

CRONY CAPITALISM: RIGHT HERE, RIGHT NOW

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Crony capitalism describes an economic and political environment in which pursuing and obtaining government favors is both part of everyday life and a necessary protocol for succeeding in business. Where crony capitalism exists, notions of meritocracy have been displaced by notions of cronyism or kleptocracy or something similar. Crony capitalism has ebbed and flowed in our history, and it seems as though today it is on the rise.

Just looking at late 2012 and early 2013, one could talk for hours about the examples of crony capitalism—for example, the \$78 million tax write-off in the new tax bill for NASCAR drivers.¹ That write-off may be very popular—I don't know—but it is crony capitalism.

The tax benefits for the New York Liberty Zone provide another example.² Yet another was the tax victory given to companies operating in American Samoa by Chris Dodd—a former Connecticut Senator—who now represents Hollywood's movie studios. He got those companies a two-year extension on a provision allowing film and television producers to expense the first \$15 million of production costs incurred in the United States—a kind of wholesale crony capitalism.³

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1. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 312, 126 Stat. 2313, 2330 (to be codified at 26 U.S.C. § 168(e)(3)(C)); Robert Pear & Mary Pilon, *Auto Racetrack Owners Keep Coveted Tax Break*, N.Y. TIMES, Jan. 5, 2013, at A13, available at http://www.nytimes.com/2013/01/05/us/politics/owners-of-auto-racetracks-retain-a-tax-break.html?_r=0.

2. American Taxpayer Relief Act § 328 (to be codified at 26 U.S.C. § 1400L).

3. *Id.* § 317 (to be codified at 26 U.S.C. § 181); *Crony Capitalist Blowout*, WALL ST. J., Jan. 4, 2013, <http://online.wsj.com/article/SB10001424127887323320404578216583921471560.html>.

There are also examples involving recent political appointees. The Senate confirmed Jack Lew as Secretary of the Treasury in February 2013,⁴ and one of the striking things about that appointment is that his contract at Citibank, where he did administrative work with a hedge fund, stipulated that he would receive a bonus if, and only if, he were appointed to a senior position in government.⁵ It now appears that not all bribery is illegal, because it appears that prospective bribery is okay. As long as you buy the futures contract that calls for paying a bureaucrat in the future, it is not the same thing as buying it on the spot market, where bribes are paid at around the same time the favors are granted. I think that permitting prospective payments to government regulators is not such a good idea.

Mary Jo White provides another example. White is a very distinguished lawyer—a former partner in the law firm of Debevoise & Plimpton—who has now been confirmed as the Chairman of the SEC.⁶ While White was at Debevoise, one of her clients was the investment banking firm Morgan Stanley. In 2005, Morgan Stanley’s board of directors decided to make a man named John Mack the CEO, but they encountered a problem. Reports suggested that Mack might have violated those pesky provisions in the federal securities regulation that outlawed insider trading.⁷

White’s client, Morgan Stanley, called her.⁸ They said it would be embarrassing if they elected John Mack as CEO and he was sued for securities fraud the next day. So they asked White to find out whether he would be sued. White then called the head of the Enforcement Division of the Securities and Exchange Commission, Linda Chatman Thomsen, to ask how things

4. Jeffrey Sparshott, *Lew Wins Confirmation to Become Treasury Secretary*, WALL ST. J., Feb. 27, 2013, <http://online.wsj.com/article/SB10001424127887323293704578330542638408164.html>.

5. Jonathan Weil, *Citigroup’s Man Goes to the Treasury Department*, BLOOMBERG, Feb. 21, 2013, <http://www.bloomberg.com/news/2013-02-21/citigroup-s-man-goes-to-the-treasury-department.html>.

6. Jennifer Liberto, *Senate confirms SEC chief Mary J. White*, CNN MONEY, Apr. 8, 2013, <http://money.com/2013/04/08/news/economy/sec-chairman-white/>.

7. Susan Antilla, *Mary Jo White’s Past and the Future of the SEC*, BLOOMBERG, Feb. 7, 2013, <http://www.bloomberg.com/news/2013-02-07/mary-jo-white-s-past-and-the-future-of-the-sec.html>.

8. *Id.*

looked for Mr. Mack.⁹ Though there are at any given time hundreds of people begging for information about whether and when the SEC will finish investigations or reach a conclusion in a particular case, White got her answer.¹⁰ Mr. Mack ascended to the position of CEO of Morgan Stanley. Thomsen, incidentally, is no longer the head of the Enforcement Division of the SEC. She is now a partner at Davis Polk & Wardwell in New York.¹¹

In short, the United States has many examples of crony capitalism. It is clear that the supply and demand of crony capitalism is such that this sordid brand of capitalism is going to emerge and even dominate wherever the conditions are ripe for it. Crony capitalism involves a demand side—which is the demand of regulated institutions like Morgan Stanley or Goldman Sachs or whomever for legislative favors—and a supply that is provided by bureaucrats and elected officials. The main point is simply that as economic regulation increases and competition decreases, crony capitalism grows. It is not really a moral story because both our elected political officials and our business people operate in Darwinian environments in which not everybody survives, the process weeds out the weakest, and firms and legislators with better survival characteristics do better. This situation explains both the rise of crony capitalism and its periodic decline.

