# Moral hazard and crony capitalism [1]

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Yesterday I argued that we are facing a crisis of government that is leaving its mark on everybody. Today I want to mention some more hoof prints left on society by government.

"Crony Capitalism" is a description of an economy in which success in business depends on close relationships between business people and government. Crony Capitalism occurs when business people seek regulation and the massive cash flows held by government.

This rent seeking occurs through self-seeking behaviour by those competing to receive rents generated by government decision making. Rent-seeking includes lobbying for positions and contracts and campaigning for policies that create rents. Rents are revenues paid to favoured companies or individuals for services rendered. Rent seeking is endemic in crony capitalist systems today. When rent-seeking and payoff become more important to producers than the delivery of goods or services to customers, it causes markets to eventually fail.

In his seminal 1971 paper, "Theory of economic regulation", Nobel laureate economist George Stigler observed that regulation by the state is a more important source of rents, benefitting incumbent firms and individuals at the expense of potential competitors (this rent is sometimes referred to as gains from "barriers to entry").

Moreover, Stigler suggested that regulation is sought by the regulated industry - and is designed and operated primarily for the industry's benefit. Consumer activists Mark Green and Ralph Nader largely concurred, writing in 1973 [3], "the verdict is nearly unanimous that economic regulation over rates, entry, mergers, and technology has been anticompetitive and wasteful".

Remember the recent horror [4] when Ford announced they were closing their Transit production facility and transferring it to Turkey, having just received a £10million handout less than one week before they announced the closure. Explicit subsidies to corporations foster inefficiency and uncompetitiveness in private and public enterprise.

Often the government does not even have to provide cash. An endorsement of a company is enough to carry massive benefits to the recipient. Some UK banks have 'Too Big To Fail' status bringing them massive implicit subsidies. These same banks reap massive profits because of their TBTF status and the additional risk they carry because management knows government can always bail them out if it all goes wrong.

Government creates moral hazard when one party to a contract takes advantage of asymmetric information to act in a manner inimical to the interests of the other party. Looking at UK banking again, we see moral hazard created through asymmetric information provided by government passing TBTF status to some banks and excluding others. The government then wonders why distortions in the banking market create a lack of competition and embarks on generating more regulation to fix the problem. Many industries face moral hazard where government involvement means government sponsors excessive risk taking or poor management while taxpayers pick up the tab if things go wrong. That kind of moral hazard is not just harmful, it is wrong.



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