many things in common. Both acquire capital by producing financial assets for others. Both are agencies through whom the capitals of many individual owners are activated in profit-seeking as larger unified masses of capital. Both can use the capital at their command to acquire some control rights over assets owned by other corporate entities, by the takeover route in case of investing corporations and by becoming 'institutional investors' in the case of financial intermediaries. Even the fundamental difference between them, that intermediaries use the capital at their command to acquire financial assets while corporations acquire real assets, from their own point of view may be nothing more than a matter of relative specialization in business activity. These specializations may not even be maintained by firms in the absence of legal constraints.

This only serves to emphasize that crony relations in the financial system that are in fact possible are those between the managements of these two kinds of business firms. The potential and incentives for such crony relations arise on account of the fact that their respective profit-making activities are intertwined in many ways. This intertwining, however, is not limited to the case where they have direct interaction as providers and users of funds, typical of the so-called 'relational' financial systems. Institutional investors in market based systems can also exert control over corporate managements and collude with them. When intermediaries directly finance investments and particularly if this takes the form of illiquid debt financing, a reasonable return on actual investment is a necessary condition for the intermediary to be able to earn a return on its financial assets and the controlling power of the intermediary should be expected to be directed towards that. But when equity financing predominates, the control exercised by

²⁸ Concentration in the ownership of equity can, however, be achieved even without the involvement of financial intermediaries, for example, through cross-holdings between companies.

an institutional investor may be through stock acquired through secondary purchases and therefore not based on any actual financing of investments. Moreover, in the absence of a direct relationship between the rate of return on the real investments by the corporations and the appreciation of the market value of the institutional investors holding of stock, these investors would be more likely to use their control to influence decisions affecting equity prices and to gain privileged advance access to information that could influence these prices. The availability of an exit option would only reinforce this tendency. Intermediaries also would enjoy a strong element of market power in the markets for financial assets and the scope for collusive behaviour between different intermediaries would also be a possibility.

In other words, in intermediary-based financing systems, some business enterprises may benefit from crony relations in gaining access to funds for real investment. In market-based financing systems, the benefits of crony relations may be substantially derived by financial entities relatively independently of the real investment process. Cronyism in the financial system could, therefore, be more dangerous and distortionary in the latter case.

6. Cronyism and the Business-State Relationship

Like in the case of the arm's-length financial system, pure arm's-length governance may also be a fictional scenario in at least modern capitalism. The theory of crony capitalism fails to properly appreciate either the intrinsic character of the mutual interaction between the world of business and that of the State or the depth and ambit of this interaction. Its individual centric approach lies at the root of this, because a proper understanding of the business-state interaction requires first and foremost a recognition that while this interaction does involve individuals, neither side of it can be understood purely as aggregates of individuals.

Every capitalist/business firm is one amongst a group. Their common situation on the one side pits them into competitive relations with each other whereby their individual interests may often collide. Despite this, and even because of it, capitalists also constitute a distinct "community of interests" in relation to the rest of a capitalist society²⁹, particularly the working class. In between these two extremes, of individual capitalists and the capitalist class, can usually be found numerous 'collectivities' of capitalists based on common group interests—common industry, common size category (small and big), common type (industrial and financial), etc.—between and within whom there may be

²⁹ That the two are not in conflict was emphasized by Marx by positing competition as the internal mechanism in capitalism that enforces the logic of capital on each capitalist [Marx (1993)].

competition. Capitalists not only exist as social groups at different levels, but also operate as such. Also, typically, they are amongst the most organized groups in capitalist society, and one of the key features of such an organised character is provided precisely by its orientation towards influencing the State and public authorities.

Whether they are 'reactive' or 'proactive' in the process; whether it is undertaken through this or those means or assumes this or that form; and whether it is for protecting or securing individual benefits or collective ones; the attempts of capitalists to influence public decision-making should be expected to be incessant. Capitalists as merely passive spectators of the public decision-making process that can affect their profit-making prospects can only be a result of constraints that circumstances impose upon them and not their inherent behavioural feature. This interest of capitalists in the 'affairs of the state' cannot also be a minimalist one because directly or indirectly, there is very little within those affairs that capitalists, individually or collectively at different levels, would not have a stake in. From overall economic policy to matters of detail at the implementation level; from 'rules' framing to the rule enforcement processes; from decisions and therefore to the selection of decision-makers; everything could come within its ambit.

The entity towards which all this influencing activity is directed, the State, also has a dual character. On the one hand there are individuals who man the apparatus of the State and through whom the State works. Formal decision-making powers would be distributed between them and to that extent the State is never a completely monolithic entity in regard to all its decision-making activity. But neither is it its complete opposite. For one, the different individuals are bound together in some kind of hierarchical and multiple-organ structure of the State, and operate within its constraints. More fundamentally, the State in capitalism always comes into being through the historical process that begets a capitalist society. It consequently acquires coherence as a state only by virtue of being a *capitalist* state and a *national* state (the latter we discuss in the next section). This imparts to the state, independent of its specific structure or of the specific individuals within it, a definite broad character that both underlies and bounds its actions such that it functions as an overseer and preserver of the capitalist social order. With regard to decisions of public authorities then, one must make a distinction between those that have to be attributed to the *State* and explained with reference to its character and role, and those that can be related to the choices, preferences, and motivations of particular individual state personnel. The influence of capitalists would, however, operate on both broad categories of decisions but in different ways.

The capitalist character of the State does not, however, have to mean that it is merely a pocket organization of capitalists. Discharging its role as the preserver of the capitalist order, a role that has both political and economic dimensions, can often involve the State having to save capitalism from itself, albeit within its limits. The coercive power of the State may therefore be directed against capitalists just as it may be against other segments of society. When the State, for example, enforces minimum wage laws, tax compliance, trade union rights, etc., it does not do so because capitalists want these but because capitalism needs these. The imperatives to which the State responds are thus not identical to those of capitalists whose outlook cannot beyond limits transcend their private interests as capitalists. Yet, while this may mean that such opinion is not always decisive and in some cases cannot be because of conflicts between capitalists themselves, every State is likely to attach significant weight to the opinions of the nation's capitalists simply by virtue of their dominant position in the social and economic structure of capitalism. This position in fact gives private capital a potential leverage over the State, a power that can be impersonal in nature, because any broad objectives with an economic angle that the State may even independently be interested in pursuing would involve private capital or segments of it playing some definite role.

