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What's Bad About Crony Capitalism?

Peter Enderwick
Faculty of Business, Auckland University of Technology, Auckland, New Zealand.
E-mail: peter.enderwick@aut.ac.nz

While there has been much discussion of the negative effects of crony capitalism, there has been little analysis of their precise nature. It is widely agreed that crony capitalism generates significant economic rents, which result in a misallocation of resources and lower incentives for wealth creation. In addition, the corruption that accompanies cronyism constitutes a considerable impediment to growth and development. This paper provides an analysis of the likely costs of cronyism and categorises them into four principal groups: allocative inefficiencies; dynamic inefficiencies; corruption and transaction costs; and problems of social and political stability. The analysis suggests that the most damaging aspect of crony capitalism is its tendency to discourage restructuring and adjustment at a time when such traits are central to economic success. The various linkages between the cost components are also explored. Examination of the claimed benefits of crony capitalism shows that they are more than offset by the negative effects.
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Introduction

Crony capitalism refers to a form of capitalism that restricts the allocation of economic resources and opportunity to a country's privileged elite or politically connected 'cronies'. The Asian economic crisis of 1997 brought widespread interest in the concept of 'crony capitalism'. One school of thought argues that the close and enduring relationships between business, governments and banks actually caused the crisis; a weaker version is that they impede recovery from the crisis. Regardless, there is a general consensus that crony capitalism is somehow harmful. Despite the widespread interest in the topic, there has been little systematic analysis of the question of why it is so harmful. The focus of much of the literature is on the resource allocation (or misallocation) costs of cronyism and the need to sustain high levels of economic rents. In addition, it is recognized that the persistence of such rents

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distorts business behaviour, encouraging rent-seeking behaviour at the expense of wealth creation.

While there is certainly considerable validity in such views, it does not explain how many crony economies, particularly those in Asia, enjoyed such high rates of growth in the period from the late 1960 s to the mid-1990 s. Neither does it explain the timing or the severity of the Asian economic crisis.

The intention of this paper is to explore the likely costs that are associated with a system of cronyism and examine their economic implications. We discuss these costs within four key categories: allocative efficiency; dynamic efficiency; corruption and transaction costs; and social and political stability. Offsetting these costs are some of the claimed benefits of a system of crony capitalism, which we shall also discuss. However, on balance the analysis suggests that the costs substantially exceed the benefits and that the most damaging impacts relate to dynamic efficiency in the form of low rates of innovation and technical change and in the creation of considerable impediments to corporate restructuring.

The discussion is organized around five substantive sections. The following section discusses the reasons for the existence of systems of crony capitalism and discusses the idea of credible commitment by governments. The next section offers a brief discussion of the claimed advantages of a system of crony capitalism, particularly for economies at relatively early stages of development. The subsequent section provides a detailed discussion of the costs of crony capitalism and their interrelationships. Concluding comments are provided in the final section.

A Rationale for Crony Capitalism

The question of why crony capitalist economies exist is by no means a trivial one. The answer appears to lie not in simplistic explanations based on cultural characteristics, but rather in terms of a general economic problem, that of governments' credible commitments (Haber, 2002). The problem arises because of the need for government to ensure and arbitrate private property rights. Where governments enjoy the power of allocation and arbitration of such rights, they also have the ability to usurp those very rights. The dilemma is how to constrain governments to ensure that while they offer a degree of protection of property rights sufficient to enable economic investment and growth they do not usurp these rights. Usurpation could occur in the form of taxation of private economic rents, or the seizure of rent-creating assets. Such threats would be sufficient to discourage investment and hence growth. A variety of institutional solutions to this dilemma are available.

The simplest solutions are those of the two extremes, Anglo-Saxon capitalism and socialism. Under Anglo-Saxon capitalism the problem of credible commitment is addressed through 'limited government'. In this case, the degree of government involvement in the economy is generally low and is assured through an elaborate set of complementary institutional devices designed to support and guarantee individual and property rights. Elaborate and sophisticated economic and political systems have evolved a complex system of checks and balances designed to ensure that the power of the individual is subservient to that of the system. In the political realm these safeguards are reinforced through a professional and independent bureaucracy. The key elements of such a system are an independent judiciary, central and local governments, autonomous specialist national agencies, a professional public service, a free media and an active civil society.

