Regulation, Crony Capitalism, and Economic Growth

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FREE MARKET CAPITALISM

True “capitalism” consists of free market capitalism. “Free Market Capitalism” exists where people are free to enter and deploy their productive assets and abilities as they wish in any markets that they wish and, as a result, personally reap either the rewards of success or the penalties of failure. Government’s role in such a system is generally limited to making sure that individuals or enterprises will engage in honest behaviors, making sure property rights are protected, and facilitating legitimately negotiated and recognized transfers of property rights.

CRONY CAPITALISM

In crony capitalism, governments play a much larger role in determining how economic gains or losses are determined, and who can profit from or lose from various economic activities. Governments can directly influence the potential profitability or losses associated with any economic enterprise in various ways. One way is through the direct imposition of taxes and fees on an enterprise. Another way is to provide for transfer payments (direct payments), negative taxes or credits, or risk assumption guarantees that can benefit an enterprise or individual in various ways. In addition, a government can influence the potential profitability of an enterprise through regulations or subsidies of various types. Those who become “cronies” of the governmental or regulatory agents can gain from those relationships by obtaining favorable, or less harmful, tax and regulatory policies.

TYPES OF REGULATION

PROTECTED MARKETS AND SUBSIDIZED “PRODUCTION” PAYMENTS

Governmental regulations can take various forms and can either be beneficial or detrimental to an economic entity. For instance, a government can provide an enterprise with economic rents by prohibiting other entities from competing with it. Thus, the enterprise will have the ability, free from competition, to charge its customers more than would otherwise be possible. Competition can be limited geographically, within a country, or even internationally. Potential international competitors can also be hobbled in various other ways. Most directly, their goods can be subjected to tariffs that raise their goods’ prices once they cross borders into the country where the governmentally favored enterprises operate. Alternatively, international competitors may find that their goods are subjected to expensive inspections and’or required modifications before they are allowed to compete with domestic manufacturers. Alternatively, domestic manufacturers may have their foreign exports subsidized by their government or government agencies either by direct subsidy payments to domestic exporters or by cheap credit (such as that provided to US exporters by the Export-Import Bank).

In addition, many government regulations can directly impact the costs of production or potential revenues for various enterprises through the provision of direct subsidies or via the provision of tax credits to those who purchase the products of the favored enterprises. Such examples have been quite popular in the “clean energy” industry and may explain why many participants in those industries have been firm advocates for “global warming” alarmism. Those subsidies can include direct payments to affected firms, subsidized credit provisions for affected firms, or tax credits for firms that reduce their carbon footprints or provide products (such as electric vehicles) that are deemed to allow their customers to reduce their carbon dioxide generation activities. They can also include payments to agricultural producers that guarantee minimum payments for various types of crop production (price supports) or for withholding land from production (conservation reserve programs).

REGULATORY PENALTIES

In addition to tax levies. Various regulatory fees or taxes can be imposed upon various individuals or productive enterprises. Often, the cost of such fees or penalties are so great that they can discourage various financial activities directly. For instance, I have witnessed people at foreclosure auctions who were unwilling to bid on some properties, even at very low prices. The properties were in desirable locations and seemed to have favorable attributes. When I asked why no one would bid I was told that the properties suffered from regulatory complications. If they contained asbestos, they could not be repurposed without incurring exorbitantly high renovation costs. If they had had some sort of adverse chemical spilled upon or under their land the costs of regulatory required cleanup would far exceed the value of the property after all regulatory requirements were fulfilled. Personally, I closed the small Keough Account I had formed for my consulting and book royalty operations. It sheltered only a small amount of income, yet if I were even one-day late in submitting the required (and complicated) forms each year, I could be subjected to a penalty of $25,000, plus $10,000 more for each day it was late. That was far more than I earned or owed in taxes on those activities. Also, I owned apartments in the past and had to comply with a “Red Book” of regulations that was nearly 2 inches thick, and has since grown. Those regulations, on balance, increased regulatory compliance costs--for instance, if someone moved out and left some property, that property had to be retained and stored for at least 30 days (at my expense) lest the former owner wish to reclaim it. Since regulations have increased in recent years and I did not have an operation large enough to employ a compliance officer or lawyer, I now am reluctant to reacquire rental property. I also am reluctant to acquire any other property that might be subject to unknown regulatory risks--such as harboring birds (lesser prairie chickens or spotted owls) or other creatures that may be declared an endangered species (such as sand dune lizards), or land where its potential use might be restricted by various other environmental regulations. In short, where regulatory penalties are high, potential economic activities may be inhibited--particularly for small enterprises that are unable to afford to pay extensive compliance costs or hire compliance officers or lawyers to comply with and obtain favorable regulations.