These broad generalizations about the business-state interaction in capitalism still leave sufficient scope for variations in the specifics of that interaction. The question, however, is: Can crony capitalism and arm's-length capitalism be properly distinguished on the basis of these possible variations? The theory of crony capitalism does not take into account the totality of the business-state relationship in capitalism. As such it restricts the concept of 'state capture' to a narrow sense where it indicates the relatively privileged position of some firms *within the category of business firms* to be able to manipulate the public decision-making process in their favour. This is thus associated with the existence of *inequality of influence*, which results in a *selectivity or discrimination* in the granting of favours to businesses, or the *dominance of sectional over collective interests*³⁰. But it is clear that state capture can also be given a broader meaning, one that takes into account the existence of other sections in capitalist society. The degree of state capture in this sense would reflect the extent to which the State is *captive to the interests of private capital relative to those of other sections*.³¹ Clearly these two conceptions are not identical. But they can

³⁰ Hellman and Kaufmann (2002), Desai (2007). Professor Tyabji had at the symposium suggested the latter as a possible working definition of crony capitalism.

³¹ The varieties of decisions that the State or State authorities take and which capitalists may have an interest in influencing, cannot also be seen as completely independent decisions, even when they are taken by different entities, nor are they all of equal significance and magnitude. Some decisions taken by one authority may be conditioned by others taken by other authorities. For example, decisions related to the process of enforcing rules have a relationship with the rules

contd...

overlap. The narrow concept of state capture does not necessarily require an assumption that capitalists as a whole exercise no influence on the decisions of public authorities—it is merely silent on the question of its degree and more concerned with its distribution pattern between capitalists.

But even the narrow concept of state capture is not necessarily entirely captured if only individuals and their ‘connections’ are focused on as in the theory of crony capitalism. This is because the inequality of influence may not only be between individual capitalists, but also between different interest-groups within private capital, and because such inequalities based on factors other than connections with those exercising public authority. Moreover, individual capitalists or firms do not have personalised relations with the *State*, but rather with particular individuals occupying positions of public authority. The degree to which this gives them influence depends then on the extent of concentration of decision-making power in the hands of these individuals, not merely in the formal sense but in the functional sense³². In fact, when there are many individual capitalists and many individual public officials or bodies that could bestow favours and therefore many different connections at work, the degree of state capture understood as the extent to which decisions of public authorities are determined by the private interests of capitalists would to an extent reflect the *aggregate* of the influences of different capitalists rather than the *inequality* amongst them.

State capture working through the individual connections of capitalists may in fact be associated with an entire spectrum of disparate situations. At one end of that spectrum we may have an entirely anarchic scenario where many different business firms have their own separate connections with different individuals so that the favour bestowing process is disbursed and dissipated or paralysed by competing attempts for getting mutually exclusive favours. At the other end, there could be a highly organized mechanism where there are only a few firms which are consistently benefited. It may be legitimately asked whether clubbing all these together under the single head of crony capitalism makes much sense³³.

themselves. Some choices are available to be exercised only because other choices have been made elsewhere (the case of the contract referred to earlier).

³² Functional would be taking into account the effective constraints associated with the context.

³³ It may be noted that while Kang (2002, 2003) clubs all of these under the head crony capitalism, his explanation of the huge difference between South Korea’s and Philippines’ economic performance despite the common element of corruption is based on precisely such differences in their structures.

The argument may be made that the specific inequality of influence captured in the extremely narrow notion of state capture associated with crony capitalism is important because it is what distorts the competitive process in favour of the more powerful and connected firms. The problem with this is that it implicitly assumes that there is no such bias in the competitive process unless and until it is introduced by the inequality of influence. But instead of the inequality of influence being the cause and the distortion of the competitive process the effect, both can in fact be mutually reinforcing phenomenon with common roots in the structural features of the capitalist economy. Some firms may exercise greater leverage than others over the State by virtue of not primarily their connections but their relatively dominant position in the structure or because of their ability to do what others cannot do. Big business firms, for example, would tend to have greater influence than small businesses. The presence of such firms, associated with the phenomenon of business concentration, can be found in all contemporary capitalisms. Appreciating this requires firms to be central categories in the analysis, and when this is done a fundamental question arises.

In a context where a group of large business firms occupy a dominant position in a capitalist economy, is it at all fruitful to think in terms of distinctions such as arm's-length rule based governance versus relational governance? Unlike firms that are small and with limited ability to influence the external conditions on which their success depends, large firms can and do seek to shape those conditions to suit their interests, and the competition between them only reinforces this tendency. Unlike in the situation where there are many small firms, a smaller number of large firms can also enter more easily into different kinds of collusive arrangements. Since the State, what it does or does not do, necessarily has an important role in determining those external conditions and the freedom they have to use their strengths and to collude, active intervention in the process of public decision-making is part of the normal mode of doing business for large firms. Their passivity is not just unlikely but rather impossible.

On the other side, the importance of large firms occupying a dominant position in the economy also has to be acknowledged by the State. This acknowledgement may be done in different ways—the State may regulate their activities in the pursuit of some larger objective; it may coordinate with them for the same reason; or it may simply succumb to their pressures and influences—but ignoring them would be impossible³⁴.

³⁴ It has also been argued that even if the State is autonomous, for information and coordination purposes 'relationships' are necessary—this is the reasoning behind Peter Evans concept of 'embedded autonomy', see You (2005)

What does the neutrality of the State in the competition between business firms mean in such a background? The typical answer that is associated with the narrow concept of state capture is the distancing of the state from the process through which the winners and losers are determined. But such distancing may in fact be the form in which the State's lack of neutrality and the inequality of influence expresses itself when there are inherent biases in the competitive process in favour of dominant firms. Elimination of the influence of that dominance in such circumstances would actually be contingent on the State actually becoming explicitly *involved* in the competition process, including the possibility of it affecting even the structural features of the economy—in other words, regulation of the economy by the State. How indeed, except through intervention, can crony relations between firms be tackled by the State?

The above conclusion is completely at odds with the conception where crony capitalism is in fact causally connected to state intervention and the absence of limited government. But this is only because the structural features of the capitalist economy in which the State exists is completely ignored in such analysis, and it is not appreciated that the extent of that intervention is itself a choice exercised under certain influences. This is not to suggest that regulation and state intervention cannot be manipulated by individual business firms in their favour. What is being pointed out instead is that this manipulation of the competitive process is not peculiar to the context of state intervention and regulation but a tendency inbuilt into the context of a capitalist economy characterized by concentration. This tendency can only be curbed by regulation and State intervention without being the guaranteed result of such intervention. To put it differently, monopoly power is not merely conferred by state intervention, it also has a structural basis and it is the latter which is systemic.