At the other extreme, socialism, the problem is resolved by the elimination of private property rights, that is, the state owns the means of production. In this case, the problem is eliminated since the state is unlikely to threaten itself. The experience of history suggests that this solution is likely to bring considerable economic costs and inefficiencies.

In between these two extremes are sets of arrangements, which offer solutions to the problem of credible commitment and, which vary in the extent of government involvement. The stakeholder model has gained a strong following in recent years and while primarily intended to ensure a stronger representation of interest groups in the production process, it does impinge on the commitment issue by ensuring a higher level of vigilance of economic activity. The corporatist or tripartite model is particularly favoured in Europe and provides a mechanism for balancing (potentially) conflicting interests and for ensuring convergence of expectations. The three parties typically involved are business, government and organized labour. Again, while not designed specifically to address the commitment problem, it does have the effect of clarifying intentions and gaining consensus on boundaries and obligations. The Asian Development Model implies a further degree of involvement whereby the state directs the economic development process through active industry policy. Such a strategy follows from a belief that, on their own, markets fail, or work too slowly to be acceptable.

A further development of this model is in the form of crony capitalism, a system that integrates the interests of government, business and banking to ensure that considerable advantages are enjoyed by a select, connected group. To the extent that politicians create economic opportunities benefiting select élites, and that this is reciprocated in the form of political support or a share of subsequent economic rents, cronyism provides a solution to the credible commitment problem. In such a case, the property rights of a sub-group of asset holders are assured because the politicians offering such an assurance share in the stream of earned rents. Presumably, this is more attractive from the perspective of the government than seizing and owning the means of production (socialism).

Such a solution offers two distinct advantages. First, it allows investment and economic growth to occur in the absence of limited government. This is a significant consideration when it is realized that limited government is by no means a universal solution to the problem of credible commitment. Indeed, it is unlikely that more than some 30–40 economic systems worldwide can be characterized in this way. The majority of these are advanced (OECD) nations. Much more commonplace would be alternative institutional solutions, including crony capitalism. The attraction of crony capitalism lies in the fact that it provides a solution without the need for the considerable investments of time and resources that are necessary to create the elaborate political and economic institutional structures that limited government requires. Indeed, in a number of nations cultural and historical factors tend to favour alternatives to representative democracy and market economic systems. The prevalence of relationship-based, as opposed to rules-based, economies in Asia and Latin America provides examples. In these cases economic and political activities are organized in ways that minimize the need for market-augmenting institutions that are extremely costly to establish and maintain.

Second, crony capitalism also allows the resolution of a related problem, that of enabling growth in the face of political instability. Again, the reality is that a greater number of unstable than stable political systems exist in the world. Instability negates the possibility of limited government, because it does not enable the creation, maintenance and effectiveness of self-enforcing institutions. The result is a system built around political and economic integration of a favoured elite, what has been termed 'vertical political integration' (Haber *et al.*, 2002). In this way economic actors directly participate in the policy determination process, ensuring outcomes that encourage investment and growth.

While crony capitalism can confer these apparent advantages, it offers a second-best solution carrying considerable costs. Three costs are readily identifiable (Haber, 2002; Krueger, 2002). The first is a misallocation of resources. To induce investment in the absence of the assurances of limited government, economic rents are required. Crony capitalism not only encourages rent-seeking behaviour, it actually requires the persistence of such rents. Rent levels will also exceed the minimum required to induce investment, since they must be shared with the controlling political elite. Such misallocation will manifest itself in the form of protected and inefficient industries, the existence of industries that do not enjoy comparative advantage, and barriers to entry to aspiring entrepreneurs lacking appropriate political connections.

Second, cronyism necessitates the maintenance of political relationships and by implication, the continuation of the existing political elite. This encourages political authoritarianism, the repression of political competition and a focus on the short term. Short-term horizons mean that investors demand high rates of return, bias investment away from long term projects, and encourage asset price bubbles.

Third, crony capitalism is likely to have a detrimental impact on the distribution of income. While the favoured economic and political elite enjoys economic rents, these are obtained at the expense of producers, and more generally, consumers.

While these are valid assessments of the costs of cronyism, they are far from complete. In particular, they take no account of cultural characteristics that encourage relationships, they fail to incorporate the very considerable costs of establishing appropriate market institutions and pay little attention to the inflexibilities that such a system creates. We consider the benefits of crony capitalism in more detail in the following section.