REGULATION OF PRICES, WAGES, OR CONTRACT TERMS

Various regulations can also affect individual enterprises’ potential costs or methods of production. Price controls can influence firms’ decisions to produce certain goods or their willingness to maintain various productive activities. For instance, it is well known that rent controls can reduce incentives for people to provide new rental housing and can reduce incentives for owners to spend on maintenance for housing that already exists. Price controls can also reduce incentives for suppliers to increase production levels, at increased expense, when shortages exist--and may result in queueing, quotas. political allocation, or other rationing techniques when shortages exist.

Wage controls in the form of minimum wage requirements can have an adverse incentive upon producers' willingness to hire and employ additional workers--particularly at times or in industries or markets where prices and/or demand for a producers' products is falling-- as I have shown in a related paper that relates a worker's potential "marginal revenue product" to the willingness of an employer to hire an additional worker.

Contractual obligations can also have an important influence upon markets. Extensive requirements regarding product composition, environmental, safety, or guarantee requirements can raise the costs associated with producing and supplying various goods. As a result, such regulations can potentially limit the provision of the affected goods, either by restricting their production or by restricting the effective demand for the goods due to their increased prices.

Regulations that affect labor contracts can have an adverse effect upon hiring incentives. For instance, if workers cannot be fired without incurring extensive costs and potential litigation--particularly for members of "protected groups"-- an employer will be more reluctant to hire workers who might have to be terminated in the future. If all workers must be provided with health insurance and/or other regulatorily required benefits, the potential cost of hiring a new worker may far exceed the potential marginal revenue product added by that worker, so fewer workers will be hired. If hiring contracts only allow a worker to be employed in one particular type of job, an employer will be more reluctant to hire such an employee than one whose job skills can be used more flexibly. In short, numerous regulatory restrictions involving employment conditions may adversely affect potential employers' hiring incentives.

THE REGULATORY DIALECTIC

Because regulations typically impose costs upon or reduce the potential profits of regulated entities, those entities have strong incentives to find ways to neutralize or ameliorate the effects of the regulations. Once the regulators become aware that their regulations are being evaded, however, they are likely to respond with a new set of regulations. Subsequently, the private entities may develop new innovations to evade the newly imposed regulations, and the process repeats. The regulation, innovation and evasion, and reregulation may go through many cycles. Ed Kane, a former President of the American Finance Association, gave this process a name. He called it "the regulatory dialectic." The regulatory dialectic is particularly apparent in the financial world since money and contracts can be highly flexible.

For instance, as interest rates rose following the high rates of inflation during the 1970s, many mortgage-oriented savings institutions found that if they had to pay too much in interest to attract deposits, they would lose money because they weren't earning high enough interest rates on the long-term mortgage loans they had made in the past when interest rates were lower. Thus, they appealed to their regulators to restrict the interest rates that they and their close competitors were allowed to pay their small depositors. Their regulators did so. However, that meant that potential depositors had less incentive to deposit money in those institutions. Consequently, the institutions began to offer "free" gifts to depositors who deposited enough money. Regulators then began to restrict the value and terms that could be offered via "free" gifts. The institutions also offered premium interest rates to depositors who bought "jumbo" certificates of deposit of $100, 000 or more. The jumbo certificates were designed to compete for funds with treasury bills and commercial paper in the money markets, not with individuals' deposits. However, entrepreneurs began to offer "pooled" deposits where intermediaries would let small depositors pool their funds to acquire shares in "jumbo" deposit obligations. The regulators then outlawed that approach, etc. The net result was that as regulations grew, regulatory compliance costs grew, and investment frictions grew so relatively more money went to regulators, lawyers, and other parties and less to the ultimate depositors and savings institutions than would have otherwise been the case.