These problems with it only serve to emphasize the more fundamental question as to why should the concept of state capture be restricted to its narrow sense? From the developmental perspective, or from the angle of maintaining the democratic content of public decision-making, what is important is surely the extent to which capitalist firms are able to exert control over the public decision-making process to the exclusion of other segments of society. The issue of the public versus private character of the decision-making by public authorities arises precisely in relation to this aspect. Moreover, in a context of concentration of capital, the distinction between 'collective' and individual benefits or interests also becomes more blurred³⁵. Instead, the qualitative character of the

³⁵ Collective interests have two possible meanings—one where it is related to benefits that are uniformly available; and the second where it is the interest of the class as a class whose benefits and costs may be unevenly distributed between its members. It is in the former sense that

favours or benefits privileged firms may receive may also be partially dependent on the extent to which the accommodation of the interests of other social groups constitutes the background for the conferring of such benefits³⁶.

The relationship between limited government and limiting of the degree of 'state capture' in this broader sense may in fact be even more contradictory than in the case of its narrower conception. This is because the less the capacity of the state to replace the role of private capital or direct its activity, the more would be the need for the State to obtain the cooperation of private capital through concessions to it³⁷. In other words, the extent of relative autonomy of the State from the influence of private capital is both dependent on State intervention as well as the important factor in determining the effectiveness of that intervention.

It also follows from the above that formal electoral democracy is no guarantee that cronyism or state capture would be absent or at best a transient phenomenon. That state capture even in the narrower sense can be compatible with a competitive electoral democracy has been explicitly recognised by emphasizing the possibility that different political formations may have their different favoured groups³⁸. But more generally, when state capture is not a phenomenon reducible to the character and relations between a few individuals but has structural causes, not only does formal democracy not constitute an automatic check on it, the depth and extent of that democracy may itself become an effect of the extent of state capture.

7. Crony Capitalism and the Internationalization of Capitalism

So far we have discussed the concept of crony capitalism without explicitly bringing in what is undoubtedly one of the extremely important dimensions of capitalism throughout its history and certainly in the present—its internationalization. The theoretical analysis woven around the concept of crony capitalism often tends to suggest that crony systems tend to flourish in closed economies and in fact require an element of autarky in order to exist. The contention is that openness to trade and capital flows is inconsistent with crony arrangements, which have to rely on special entitlements to

collective interest is used here.

³⁶ Professor Tyabji had suggested that one may need to make a distinction between different kinds of cronyism because of such differences in their total outcomes. In the literature on corruption too, there exists a narrower distinction of this nature, between rent-seeking, tollbooth, and profit-scraping corruption [Bhagwati (2000), Boehm (2007), Jain (2001)].

³⁷ The classic analysis of this is Kalecki (1971)

³⁸ Sharafutdinova (2007)

favoured business firms from which others are excluded. The process of *globalization* in that sense should be seen as one that would undermine cronyism globally.

The problem with this argument is that it first brings into the picture economic interconnections stretching across political borders, and then proceeds to eliminate from the analysis the implications of those economic connections, the creation of a capitalist economy with international dimensions, and the basis for those borders, that is national states. Once these are explicitly acknowledged, it more or less automatically follows that by the standard definitions of crony capitalism, capitalism as an international system is inherently, and can only be, crony capitalism. Three mutually reinforcing simple truths about international capitalism would be sufficient to establish these.

Firstly, that there are biases in the competitive process is certainly not less true in the context of the international capitalist economy than in the case of any domestic economy. Indeed they are much stronger and have many more causal factors—putting some firms in a dominant position in the international capitalist economy where they enjoy tremendous monopoly power. These firms are the ones which can be international in their operations and through whom the links of others to the international economy are established.

Secondly, the neutrality of the State or its arm's-length attitude towards all business firms is impossible when there are *national states*. The accommodation of the interests of capital of other nationalities by national states can be done only to the extent that such accommodation coincides with some national objectives or is the result of coercion exercised on a state by other external forces. Additionally, the role that any State may play to assist its national firms is not limited to what is possible in the domestic economy—the potential domain for 'cronyism' becomes the entire international capitalist economy.

Thirdly, there is the inequality between nations and their states, expressed at one time by the direct domination of some by others, but presently mainly taking the form of unequal positions of different states in the interstate interaction process. It is only out of such a context that emerge any multilateral and bilateral rules governing international economic interaction and the economic policies of different national states. One important aspect of this inequality is that the extent of international reach of different states is different and therefore there are varying capacities for cronyism in that domain.

The unequal positions of firms and of states are mutually reinforcing, and this combined with the non-neutrality of states means that the inequality of influence that defines the narrow form of state capture is inherent to the international capitalist economy. In such a

background, the difficulties with the concept of crony capitalism become highly magnified.

To recall, many of the definitions of crony capitalism cited earlier had the following common features: firstly, that crony capitalism involves *public authority* being exercised in a manner that *favours the profit seeking effort* of some businessmen; secondly, there is an inherent *inequality* in that process in that these favours are not available to all actual or potential business firms; and those who constitute the favoured set do so on the basis of their close *connections* with individuals exercising public authority. Now virtually any policy pursued by a State that seeks to promote the interests of its national capital would result in the existence of all these attributes. This policy may be one of imperial expansion when the State concerned is a major power, and at the other end it may assume the form of protectionism pursued by a Third World State. In relation to the latter kind of scenario, since a policy of favouring national enterprises over foreign ones involves the use of public authority to favour a sub-set of enterprises, it does not even matter whether they have any personal connections with the State officials administering that authority or whether that policy is implemented through a set of rules or through discretionary powers. It would still be crony capitalism even though it may be characterized by rule-based arm's-length governance.

One implication of this is that, as suggested earlier, crony capitalism becomes such a broad concept that it in fact becomes inherent to a capitalism that is internationalized because States do not in fact promote a non-national general interest. A second and perhaps even more serious implication is that sharply differing capitalist scenarios involving promotion of national capital by states, like the cases of imperial expansion and Third World protectionism, are illegitimately equated and put in the same category. The failure of the theory of crony capitalism to appreciate these and to relate cronyism more or less automatically to State regulation of an economy's international economic transactions, irrespective of its context, is only because the international nature of the capitalist system and its fundamental asymmetries find no acknowledgement in the theory. Correspondingly, it also fails to appreciate that economic openness may favour the more dominant firms or the dominant capital in the international capitalist economy. Such openness of particularly developing economies to foreign capital may be the result of the combination of two factors. First, the structural feature of their dominant position in the international capitalist economy and the inability of Third World States to replace their role imply concessions to these firms. Secondly, given the association of these firms with the more powerful states, coercive pressures exercised by these states also work in shaping the degree of openness. "Cronyism" in the international domain can therefore lie behind economic openness.