The Benefits of Crony Capitalism

There are three main arguments in support of crony capitalism. The first is the argument outlined above, that it provides a solution to the problem of credible commitment, encouraging firms to invest even in the absence of 'limited government', the most widely advocated solution to the credibility problem. Furthermore, crony capitalism enables investment and growth to occur under conditions of turbulence, because it is only the rights of a minority of businesses that have to be assured.

The second argument in favour of cronyism is the empirical observation that it appeared to work very effectively in many economies, particularly within Asia, between the 1970 s and the late 1990 s. High growth rates and significant real increases in income created a belief in the so-called 'Asian Miracle'. However, there is now significant doubt about the extent to which this was a miracle (Krugman, 1994) and as to whether the Asian model has value in the future (Richter, 2000).

From a micro-level perspective, the claimed advantages result from a range of benefits to stakeholders. Banks were able to direct lending to a small number of favoured clients, ensuring their needs were met and facilitating high growth. The flexibility of these institutions meant that when markets turned down, help was still provided. In part the high risks involved in this were attenuated by the close relationships: banks secured guarantees from government on funds provided and enjoyed inside information on planned activities and performance. The family nature of many of the client firms brought high levels of flexibility and an ability to exploit opportunities. The fact that the growth came to a sudden end and created immense problems of restructuring may suggest that such advantages are transitory or only apply to economies at certain stages of development or rates of growth. Again, this argument does not provide any clear-cut case for cronyism.

The third argument is that cronyism provides a way of overcoming some of the weaknesses of a market system. This is not to suggest cronyism as a response to market failure; rather it can be used to augment processes that are slow or unreliable under a pure market system. Examples include the identification of new market opportunities or of entrepreneurial talent (by government bureaucrats). Furthermore, cronyism can be used to establish profitable conditions right from the inception of a project. While it may take a considerable period of time to build up scale, market share or quality under competitive market conditions, common responses under cronyism include subsidized capital, tariffs and other import protection, monopoly status, loss write-offs and nationalistic appeals to consumers. Limited foreign exchange channelled to those most needing to import capital goods and selected infrastructure investments can be used to facilitate favoured industries.

It should be apparent that these arguments pay little attention to the costs that they generate. The apparent short-term benefits of establishing new activities in this way have to be compared with the very considerable inefficiencies that are likely to result from pervasive protectionism. The struggling Malaysian car manufacturer Proton provides an example. While cronyism may appear to bring advantages over markets in initiating economic activity, a market system is likely to prove far superior in terms of resource reallocation, restructuring and exit. The increasing pace of economic change and level of turbulence mean that adjustment activity has become far more significant for most economies in recent years.

It is hard to establish a positive case for crony capitalism and even arguments in its favour are likely to be eclipsed by the accompanying inefficiencies and inequalities that result.

The Costs of Crony Capitalism

In this section, we offer a systematic analysis of the costs of crony capitalism. Furthermore, we highlight the considerable interdependencies that are likely to exist between the principal cost components. The conclusion of the discussion is that the benefits of crony capitalism are far exceeded by the costs. In particular, we argue that a system of crony capitalism creates considerable rigidities, which impede the process of economic and corporate restructuring. As the pace of change in the global economy has accelerated, this has placed an intolerable strain on such systems and in the case of Asia generated a massive economic crisis. While cronyism is embedded within country-specific political and economic systems and it is recognised that its effects will vary with the

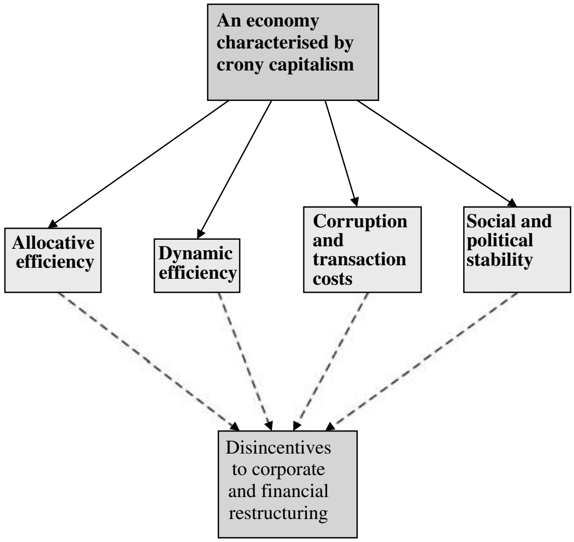

Figure 1 The types of costs of crony capitalism.

parameters and dynamics of such systems (Williams, 1999), we believe that some generalization about its costs are possible.