REGULATORY CAPTURE

One result of regulation, as illustrated above, is that regulators often pass regulations at the request of the industries they regulate in order to try to enhance the profitability of those industries. There is often a mutual interest of industries and their regulators in supporting each other's viability. If the industry fails, there is less need for regulation. If regulations grow, there is more need for the industry to hire former regulators to help them comply with and influence the new regulations. Thus, a healthy industry can provide job opportunities for former regulators-- and can also wine and dine current regulators while in the process of explaining their need for favorable regulations. Because of their mutual interests, a process of "regulatory capture" often exists where regulators and existing institutions work closely together to further their mutual interests. Mutual cooperation can be particularly beneficial to regulators when industry membership is concentrated and has sufficiently profitability so that it can provide lucrative post-regulatory job opportunities to regulators.

REGULATION AND EXTORTION

LOWER LEVEL EXTORTIONS

The existence of regulations that can either increase or decrease the profitability or viability of various enterprises grants power to the regulatory authorities and legislators who can either grant or deny favorable regulations, permits, and permissions or may impose unfavorable regulations, penalties, fees or taxes with some discretion. The existence of such powers gives rise to possibilities for "extortion" of various types.

When one thinks of the underworld, one tactic mafias and other criminal organizations often use is to run "protection rackets." In such a racket, an enterprise or individual may be asked to pay "protection" money to ensure that nothing bad happens to them or their business. Government officials and regulators can essentially do the same thing by asking for or encouraging that various payments be made before favorable rulings occur or negative events happen. In either case, the individual or business who pays the money is essentially being "extorted."

Extortion activities can either occur at low levels or at relatively high levels of the regulatory and legislative apparatus. Low level extortions are quite common in some cultures and countries. However, one cannot assume that our culture is immune to such effects. While most people are taught to believe that “public servants” have no higher goal than to serve the public, that is unlikely to be true. James Buchanan received a Nobel Prize in economics for his work on “Public Choice” economics which demonstrated that legislators and regulators could put their own interests above those of the various publics whom they purported to serve.

I became aware of regulatory and political corruption when I studied economic development in graduate school. My major professor had traveled to Nigeria to help create an economic development plan. While there, as I recall, he encountered a minor official who denied him the permission he needed to exit the country and was obviously looking for a bribe before the permission would be forthcoming. My professor, who was of a Germanic background and therefore believed in honest compliance with regulations, punched the offending minor official. That created quite a stir but my professor was famous and had been asked by important people to help the country, so it all was smoothed over. Also, in graduate school, I learned that one problem with Indian economic development was that India had an extensive bureaucracy that , at that time (50 plus years ago) frequently was corrupt. The bureaucracy had many college educated petty bureaucrats who were paid very poorly and enhanced their meager incomes by enacting myriad regulations and obtaining bribes and side payments before potential enterprises could obtain all the required permissions. Consequently, innovations and economic growth were often stymied by the vast quantity and high costs and uncertainties that surrounded the obtaining of required permits and permissions.

My son also experienced regulatory corruption in India and elsewhere when he traveled around the world on a very low budget at a young age. In India the practice of making side payments had a name. It was called “baksheesh.” He found that knowledge useful when he was told that he was 143rd on the waiting list for his plane flight to leave the country. Consequently, he took all the Indian money he had left out of his pockets and asked if there were any payments he could make to improve his position. He gave the money to the official and was told that he was now number 1 on the waiting list. In other countries such as mainland China, Russia, and the Congo, he learned that when a petty bureaucrat told him that he was unable to do something without the required permission, he asked if there was a fine he could pay. Usually, after a side payment was made, the required permission was either received or the requirement was ignored by the official who received the payment.