More fundamentally, economic openness also has important implications for the degree of state capture in the wider sense. Openness is not only the result of restriction on regulation of external economic transactions by the State, it also reduces the State's capacity to regulate private capital in general. As such there could even be a strong tendency for openness and the degree of state capture to be directly related.

8. American Capitalism and Crony Capitalism: Polar Opposites or Synonymous?

In this penultimate section of this essay, we take up the issue of the positing of the American model of capitalism as the archetypal example of arm's-length capitalism. This obviously represents a *particular interpretation* of that capitalism and one that may be considered rather intriguing. Even if we leave aside the strictly Marxist discourses on American capitalism, there have been in the past an array of thinkers who have forcefully argued that the process which resulted in the separation of ownership and control and the emergence of the widely-held managerial corporations as the centres of productive activity was one that wrought a significant transformation in American capitalism, and one that should have made for an *elimination* of the conditions of arm's-length capitalism. Such assertions were made among others by people like Berle and Means, Chandler, and Galbraith, and with particularly American capitalism in mind³⁹.

One key part of this story of American capitalism was that the process of separation of ownership and control was a two-sided process—*dispersion* of the ownership of business firms with these firms assuming the form of corporations at one end, and *concentration* in the control over capital and economic activity in the hands of a few corporate managements on the other. As Berle and Means put it:

"Economic power, in terms of control over physical assets, is apparently responding to a centripetal force, tending more and more to concentrate in the hands of a few corporate managements. At the same time, *beneficial ownership is centrifugal, tending to divide and subdivide, to split into ever smaller units and to pass freely from hand to hand. In other words, ownership continuously becomes dispersed; the power formerly joined to it becomes increasingly concentrated; and the corporate system is thereby more securely established.*"⁴⁰

The relationship between the emergence of 'concentration of economic power' and the separation of ownership and control (in the sense of corporations being controlled by

³⁹ Berle and Means (1968), Chandler (1988), Galbraith (1972)

⁴⁰ Berle and Means (1968), Pp. 9–10

paid managers with little direct control by the owners of its shares) may not have been as straightforward as suggested by the above quote. Becht and DeLong's account, for example, suggests that the former phenomenon appeared first accompanied by a few powerful families and financiers controlling the major corporations through large blockholdings, and the dispersion of ownership and the ceding of control to professional managers happened subsequently as a result of a distinctively American process⁴¹. But these questions of historical interpretation apart, what was not disputed was that the transformation experienced by American capitalism was a variant of a wider historical transformation in capitalism, one characterized by the emergence of aggregate concentration or the establishment of the dominance of *big business*, and the irreversible passing of the age of the small enterprise⁴².

Many other aspects of the new reality were brought in as explanations for, and associated with, the dominance of large business enterprise—the nature of modern technology, economies of scale and scope, the importance of diversification, etc. A common explicit second element that these gave rise to was that the transformation experienced by American capitalism meant the demise of the prominence of individuals and individual initiative, and the heightened importance of hierarchy and organization. Galbraith perhaps went furthest in this regard asserting that power in this transformed society had come to be actually vested in an organization, the *technostructure*⁴³. But even somebody like Kaplan, whose analysis of big business otherwise had a distinctly Schumpeterian flavour, concurred with the conception of the declining role of the individual when he treated the dynamic process of innovation as the distinctive contribution of big business to the competitive process, it being an effective innovating agency⁴⁴.

The third element of the transformation highlighted was that instead of an economy where competition and the price-mechanism performed the functions of regulation and coordination, the big business dominated economy was more of a 'controlled' economy. Galbraith again took the most extreme position in this matter, arguing that it was not merely the replacement of the invisible hand of the market by the 'visible hand' of the managements of a relatively small number of enterprises that had happened; rather 'industrial planning' had replaced the market so thoroughly that the latter existed only in mere form. The internalisation of co-ordination inside large firms, collusion and alliances between them, as well as the power to influence the market because of their size, were

⁴¹ Becht and DeLong (2005)

⁴² Broadly similar to what is described by Marxists as the transition to monopoly capitalism

⁴³ Galbraith (1972)

⁴⁴ Kaplan (1954)

seen as the factors that made for this fundamental transformation in the economic mechanism. Consequently, traditional economic theory was considered inapplicable to this new reality. Additionally, either on the grounds that some external intervention was necessary to ensure that the massive power in the hands of corporate managements was not abused and remained something to be exercised for the general good, or on the grounds that there was some kind of a residual coordination activity that could not be done by firms, the State was seen as having an essential role to play in the economy.

In the work of others like C. Wright Mills, the transformation in American capitalism was also one that encompassed the social and political spheres, creating a reality that could be considered very akin to structurally inherent crony capitalism, dominated by a 'power elite'—a network of corporate chieftains and political and military leaders.

“When both economic and political institutions were small and scattered—as in the simpler models of classical economics and Jeffersonian democracy—no man had it in his power to bestow or to receive great favors. But when political institutions and economic opportunities are at once concentrated and linked, then public office can be used for private gain”⁴⁵. And,

“There is no longer, on the one hand, an economy, and, on the other hand, a political order containing a military establishment unimportant to politics and to money-making. There is a political economy linked, in a thousand ways, with military institutions and decisions. On each side of the world—split running through central Europe and around the Asiatic rimlands, there is an ever-increasing interlocking of economic, military, and political structures. If there is government intervention in the corporate economy, so is there corporate intervention in the governmental process. In the structural sense, this triangle of power is the source of the interlocking directorate that is most important for the historical structure of the present.”⁴⁶

It may be noted that the context focused on by the versions of the transformation in American capitalism highlighted through the above after the age of the “Robber Barons”, when corruption and the use of political influence to amass large fortunes was rampant in the US⁴⁷. Yet these versions do not sit comfortably with the theory of crony capitalism insofar as the image of American capitalism they created can hardly be described as Arm’s-length Capitalism. It is of course true that these perspectives have been debated in the literature, and by no means is it the case that they have universal acceptance. Nor is