Our analysis of the costs of crony capitalism is summarised in Figure 1. We distinguish four principal cost categories: allocative efficiency; dynamic efficiency; corruption and transaction costs; and social and political stability. These cost categories are interrelated, and their overall impact is to retard rates of social and technological change and to create significant disincentives to restructuring. We will discuss these four components in detail.

Allocative efficiency

The concept of allocative efficiency considers the extent to which resource use at any point in time deviates from that likely to prevail under competitive market conditions. It is this component that has received most consideration in the literature. While such costs are significant, our analysis suggests they are simply one part of the total costs of cronyism.

Analysis of allocative efficiency starts from considerations of corporate and market structures. In the majority of economies characterized by crony capitalism, businesses are predominantly family-owned (Claessens *et al*., 1999). This is certainly true for Indonesia, Thailand, Malaysia and the Philippines. In the case of Korea, the large *chaebol* were established by favoured and supported entrepreneurs, who often maintain a strong family influence through stock-holdings (Ungson *et al.*, 1997). Family ownership is likely to result in poor corporate governance. The unification of ownership and management means that there is no agency problem as commonly identified in the Western literature. Rather, the issues focus on poor transparency, accountability and risk distortion. Transparency is likely to be low when businesses base competitive advantage on preferential access to information or resources. Governance in crony systems, by definition, relies on non-publicly verifiable information and there exist strong incentives for the parties to suppress the sharing of such information with potential competitors. The structure of family firms also discourages transparency. Where relatives and friends are appointed to management and board positions, when funds are raised internally or from banks (to limit equity dilution), or business relations are restricted to a small pool of suppliers and distributors, there is little need for transparency and information disclosure (Robertson-Snape, 1999).

Problems of accountability exist when large shareholders are subject to limited control from other shareholders or the governance system. Under crony capitalism one does not find a strong legal system, market regulatory bodies, independent banks, clear and enforced rules governing financial reporting, active shareholders, including institutional investors, or a strong independent financial press. In a rules-based economy, all of these contribute to ensuring accountability.

Low levels of transparency and accountability, coupled with a reliance on bank financing, raise the possibility of risk distortion, over-investment and declining returns. Crony capitalism distorts risk assessment in a number of ways. On the one hand, familiarity between the parties (lenders and borrowers) can reduce search costs and perceived risk assessment. On the other hand, subsidized funding or implicit guarantees of continuing financial support (a moral hazard problem) encourage over-investment. There was some evidence of this in the run-up to the 1997 Asian economic crisis. Again, the underdevelopment of financial markets and regulatory institutions mean that such investment may be larger or occur over a longer period, before any pressure for adjustment comes into play.

Firms respond to these distortions in predictable, but often-undesirable, ways. One is through excessive diversification. There are strong incentives for family firms to pursue a path of conglomerate diversification. First, in many cases alternative growth paths, such as internal expansion or mergers and acquisitions, are not feasible. In the case of internal growth the firm is likely to run into a management constraint where there is reluctance to share control with those outside the family. Similarly, growth through mergers and acquisitions assumes the existence of an efficient market for corporate assets, which are not found in many developing economies. Second, conglomerate growth can provide an effective strategy for risk reduction or as a way of economising on search costs. Third, such a path is often a logical way to exploit the types of competitive advantages possessed by many firms in relational-based economies, which are generally based on political connections, a dedicated distribution system or strong company or brand names.

A second bias is towards the short term. Where favoured access is the result of political connections, there may be a tendency to view such advantages as tenuous and dependent on continuing political patronage. Fear of political change can foster a strong short-term focus and the pursuit of high rates of return, perhaps at the expense of long-term investments in competitive advantages. Both factors, when combined with protectionism and favouritism, mean that above-normal returns are likely to persist (Claessens *et al.*, 1999). Such distortions clearly contribute to a problem of allocative inefficiency.

Dynamic efficiency

While the welfare costs of allocative inefficiency are often considerable, for many reasons they are likely to be eclipsed by dynamic inefficiencies, that is, the inefficiencies that accrue over time as opposed to at one point in time. As world economic forces have become increasingly dynamic — through deregulation, liberalization and globalization — they have raised the potential magnitude of dynamic inefficiencies. At present there are considerable advantages stemming from adaptability and flexibility (Best, 2001). It is our contention that the major costs of crony capitalism result from distortions in this area.