In the US we like to think that our bureaucrats and officials are above such enticements, and many of them are. However, petty extortions still may exist. I first became aware of such possibilities when I moved to Washington, D.C. Since I didn’t plan to return, I sold my house in Dallas. The sale was partially financed with a VA loan for the buyer. The loan required regulatory approval. That approval was not forthcoming before our move since the house had not yet been inspected. After we were in Washington, we were told that the inspector had found a scratch on a screen that had to be replaced before the loan could be approved. I could recall no such scratch but was no longer in a position to dispute it, so we made all required payments, which were relatively large for a minor screen scratch, and paid for a new inspection. I couldn’t help but think that some of the extra money might have made its way into the pockets of the inspector.

Another possible example I can think of was related to me by a friend who is in the oil business. He had an oil operation that needed regulatory inspection and approval. The inspector who was sent out had very little experience in the oil industry. However, he was very personal and talked a great length about the value of trading card investments. My friend was intrigued by the possibility of profit in such ventures and gave the inspector some money to invest on his behalf. Subsequently, he had no trouble getting the required operating permissions, but I don’t think he ever made any money on his trading card “investments.”

HIGHER LEVEL “EXTORTIONS”

The possibility for legislators and regulators to obtain additional income through various forms of “extortion” also exists. Some of the required payments may be substantial. I first became aware of such possibilities when I was invited to provide expert witness testimony to a state legislature. I was to be paid well and my travel expenses were to be paid by financial industry lobbyists so I agreed to make the presentation.

The issue upon which I testified was a recent proposal before the legislature to enact a “usury” law that would severely restrict the interest rates that lenders could charge on consumer loans. This was supposed to “protect” consumer borrowers. In my testimony, however, I pointed out that in states with strict usury laws, consumers often were unable to obtain cash credit from legitimate lenders, but they still could borrow to finance the purchase of consumer goods. The only problem was that those goods cost more than they did in other states, as retail lenders attempted to make up enough in the goods’ extra prices to compensate for the fact that the interest earned on the credit contract was inadequate to cover the lenders’ financing costs and the risks of loss on the loans. In addition, cash credit might still be available, but only from “illegal” lenders, such as the Mafia. Such lenders did not have access to the court system to collect on defaulted loans. Thus, they often used rather brutal loan collection techniques to enforce loan repayments. In short, there would likely be more consumers who would have to buy goods at higher prices or take on potentially burdensome collection risks if a strict usury law were passed.

After my testimony was concluded, the legislators proposing the strict usury law, the financial industry officers and lobbyists, and I all went to lunch. On the way, I noted that all the participants got along with each other very well. It also was clear from the conversations that they all understood the issues very well. In a sense, my testimony was redundant because I had not told them anything they didn’t know. However, during their conversations, they also talked about the upcoming legislative elections. Thus, I realized that my presentation provided an excuse for the proposing parties to withdraw their potentially harmful legislation in the event that they received sufficient contributions to support their upcoming reelection campaigns. It was all an expensive Kabuki theater presentation to justify enhanced political contributions to needy legislators. In a sense, the proposed legislation was a form of extortion.

After realizing that many laws might be threatened or withdrawn as a way to obtain political contributions and other side payments (we had an excellent lunch at the lobbyists expense) to legislators. I realized that political contributions in general serve the same purpose.

However, political contributions by businesses who may need a favorable legislative or regulatory interpretation are often made on a preemptive basis--as a form of insurance against potential future extortion attempts. Thus, even though staunch Republicans have criticized Donald Trump for the fact that he made large past contributions to Democrats as well as Republicans, it makes sense from a business standpoint. As the owner of businesses that might require favorable rulings, laws, or regulations from either party, it made sense to pay them both preemptively. Many businesses do the same thing.