⁴⁵ Mills (2000), p.346

⁴⁶ Mills (2000), p. 8

⁴⁷ Jay Bhattacharjee had drawn the attention of the symposium to this history. For an account, see DeLong (1998)

any claim being made that they necessarily represent a completely accurate description or analysis of the transformation that actually occurred in American capitalism. The purpose of drawing attention to them is simply to highlight the following. The theory of crony capitalism in effect ends up making the case that rather than undermining the price mechanism, the rise of big business only more fully created the conditions for the operation of the price-mechanism in the US. This is implicit in the view that it is the separation of its ownership and control that allows the flow of capital to be guided by the market to the best projects and the best people, something that was not possible when there was a unity of ownership and control. It follows that the other side of that process of separation, the concentration of capital, is not considered to be of any great significance, once again because it is individuals and not firms that loom large in the theory of crony capitalism. But if the 'concentration of economic power' is seen to be important, and the phenomenon of cronyism is related to it, then the distinctions between American or Anglo-Saxon capitalism and other capitalisms may be less sharp than made out by the theory.

The conception of American capitalism as Arm's-length capitalism could still be considered credible if it could be established that it is the result of important changes that have subsequently occurred. There is no doubt that there have indeed been important changes. But what, however, has manifestly not been the case is a disappearance or receding of business concentration, even though the large American firms may have become more global in their operation⁴⁸. One major tendency in the opposite direction has been in fact provided by the so-called market for corporate control. Moreover, the implications for the arm's-length view of American capitalism of other significant changes that have occurred are even more severe.

The first of these is the declining importance of personal savings relative to retained earnings in total US savings particularly from the beginning of the 1990s. The decline has been particularly sharp with personal savings becoming negligible by 2006 (see Table-1).

Secondly, there seem to be important changes that have taken place in the pattern of US stock ownership. Judging by data and evidence available from different sources, the following elements seem to define the broad direction of this change. In 1950, over 90% of US corporate stock was directly held by households, with the equivalent figure for

⁴⁸ For a relatively recent study of the trend in US aggregate concentration between 1967 and 2002, see Nissan and Caveny (2005)

Table-1
Distribution of US Net Private Savings, 1950–2006
(Percentage Shares in Period Averages and Annual Values)

<i>Private Savings Category</i>	1950–59	1960–69	1970–79	1980–89	1990–99	2000–06	2005	2006
Personal Savings	62.91	58.57	69.00	71.82	57.19	30.63	10.42	8.68
Undistributed Corporate Profits	37.14	41.42	31.00	28.19	42.13	68.94	88.42	89.65

Source: US Department of Commerce, Bureau of Economic Analysis <<http://www.bea.gov>>

1980 being 67.9%⁴⁹. But this predominance of individual holding has been steadily displaced by the increasing importance of institutional investors in the ownership of corporate stock⁵⁰. In 1980, institutional investors held 37.2% of total US equities, but by 2005 this had risen to 61.2%⁵¹. But while till 1980 the declining share of direct household holding mainly reflected the rising importance of non-household investors, since 1980 it mainly reflects an increasing shift towards *indirect* holding by households, through pension funds primarily in the 1980s and then more prominently through mutual funds in the 1990s⁵². Mutual funds have been also the principal medium for increasing holding of foreign equities by American households. It has also been suggested that accompanying the reducing importance of direct investment by individuals not involved with control has been an increasing share of stock ownership in publicly traded US firms held by managers⁵³. All in all US stock ownership appears to have become considerably more concentrated, and a recent study has even concluded that it is by no means less concentrated than in other parts of the world⁵⁴.

What both of these two sets of changes—in the pattern of US savings and the changes in stock ownership pattern—suggest is the receding role of market interaction between *individual* owners of capital and manager controlled firms in shaping the allocation of

⁴⁹ NYSE (2000). This includes both direct holding and through Bank Personal Trusts and Estates. The data on the break up between the two before 1970 are not available, when their respective shares in the aggregate were 68% and 10.9%. In 1980, these shares were 58.6% and 9.3% respectively.

⁵⁰ This is also true of the United Kingdom, where the holdings of individuals declined from 54% in 1963 to 14% in 2004 [Mallin (2007)].

⁵¹ The Conference Board (2007). It may be noted that institutional investors include pension funds, investment companies, insurance companies, banks and foundations, but *not* new classes of investors such as hedge and private equity funds.

⁵² NYSE (2000), and Investment Company Institute and Securities Industry Association (2005)

⁵³ Holderness, Kroeszner, and Sheehan (1998)

⁵⁴ Holderness (2005)

savings in American capitalism. Instead the management of *both* real property as well as financial property have tended to become concentrated, like in economies with intermediary-based financial systems. Yet the stock-market has continued to occupy a central position in American capitalism, not as the medium for routing funds to investments but for other reasons.

The period since 1980 has also been one where there has been a massive increase in inequality in the distribution of income in the United States that has been intimately tied up with the stock-market⁵⁵. The top 1% of the US population increased its share in income from 12.8% in 1982 to 20% in 2000, largely at the expense of the bottom 80%, many of whom experienced a decline in absolute real income. One of the major sources of this trend was the distribution of income under the head of 'capital income', with the top 1% increasing their share from 37.8% in 1979, and 38.3% in 1991, to as much as 57.5% in 2003. Underlying this is the high and rising trend of concentration of wealth including financial wealth in the US⁵⁶. As far as stock ownership is concerned, even though more than half the US population directly or indirectly owns corporate stock, the top 1% of households accounted for as much as 33.5% of this ownership in 2001 and the next 19% for another 55.8%, leaving a little over 10% for the rest. The period since 1980 has been described as one that has seen the return of the super-rich in the US, ending a relatively lean period of over five decades when there were relatively few⁵⁷.

Another component of this story of rising income inequality in the US is the sharp rise in the pay of CEOs of American corporations since 1980, part of which has been through the cashing of stock options, and the widening gap between this and the wages of workers⁵⁸. The ratio of average CEO pay to factory worker pay rose from 42:1 in 1960, which was also the level around which it was in 1980, to as high as 531:1 in 2000, before coming down to 411:1 in 2005⁵⁹. Between 1990 and 2005, CEOs' real pay increased by nearly 300%, while that of production workers increased by only 4.3%.

The picture that emerges from the above is that American capitalism at the beginning of the 21st century is one in which a small minority owns *and* controls the bulk of the productive wealth of the US economy as well as the claims to it. There is, and has been even earlier, concentration in the direct control of productive assets whose legal

⁵⁵ Domhoff (2006)

⁵⁶ According to a WIDER study cited in Domhoff (2006), the degree of concentration of wealth ownership in the US was second only to that in Switzerland amongst developed countries.