The key restrictions stem from a preference for bank financing, coupled with pervasive barriers to market entry. The two are in fact related (Hughes, 1999). Banks are more willing to lend to firms that are protected from strong competitive pressures. The results of this are underdeveloped financial markets and institutions (which impede the process of corporate restructuring through mergers and acquisitions) as well as low levels of entry by foreign firms. Both contribute to low rates of innovation and change. The absence of strong competitive pressures encourages firms to restrict themselves to current activities (which offer above-average returns because of the availability of lucrative and protected economic rents), or at best to pursue conglomerate diversification. Incentives to invest in technological upgrading and innovation are weak. In the longer term, it is likely to be the slow rate of innovation and limited investment in sustainable forms of competitive advantage that are the most damaging aspects of crony capitalism. Again, there is likely to be inherent resistance to change within a system of cronyism. Protecting the interests of owner-families tends to override any desire for economic, institutional, legal or regulatory reform.

Dynamic efficiency is also impaired by the growth and risk distortions created by corruption. Any corrupt payment necessary to obtain an investment license raises the costs (and uncertainty) of such investment, lowering the incentive. Slow rates of private investment, coupled with a leakage of public investment into private consumption, adversely affect growth rates.

Risk is also adversely affected by corruption. This provides a further illustration of the differences between taxation and corrupt payments. While the taxation system in many countries allows deduction of losses from taxable investment income, there is no corresponding allowance for corrupt payments, so that corruption has a strong negative impact on risk-taking in the face of innovation and uncertainty. Similarly, since new products and processes typically require far more regulatory approvals, innovative firms are particularly susceptible to demands for illicit payments (Bardhan, 1997). The problem is compounded where new activities require considerable up-front fixed-cost investments (Romer, 1994).

Corruption and transaction costs

High levels of corruption usually accompany crony capitalism (Mauro, 1998). In some cases the corruption may be confined to a relatively small group of senior politicians and their business associates, but in most cases corruption becomes endemic. This is certainly the case in countries such as Thailand and Indonesia. Indeed, there is evidence that in the face of pervasive corruption foreign investors are just as likely to offer such payments (Hellman *et al.*, 2000).

Corruption brings a number of costs (Gray and Kaufmann, 1998). It raises both transaction costs and uncertainty. It is unfair in the sense that it is a regressive tax that imposes a considerable burden on smaller firms. It undermines the legitimacy of the state. Perhaps most significant from our perspective, corruption distorts resource allocation. By raising transaction costs, corruption reduces the amount of investment, both domestic and foreign. It can also distort sectoral resource allocation, favouring large projects (where potential bribes are likely to be greater), and encourage greater levels of technology-intensity than would be warranted by factor costs and conditions. More generally, corruption encourages behavioural shifts favouring rent-seeking as opposed to wealth-creating activities.

Despite assertions that corruption can have desirable effects in allowing businesses to overcome excessive or cumbersome regulation (Leff, 1964), there is little evidence to support the so-called 'efficient grease hypothesis' (Gray and Kaufmann, 1998; Kaufmann and Wei, 1999). The hypothesis is subject to a fundamental flaw in failing to recognize that regulatory controls can be endogenously determined, that is, there are strong incentives for public officials to create further regulations, since they provide a lucrative source of income.

For the purposes of this discussion, the principal impacts of corruption are on the level and composition of international capital flows. Since corruption raises both transaction costs and uncertainty, it has the effect of reducing the volume of incoming capital. The amount of international capital attracted to a corrupt economy is likely to be lower because of the increased risks that both investors and creditors face. There are grounds for believing that corrupt economies, which pay scant regard to the rule of law, are more likely to default on loans, to nationalize or otherwise restrict the assets of foreign investors (Wei, 2000).