REGULATION AND THE GROWTH OF LARGE CRONY CAPITALIST ENTERPRISES

There are a number of forces that cause legislation and related regulations to grow and to favor larger business enterprises over smaller business enterprises. First, note that the regulatory dialectic causes regulatory activities to continue to grow and expand over time. In addition, note that larger enterprises are better able to incur the extra compliance, or evasion, costs associated with increased regulation--as their larger revenues cause incremental regulatory compliance costs to be a smaller portion of their gross revenues than is the case for smaller institutions. Second, larger enterprises can better afford to make significant preemptive "extortion" payments in the form of political contributions, etc., than smaller institutions. Thus, their appeals and interests are more likely to be recognized and accommodated by legislative and regulatory authorities. Third, since institutions can often gain by becoming larger and gaining more "monopoly" powers, and politicians can often obtain larger contributions from larger enterprises that have greater profitability, politicians may look favorably on legislation that allows favored enterprises to merge or gain market protection privileges of various types that allows them to prosper and grow. Since large, more profitable, institutions can make larger political contributions and can pay former regulators more to come to work for them, the net result is that legislators, regulators, and regulated entities can all gain if the enterprises are protected and allowed to grow. At the same time, smaller institutions will be disadvantaged by the high fixed compliance costs associated with regulation and may either be forced to merge to gain a larger scale and more political clout, or go out of business.

Because politicians, regulators, and large scale enterprises all expect to gain from the growth of the enterprises, all have a vested interest in the growth and prosperity of the affected enterprises. Thus, the politicians and regulators become "cronies" with the enterprises, and over time crony capitalism tends to grow in importance relative to free market capitalism.

IMPLICATIONS OF REGULATION AND CRONY CAPITALISM FOR ECONOMIC PRODUCTIVITY AND GROWTH

Economic productivity relates the total amount of production by an economy to the amount of resources, particularly labor, used in its production. In order for productivity to increase, resources (particularly labor) must be used more productively in producing economic products.

One effect of the growth in crony capitalism relative to free market capitalism is that economic productivity is likely to grow at a slower rate as the regulatory state and crony capitalism gains in relative importance. There are several reasons for such a result.

First. regulation may directly reduce productivity by mandating restrictions upon how labor resources can be reallocated so they can be used in more productive ways. Second, regulatory compliance costs usually require that labor and other resources be devoted to compliance with the regulations instead of being directly allocated to productive activities. Thus, the amount of product produced per hour of labor employed will be lower than would otherwise be the case. Finally, larger institutions tend to have larger internal bureaucracies that have to sign off on potential innovations and as a result may be slower to adopt productivity enhancing innovations than smaller more flexible organizations. In addition large institutions that are protected from competition may have less incentive to innovate than smaller institutions that must compete with numerous ambitious competitors.

Because the growth of regulation and crony capitalism can slow the growth in economic productivity, it can also slow rates of economic growth. Economic growth depends upon both the growth in the number of economic resources employed and in the growth in the productivity of those resources. Thus, factors slowing productivity growth also slow economic growth. A recent example of this phenomenon has been demonstrated by recent US presidential administrations. Under the Obama administration, productivity growth and economic growth were relatively muted relative to what might have been expected for a period following a significant recession. Not coincidentally, regulatory efforts expanded substantially during the Obama Administration. In contrast, during the Trump Administration, significant efforts were made to try to rein in federal regulatory activities. Consequently, the reduction in regulatory burdens undoubtedly had a favorable impact upon the growth in economic productivity that occurred at that time. While other factors (such as tax cuts) also contributed to economic growth during that time, the reduction in federal regulation was also important.

Looking ahead, one has to be concerned that a resumption of intensive regulation by the Federal government is likely to generate further increases in crony capitalism and lower rates of increase in economic productivity in the US economy in the future.