⁵⁷ DeLong (1998)

⁵⁸ Domhoff (2006)

⁵⁹ The same ratio is about 25:1 in Europe.

ownership is vested in corporations. There is, again as earlier, concentration in the ownership of the stocks of these companies. On neither of these counts has American capitalism been distinct from its counterparts elsewhere in a manner whereby it could be deemed the representative instance of *diffuse* capitalism. The concentration in ownership of corporate stock at the *aggregate* level may not have reflected itself earlier in the concentration in ownership of the stock of *individual* companies because of owners holding diversified portfolios of corporate stock. But with the increasing shift to indirect holding, concentration in the ownership of individual corporations is also increasing. More importantly, the consequence of the increased importance of institutional investors is that big players are replacing individuals as the major players in stock-markets (including importantly the secondary market).

The overlapping groups of corporate managers, financiers, and wealthy individuals, clearly constitute a kind of aristocracy in the US of today who exercise tremendous social and economic power, and wield tremendous influence in the corridors of power. American capitalism does not in appearance therefore look so very different from *oligarchic* capitalism. The stock-market occupies a central role in the forging of the nexus between the different components of this aristocracy. Capital gains in the stock-market, that can be of a much greater order than the returns on real investments are the source of much of their wealth, and they therefore have a huge stake in the fortunes of the stock-market. Individually and together they also have a large role in shaping these fortunes. It is, therefore, a lethal combination of greed and the power to satisfy that greed that characterizes the position of the aristocracy of American capitalism today. A potential impediment to, as well as a potential ally in, the ceaseless pursuit of speculative profit, is the State. This is a setting for 'cronyism', where both the use of the power of the State to regulate, and deregulation that removes impediments, are its potential forms.

Since the breaking of the Enron fiasco, the existence of a stock-market centered nexus and its power has come to be partially revealed to the world through a litany of cases of stock-market fraud, and scandals pointing towards an unholy nexus between corporate America and the US establishment⁶⁰. People like Joseph Stiglitz and Paul Krugman have had no compunction in describing the prevailing American reality as crony capitalism (see Box IV). The list of individuals and firms that have been involved in these scandals reads like a veritable who's who of the corporate and financial sectors of the US, with important members of the political establishment being also connected to them (see Appendix Table for an illustrative list of cases processed by the SEC since the Enron episode).

⁶⁰ See for example Shorrock (2002), Barker (2002), Black and Galbraith (2002) and Macdonald (2004)

Box IV

“Enron used fancy accounting tricks and complicated financial products (derivatives) to mislead investors about its value. No transparency here. It used its money to buy influence and power, shape U.S. energy policy, and avoid regulations.

Crony capitalism is not new; nor is it the province of a single party. Former US Treasury Secretary Robert Rubin reportedly tried to influence the current government to intervene on behalf of Enron in its hotly contested dispute in India. In office, he had intervened when the supposedly independent board for setting accounting standards tried to clean up the accounting of senior executives' share options. Partly thanks to him, this effort to make corporate accounting more transparent was stymied.

America's willingness to provide multi-billion dollar bail-outs to airlines or to create cartels to protect its steel and aluminum industries suggests that free market ideology is but a thin guise for old-fashioned corporate welfare: give to those with the appropriate connections.”

-Joseph Stiglitz (2002)

The real questions about Enron's relationship with the administration involve what happened before the energy trader hit the skids. That's when Mr. Lay allegedly told the head of the Federal Energy Regulatory Commission that he should be more cooperative if he wanted to keep his job. (He wasn't, and he didn't.) And it's when Enron helped Dick Cheney devise an energy plan that certainly looks as if it was written by and for the companies that advised his task force. Mr. Cheney, in clear defiance of the law, has refused to release any information about his task force's deliberations; what is he hiding?

And while Enron has imploded, other energy companies retain the administration's ear. Just days before the latest Enron revelations, the administration signaled its intention to weaken pollution rules on power plants; late last week it announced its decision to proceed with a controversial plan to store radioactive waste in Nevada. Each of these decisions was worth billions to companies with very strong connections to Mr. Bush. ...

And the business magazine Red Herring has published the biggest exposé to date of the secretive Carlyle Group, an investment company whose story sounds like the plot of a bad TV series. Carlyle specializes in buying down-and-out defense contractors, then reselling them when their fortunes miraculously improve after they receive new government business. Among the company's employees is former President George H. W. Bush. Among the group's investors, until late October, was the bin Laden family of Saudi Arabia.

Another administration would have regarded the elder Bush's role at Carlyle as unseemly; this administration apparently does not. And Defense Secretary Donald Rumsfeld recently gave his old college wrestling partner Frank Carlucci, head of Carlyle, a very nice gift: Mr. Rumsfeld decided to proceed with the much-criticized Crusader artillery system, which even the Pentagon wanted to cancel. The result was another turnaround for a Carlyle-owned company.

Sad to say, none of this is clearly illegal — it just stinks to high heaven. That's why the Bush administration will try to keep the Enron story narrowly focused on one company during its death throes. Just remember that the real story is much bigger.

-Paul Krugman (2002)

What are the implications of all of this for the theory of crony capitalism? One is quite simply that it undermines the notion that the American model of capitalism has some distinctive features that inherently protect it from the vice of cronyism. But there is another graver implication, one that is indicated in the following words of Jagdish Bhagwati (spoken as an American citizen):

“Here we do have a *major advantage, so that our cronies cost less than others’ cronies...*

...we reward our cronies at the expense of others, not ourselves.”⁶¹

The United States is not any other country because of its position as the world’s dominant power. The financial aristocracy of the US therefore has an international reach through its connections with the US state. This power was reflected in both the prelude to the East Asian crisis, its making, and its aftermath, as described by Chalmers Johnson (Box V). Even a die-hard liberalizer like Bhagwati in his own way has recognized that it is this financial aristocracy that has been the major force behind the creation of the conditions for what has been considered by many as one of the crucial defining features of contemporary globalization—the free movement of speculative capital across the globe. The phenomenon that Bhagwati refers to of the same people circulating between important positions in both the corporate world and in the administration—the “Revolving Door”—has in fact become a more or less institutionalized feature of the American system⁶² (see Box VI).