However, while corruption is likely to reduce the overall volume of incoming capital to a country, it is also likely to alter the composition of capital inflows. More specifically, it may be expected to bias the capital composition in favour of portfolio rather than foreign direct investment. This occurs because the effects of corruption on FDI are much greater than on portfolio capital. Since direct investors are likely to be involved in more frequent and more extensive interactions with the local authorities, they are likely to face greater demands for illicit payments. They are also more vulnerable to such demands where investments imply higher sunk costs. In addition, the current international financial system tends to favour creditors rather than direct investors in time of difficulties (Wei, 2001). For all these reasons FDI is likely to be more discouraged than portfolio investment. One effect of this is to increase financial instability, since portfolio capital can move more easily and quickly than FDI.

When this instability is coupled with the likely underdevelopment of financial markets and institutions, the effect is a bubble-type economy characterized by dramatic swings, and where adjustment in times of crisis focuses on asset and price changes. There are few incentives to positive corporate restructuring in the forms of added value or technological progress.

While corruption reduces the overall level of FDI likely to be attracted to a country, it also appears to influence the operating form that the investing firm adopts (Smarzynska and Wei, 2000). *A priori* the impact of corruption is not clear. A corrupt bureaucracy may encourage investors to seek local partners to assist in the entry stages. At the same time such a culture decreases the assurance that investors need in sharing assets or resolving conflicts with partner firms. The available evidence suggests that the overall effect is to increase the incidence of joint ventures, but at the expense of attracting more technologically advanced firms. The implications of this for corporate restructuring are mixed. On the one hand, joint ventures encourage the sharing of management skills and resources with local firms and this could facilitate adjustment. On the other hand, if technology is not shared, the opportunities for adjustment through technological upgrading are reduced.

Social and political stability

The fourth category of crony capitalism costs results from considerations of social and political stability. While it has been argued that vertical political integration provides a solution to the credible commitment problem, it is always a second-best solution. One problem that arises is the likelihood of a higher level of power and income inequality. Almost by definition, cronyism implies that a small majority will be positively favoured economically and that the costs of this will be carried by a larger majority of consumers and taxpayers that finance the persistent economic rents that are fundamental to the system (Hutchcroft, 1993).

Corruption and cronyism are linked to high levels of economic inequality and social instability (Rose-Ackerman, 1997). The poorest will be disadvantaged, in that infrastructure investment will be biased against projects that favour the poor; they may face higher taxes or enjoy fewer services and are likely to be disadvantaged in selling their output. More generally corruption has been shown to increase social inequality by lowering growth rates, reducing access to education by the poorest and promoting government policies that favour inequality in asset ownership, taxation, social spending and programme targeting (Mauro, 1997; Tanzi and Davoodi, 1997).

Economic cronyism is usually matched with an authoritarian political system. The intimate relations between government and business also have significant political impacts on adjustment processes. First, in a number of crony economies the underdevelopment of democratic processes has resulted in the undersupply of appropriate institutions that provide regulation, supervision, transparency and balance between growth and stability (Godement, 1999). Second, the absence of rights to NGOs — freedom of expression, association and assembly — attenuate processes of pluralism and the likelihood of negotiated change. Third, over-centralization of government, characteristic of crony capitalism, is associated with an increased likelihood of corruption (Rudolph, 2000). Similarly, low levels of transparency are characteristic of societies with weak civil institutions and government restrictions on the media. Both impede economic adjustment and restructuring.

In part, such systems are resistant to change because they are more difficult to maintain when there is economic instability. Indeed, such structures are vulnerable to both economic downturns and booms. In a downturn, the failure to deliver in economic terms invalidates the 'performance legitimacy' of authoritarian systems, which rest on continued economic growth. This was the experience of Indonesia during the 1997 Asian economic crisis. In an economic boom there are related pressures, which typically stem from the accompanying social change, which threaten authoritarian regimes. It is also the case that restructuring is not only resisted by such systems, it is also more difficult to achieve, since there is likely to be limited information (problems of accountability and transparency) and underdeveloped institutional mechanisms to facilitate economic change. The overall effect is to slow down the rates of social, political and economic change.

The resistance to change is compounded in three extreme cases. The first is the problem of 'mutual hostage', a variant of cronyism where the principal partners (politicians and business leaders) become locked into a situation of mutual dependency, where change by one threatens the well-being of the other. This appears to be the case in the Republic of Korea. Despite the widespread recognition that extensive corporate restructuring has been necessary for many years, successive governments have made little progress in achieving this. The large corporate groups, the *chaebol*, have resisted or defied policy imperatives to change.