Perhaps the biggest single instance of a decline in crony capitalism in the history of the United States took place toward the end of the nineteenth century. At that time, the States had none of the current rules for obtaining a corporate charter. It was, rather, the era of special charters.¹² To get a corporate charter, a group of individuals had to go to its state legislature and get it to pass a special statute for the group to, say, put in this turnpike or build that bridge.¹³ This was, of course, a kind of fertilizer for cronyism, because people got these charters by paying bribes.¹⁴ People in the private sphere were faced with a

9. *Id.*

10. *Id.*

11. Linda Chatman Thomsen, DAVIS POLK, <http://www.davispolk.com/lawyers/linda-thomsen/> (last visited Nov. 25, 2013).

12. John Joseph Wallis, *The Concept of Systematic Corruption in American History*, in *CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY* 23, 43–44 (Edward L. Glaeser & Claudia Goldin eds., 2006).

13. *Id.*

14. *Id.* at 45.

terrible choice of either doling out money to politicians or going out of business. It is universally acknowledged that these charters came with monopoly power and cost people a lot of money, from which the state legislators took a cut.¹⁵

This is uncontroversial. What is interesting is that crony capitalism in the granting of corporate charters vanished completely over time.¹⁶ Economic conditions changed when states moved to a system of incorporation by right.¹⁷ As a result, individuals or groups can now go on the Internet and, for thirty-five or fifty dollars, form a corporation immediately in any state, including, most notably, Delaware.¹⁸ This change to incorporation by right started to decrease the demand for special charters. People stopped agreeing to pay very much for them.¹⁹ Courts began to allow people to obtain charters in one state and do business in another, under libertarian readings of the Commerce Clause and the Privileges and Immunities Clause of the Constitution.²⁰ So if an individual or group went to one state legislature and it was unwilling to grant a charter, then the individual or group could go to another. The states had to compete among themselves.²¹ That competition drove down the price of corporate charters, and eventually it became value-maximizing for the states to enter into what we now know as a jurisdictional competition for corporate charters. In that way, a regulatory change decreased crony capitalism.

15. Robert M. Ireland, *The Problem of Local, Private, and Special Legislation in the Nineteenth-Century United States*, 46 AM. J. LEGAL HIST. 271, 277–78 (2004).

16. Wallis, *supra* note 12, at 50.

17. *Id.*; ALEX MARSHALL, THE SURPRISING DESIGN OF MARKET ECONOMIES 102 (2012).

18. Most instant legal services charge less than fifty dollars to produce and process incorporation applications; the price of each service, however, does not include incorporation fees to be paid to government agencies. *See, e.g., State of Delaware Certificate of Incorporation: A Stock Corporation*, DEL. DIV. OF CORPS., <http://corp.delaware.gov/incnstk09.pdf> (last visited Nov. 25, 2013); *Form 201—General Information (Certificate of Formation—For-Profit Corporation)*, TEX. SEC’Y OF STATE, http://www.sos.state.tx.us/corp/forms/201_boc.pdf (last visited Oct. 31, 2013); *Washington Certification of Formation*, CORPS. AND CHARITIES DIV., http://www.sos.wa.gov/_assets/corps/LLC2010.pdf (last visited Oct. 31, 2013).

19. L.E. TALBOT, CRITICAL COMPANY LAW 11 (2008) (“The provisions of a cheap alternative to the special charter brought an end to that most lucrative activity.”).

20. *See, e.g., W. Union Tel. Co. v. Kansas*, 216 U.S. 1, 48 (1910); *Pensacola Tel. Co. v. W. Union Tel. Co.*, 96 U.S. 1, 11 (1877); *Conn. Mut. Life Ins. Co. v. Cross*, 18 Wis. 109 (1864).

21. TALBOT, *supra* note 19, at 11.

Other examples of competition overcoming cronyism are more familiar. In the old era of NCAA basketball, particularly in the Southeastern Conference, teams were all white. That ended when several basketball coaches, particularly one at Texas Western, realized that if they did not discriminate in picking a team, they would do pretty well.²² And when a mixed race Texas Western team finally beat an all-white University of Kentucky basketball team in the NCAA championships, these walls began finally to break down.²³

I personally observed a similar phenomenon when I was at a firm in Honolulu. As the firms were becoming more competitive, members of historically marginalized groups—Japanese and Filipino and other Asian names—percolated to the top. The same change happened in New York firms with Jewish names.

So cronyism is like a biological growth: It will grow wherever environmental conditions enable it to do so. The only way to get rid of it is to create an environment where the payoffs from demanding or seeking special favors from politicians and bureaucrats are lower than the costs. In this environment there is no incentive for interest groups to demand such special favors.

Creating an economy that is free of crony capitalism requires two things. The first is a very strong competitive environment in which cronyism is a luxury that competitors cannot afford. The second is a free market system that forces entrepreneurs and businesses to compete in the marketplace along the vectors of price, service, and quality rather than in the corridors of Gucci Gulch in Washington by engaging in cronyism.

22. Michael Wilbon, *A Win for Texas Western, A Triumph for Equality*, WASH. POST, January 13, 2006, <http://www.washingtonpost.com/wp-dyn/content/article/2006/01/12/AR2006011202357.html>.

23. *Id.*