In other words, it may be said that *crony capitalism resides at the very heart of the global economic order*. Further, given that the journey of crony capitalism that transformed it into a theoretical concept began with it being offered as an explanation for the East Asian financial crisis by those who were very much part of the Wall Street-Treasury nexus⁶³, it can even be said that more than the theory of crony capitalism shedding light on crony capitalism, crony capitalism itself explains why the theory emerged in the time that it emerged and the form in which it emerged.

⁶¹ Bhagwati (2000)

⁶² See the Revolving Door database, [http:// www.opensecrets.org](http://www.opensecrets.org)

⁶³ The US Secretary of the treasury at that time was Robert Rubin, who had earlier had a long career with Goldman Sachs, and who went on to become Chairman of Citigroup after his stint in the Government.

Box V
Whose Crony Capitalism?

“With the end of the Cold War, the United States decided it had to launch a rollback operation in East Asia if it was to maintain its global hegemony. The high-growth economies of East Asia had become the main challengers to American power in the region, and it was time they were brought to heel.

The campaign worked in two phases. First, a major ideological barrage was launched to soften up the Asians. ... Ever since the Asia Pacific Economic Cooperation summit in 1993, the Americans hammered home to the Asians that they needed to open up their economies...

Then came phase two. Once the Asian economies had begun to deregulate and were standing in the world marketplace more or less naked, the hedge funds were let loose on them.

The funds easily raped Thailand, Indonesia and South Korea and then turned the shivering survivors over to the IMF, not to help the victims but to ensure that no Western bank was stuck with nonperforming loans in the devastated countries. The IMF is also the U.S. government's chosen instrument for reforming these countries to make them look more like New York.

But then it all got a bit out of hand. One of the biggest hedge funds proved to be so greedy that the U.S. government had to organize a bailout for it, which brought the scheme out into the open. David Mullins, a former deputy to Federal Reserve Chairman Alan Greenspan, had gone straight to work for the Long-Term Capital Management fund after he left the Fed in 1994. Had this not been the case, it's unlikely that the Federal Reserve Bank of New York would have arranged a \$ 3.5-billion rescue package for the hedge fund. The incestuous relationship between Washington and Wall Street--what Columbia University economist Jagdish Bhagwati calls the Wall Street-Treasury complex--made East Asia's crony capitalism look tame. ...

...Wall Street itself now looks like the ancestral home of crony capitalism”.

- Chalmers Johnson

9. Conclusion

What then are the main conclusions that one can draw from the somewhat lengthy scrutiny of the theory of crony capitalism that has been undertaken here? The straightforward one is of course a negative kind of conclusion. This is that the foundations of the theory that seeks to establish crony capitalism as a distinctive type of capitalism to be found only in particular parts of the world, and associated with mainly state intervention in the economy, is rather weak. While the claim is that cronyism is systemic to certain kinds of capitalism and not to others, the theory fails to establish a coherent set of structural features on the basis of which a crony capitalist system may be distinguished from its opposite, arm's-length capitalism. In fact, it is on relatively superficial features rather than the deeper structural features that the distinctions are made, ignoring simultaneously both the common underlying structural features as well as the real differences in the situations of the capitalisms exhibiting these features. Consequently, its archetypal representative of the polar opposite of crony capitalism

itself fails to live up to its portrayed image. The theory thus fails to establish that crony capitalist and arm's-length systems are characterized by fundamentally different allocational processes or that efficient allocation is possible in the context of modern capitalism when left to the price mechanism. As a more recent variant of an old theme in economics, namely that the State is best kept out of the economy, it offers nothing that is likely to convert those who have even otherwise been skeptical of such sweeping conclusions.

Box VI

The Wall-Street Treasury Nexus and Free Capital Mobility

"The question, then, is why the world has nonetheless been moving in this direction (of free capital mobility). The answer, as always, reflects ideology and interests-that is, lobbies. The ideology is clearly that of markets ...

But interests have also played a central role. Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money. It is not surprising, therefore, that Wall Street has put its powerful oar into the turbulent waters of Washington political lobbying to steer in this direction.

Then again, Wall Street has exceptional clout with Washington for the simple reason that there is, in the sense of a power elite a la C. Wright Mills, a definite networking of like-minded luminaries among the powerful institutions-Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank most prominent among them. Secretary Rubin comes from Wall Street; Altman went from Wall Street to the Treasury and back; Nicholas Brady, President Bush's Secretary of the Treasury, is back in finance as well; Ernest Stern, who has served as acting president of the World Bank, is now managing director of J.P. Morgan; James Wolfensohn, an investment banker, is now president of the World Bank. One could go on.

This powerful network, which may aptly, if loosely, be called the Wall Street-Treasury complex, is unable to look much beyond the interest of Wall Street, which it equates with the good of the world."

-Bhagwati (1998)

But it would not be sufficient to leave matters at that. The limitations of the theory of crony capitalism do not mean that the intertwining of business and political power is an imaginary phenomenon. Indeed such a conclusion would actually represent a serious distortion of reality, and nothing that has been said in this essay warrants such an inference. Rather, implicit in our discussion has been the suggestion that modern capitalism, and by that one means global capitalism, cannot be understood in a framework where the sphere of the political is seen as something external to and neatly separated from the economy. The problem with the theory of crony capitalism is not that it exaggerates the connections between the world of business and that of political power and administration. The real problem is that the theory does not even come remotely

close to understanding the scale, the depth, the nature, and the consequences of these connections in a world whose underlying reality is a concentrated control over the business of money-making and where the state is omnipresent whatever be the nature of the economic policy regime. If these connections are to be truly comprehended then the simplistic and also misleading approach of the theory of crony capitalism has to be avoided. That is the appropriate conclusion that must be derived from the critique of that theory. Indeed, even the recognition that the studying the business-state nexus is a crucially important task has to involve eschewing a theory, which suggests that crony capitalism is fast becoming a mere historical artifact given the global movement towards the “withdrawal of the state” from the economy.