The second situation arises where corruption is so endemic that even radical political change does not eliminate the problems of cronyism. This appears to be the situation in Indonesia, where the post-Suharto new order has simply replaced the once-ruling family with multiple oligarchies of related dependents (Wee, 2002).

The third extreme case is that of 'state capture', which is found in a number of transitional economies and which results from initiatives by firms, often late entrants, to reformulate economic rules and regulations for their individual gain. The damaging facet of this process is that firms make a strategic choice to pursue state capture to obtain the public goods that are underprovided. This again deflects effort and resources from wealth-creating to rent-seeking activities and inevitably results in both static and dynamic inefficiencies. Furthermore, the benefits obtained by the minority of firms are at the expense of the majority. Such firms, by investing in selective advantage, face strong incentives to resist any reforms seeking to improve the institutional framework (Hellman and Kaufmann, 2001).

While it is useful to separate the four categories of cost associated with crony capitalism, it is important to recognize that they are inter-related. We suggest that the common thread linking them is the creation of disincentives to corporate and financial restructuring. Where allocative inefficiency is equated with above-normal returns, there are few incentives to innovation and change. The dynamic inefficiencies that result in underdeveloped financial markets and markets, bubble economy characteristics and a focus on rent-seeking, again impede corporate and financial restructuring. The same arguments apply to corruption and high transaction costs. By discouraging FDI, the pressure for change driven by new investors is attenuated. At the same time, biasing capital flows toward portfolio investment increases the danger of financial instability and reduces the likelihood of efficient markets in corporate assets, an important source of restructuring pressure. Similar arguments apply to the costs resulting from social and political instability. Particularly, when an economy becomes subject to a mutual hostage situation, there are disincentives for both business and government to initiate significant change. In such cases, the most effective pressures tend to be external, often in the form of conditionality requirements imposed by agencies such as the IMF.

In our analysis, it is the problem of discouraging corporate restructuring and upgrading that is the most damaging aspect of crony capitalism. This problem is likely to have two key elements. The first is the disincentives which incumbent firms face to upgrade performance. The second, and related, problem is the deficiency of entrepreneurial capability that is likely to be experienced in a crony regime, where considerable barriers to business entry face the unfavoured. In both cases the result is slow and ineffective change and adjustment to emerging business conditions (Hughes, 1999; Moran, 1999).

Conclusions

This paper has provided an analysis of the costs of crony capitalism. It was prompted by the widespread view that cronyism is bad, but very little credible discussion or evidence exists on the form and magnitude of these likely costs. While attempts to measure the magnitude of a phenomenon shrouded in secrecy are fraught with difficulties, understanding of the costs of cronyism has been largely restricted to country-based studies (Moran, 1999; King, 2000; Haber, 2002; Kang, 2002). The modest contribution of this paper is in attempting to delineate the various costs and the likely relationships between them.

While there is a rationale for crony capitalism as one solution to the general economic problem of government making 'credible commitments', as a solution it can only be second-best and is likely to bring considerable costs and distortions.

This paper argues that the costs of cronyism can be usefully broken down into four major categories: allocative efficiency; dynamic efficiency; corruption and transaction costs; and those associated with social and political stability. Existing literature tends to favour the first category, citing the necessity for the creation and maintenance of sizeable economic rents. While these are a significant component of costs, we argue that it is the other sources which in combination hinder the ability of a crony system to adjust and innovate, and that in the long term create the conditions for economic instability and crisis. The difficulties of many relation-based economies in struggling to recover from the effects of the 1997 Asian economic crisis lend some support to this argument.

Our discussion also highlights the difficulty of breaking out from such a system. The impediments to adjustment are reinforced by the considerable benefits such a system offers to a favoured few. Seemingly radical political change, as in the case of Indonesia, has not substantially reduced cronyism and has not accelerated the processes of economic reform imperative for recovery. These problems are compounded in the extreme cases of cronyism, characterised by state capture of mutual hostage problems.

It is illustrative to consider the contrasting experiences of the US and Japanese systems in the 1990 s in the light of this discussion. The failure of both Japanese business and government to tackle much-needed reforms has ensured a recession lasting more than a decade. In contrast, US firms, widely perceived to be losing competitiveness in the 1980s, have come back to capture new industries and markets worldwide through high rates of innovation and adjustment. As the world economy continues to display high rates of risk, uncertainty and change, the premium on flexibility becomes considerable. It is here that crony capitalism reveals its most significant flaw and highest cost.

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