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Appendix Table

Illustrative List of Financial Fraud Cases Settled by the US Securities Exchange Commission, FY 2003 to FY 2006

<i>Business Activity</i>	<i>Entity Charged by SEC</i>	<i>Nature of fraud or violation charged with</i>	<i>Settlement or Action</i>	<i>Financial year</i>
Auditing	Pricewaterhouse-Coopers LLC (PWC) and Philip Hirsch	Failed to comply with Generally Accepted Accounting Standards in connection with its audit of SmarTalk TeleServices, Inc.'s 1997 year-end financial statements. After PWC became aware of a class action shareholder lawsuit alleging fraud against SmarTalk, it made revisions to its working papers and discarded other documents relevant to its audit.	PWC agreed to a censure, to significant remedial undertakings, and to pay a \$1 million penalty; and Hirsch agreed to an order denying him the privilege of practicing before the Commission, with the right to reapply after one year.	FY 2003
	Two Ernst & Young partners, Kenneth Wilchfort and Marc Rabinowitz	Aided and abetted violations of the reporting provisions of the federal securities laws by Cendant Corp and its predecessor CUC International	Wilchfort and Rabinowitz consented to orders suspending them from appearing or practicing as accountants, with the right to reapply after four years.	FY 2003
	Deloitte & Touche	Failure to Detect massive fraud in its audit of Adelphia Corpn.	Co commented to pay \$25 million penalty in federal court action and \$25 million in separate proceeding	FY 2005
	KPMG	Permitted Xerox to manipulate accounting practices to overstate revenues and earnings	Agreed to pay \$22.5 million in disgorgement penalties	FY 2005
Corporation	Six former Executives of Xerox Corporation including two CEOs and CFO	Fraudulent scheme to inflate earnings in order to push up stock prices	Defendants agreed to pay \$22 million in civil penalties, disgorgement and interest	FY 2003
	Lucent Technologies and Some officers, Executives & Employees	Fraudulent and improper recognition of revenue & Income	Company agreed to pay \$25 million penalty	FY 2004
	Computer Associates International Inc. (ore of the world's largest software co.) + 7 former top executives	Premature recognition of revenue and obstruction of investigation	\$225 million ordered to be returned to shareholder	FY 2004
	Royal Dutch Petroleum Co & the Shell Transport and Trading Co.	Overstatement of previously reported proved hydrocarbon resources	Defendants agreed to pay \$120 million in Penalties	FY 2004
	Time Warner	Inflated or improperly recognized revenue	Agreed to pay \$300 million in penalties	FY 2005

Appendix Table Continued

<i>Business Activity</i>	<i>Entity Charged by SEC</i>	<i>Nature of fraud or violation charged with</i>	<i>Settlement or Action</i>	<i>Financial year</i>
	Quest Communications	Inflated or improperly recognized revenue	Agreed to pay \$250 million in penalties	FY 2005
	Tyson Foods	Co. made Misleading disclosure of perquisites & personal benefit provided to Donald Tyson (CEO)	Co agreed to pay \$1.5 million penalty and Donald Tyson \$700,000	FY 2005
	McAfee Inc.	Improperly inflated revenues by \$622 million from 1998 to 2000	Consented to pay a \$50 million civil penalty	FY 2006
	Applix Inc.	Improperly recognised \$1.2 million revenues (2001-2002)	Agreed to cease and deficit - No monetary penalties	FY 2006
	Fannie Mac	Improper smoothing of earnings in violation of accounting rules	Agreed to pay \$350 million penalty	FY 2006
	Tyco	Utilized unlawful accounting practices to over state results by \$1 billion	Agreed to pay \$50 million as civil penalty	FY 2006
Financial Firm	Peter Davis, Goldman Sachs & Co., and Massachusetts Financial Services Company	Using insider information from the Department of Treasury	Defendants agreed to pay over \$10.3 million to settle the Commission's actions against them	FY 2003
	J.P. Morgan Chase	Assisting manipulation of financial statements of Enron Corp.	J.P. Morgan Chase agreed to pay \$135 million to settle.	FY 2003
	Citigroup Inc.	Assisting manipulation of financial statements of Enron Corp. and Dynegy Inc.	Citigroup agreed to pay \$101 million to settle.	FY 2003
	Merril Lynch & Co.	Assisting manipulation of financial statements of Enron Corp.	Merril lynch agreed to pay \$80 million to settle.	FY 2003
	29 actions against participants in the mutual fund industry including Pilgrim Baxler & Associates, Putman Investment Management, Alliance Capital Management, Massachusetts Financial Services, and Strong Capital Management	Market Timing, Late Trading and Selective Disclosure Cases	Commission ordered \$552 million in disgorgement and \$480 million in penalties	FY 2004
	5 Specialist firms	Executed order for their dealer accounts ahead of executable public customer or 'agency' order	Agreed to pay \$247 million in penalties and disgorgement	FY 2004

Appendix Table Continued

<i>Business Activity</i>	<i>Entity Charged by SEC</i>	<i>Nature of fraud or violation charged with</i>	<i>Settlement or Action</i>	<i>Financial year</i>
	i) Canadian Imperial Holdings & CIBC World Markets ii) Banc of America Capital Management, BACAP Distributors & Banc of America securities; and iii) Columbia Management Advisors & Columbia Funds Distributor	Market Timing abuses	SEC ordered disgorgement, pre-indictment interest and penalties of \$640 million	FY 2005
	Citigroup Subsidiaries: Smith Barney Fund Management and Citigroup Global Markets	Misrepresented & omitted material facts when recommending to boards of mutual funds that the funds change from the 3 rd party transfer agent they previously used to an affiliated Citigroup transfer agent	Agreed to pay \$208 million in disgorgements & penalties	FY 2005
	15 broker dealers including press Bear Sterns, Citigroup Global markets and Goldman Sachs	Engaged in violative practices in the sale of auction securities	Firms consented to pay more than \$12 million in penalties	FY 2006
	Millenium Partners	Fraudulently timed mutual funds	Firm and four individuals agreed to pay \$180 million in disgorgement & Penalties	FY 2006
	Bear Sterns	Unlawful late trading and deceptive market timing	Ordered to pay \$160 million in disgorgement & a \$90 million penalties	FY 2006
	American International Group (AIG) and Brightpoint, Inc.	Fraudulent Transaction that enabled Brightpoint to cover up losses of a foreign subsidiary and to overstate income	AIG agreed to pay \$10 million as civil penalty	FY 2003
	Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; Lehman Brothers, Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Morgan Stanley & Co., Inc.; Citigroup Global Markets, Inc., f/k/a Salomon Smith Barney, Inc.; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray, Inc.	Acts and practices that created or maintained inappropriate influence by investment banking over research analysts	In settling the actions against them, the firms agreed to make payment totalling \$1.4 billion.	FY 2003
	American International Group (AIG)	Improper accounting relating to share reinsurance transaction with Gente Corpn.	To resolve SEC's claims agreed to pay \$800 million in disgorgements & penalties	FY 2006

Source: US Securities and Exchange Commission, Performance and Accountability Reports, FY 2003 to FY 2006

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