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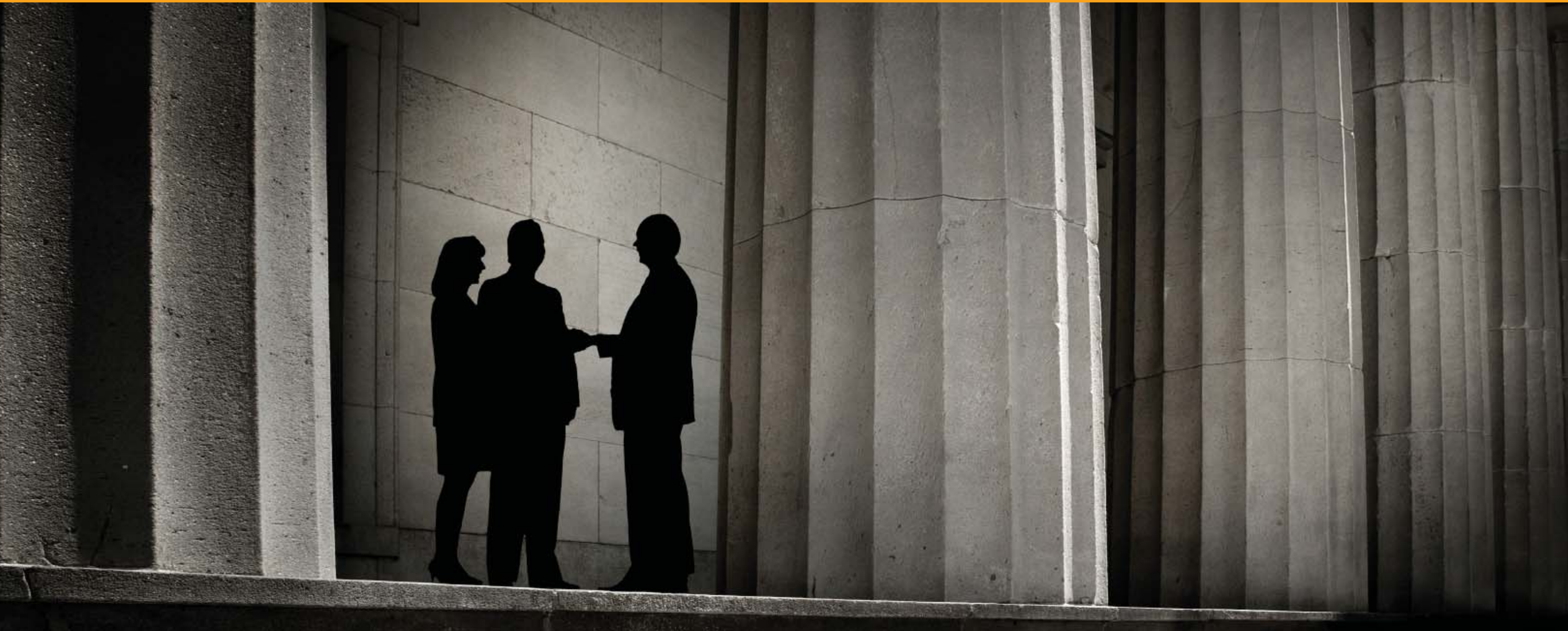

How Cronyism Harms the Investment Climate

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Summary

Cronyism undermines markets in several ways. It increases the costs of doing business for firms excluded from inner, "favored" circles. It encourages firms to spend more on cultivating political ties and less on innovation. It allows regulators and policymakers to benefit privately from relationships with certain firms. Reducing the inequality in influence between the most-powerful and least-powerful firms—the "influence gap"—can limit the harmful effects of cronyism. This can be done through support for greater public accountability, anti-monopoly enforcement, and more inclusive consultation mechanisms.

In recent years, investors, entrepreneurs, and public officials have come to understand better the effects of cronyism—defined as the arrangements by which those groups, firms, or individuals with close ties to incumbent political authorities receive favors that have large economic value—on economic performance. Where powerful private-sector interests shape the content of laws and regulations to their own advantage, the results are well known: a small number of powerful firms use their superior resources to manipulate political, legal and regulatory institutions to preserve and extend their privileged positions through inefficient redistribution, anti-competitive measures, and other discriminatory practices. A few companies benefit at the expense of the vast majority, and these privileged firms use their influence to obstruct reforms that would eliminate these advantages. Understanding the extent to which "state capture" exists, then, is an important part of assessing how economies are governed (Hellman, Jones, and Kaufmann 2003).

But in most countries, insecure property rights, high barriers to entry, and other regulatory defects do not appear simply because influential firms impose their will on unwitting legislators, judges, or bureaucrats. Instead, politicians (or other public officials) and firms are usually equal participants in a relationship that is mutually beneficial and durable, yet harmful for the investment climate. What characterizes these relationships, how do they develop, and what can be done to limit their adverse effects?

Why Distortions Develop

Property rights, tax, and regulatory regimes all generate plenty of opportunities for policymakers to reward favored firms. Governments suppress competition by conferring monopolies, devising market restrictions, or tolerating cartels. Tax systems, business and labor regulations become riddled with special exemptions—or are selectively enforced. Government contracts are awarded on the basis of political connections. Financing is granted in the form of cheap, publicly-guaranteed credit. Meanwhile, less influential firms—which come in all shapes and sizes and are found in all economic sectors—face the everyday risks and costs that influential firms avoid. In other words, bad investment climates don't just happen; they are deliberately made.

This subversion of institutions undermines the security of property rights for those less well-connected and thus weakens overall investment and growth. The least politically-connected firms face higher real costs due to delivery delays and unpaid sales, have a harder time accessing financing, waste more time with regulatory burdens, pay more in bribes, and find government services more inefficient than their politically-connected counterparts, even when controlling for country, firm size, and sector, as shown in table 1.

Table 1: Influence has its rewards

	Least Influential Firms	Most influential Firms
Working capital from subsidized sources (% total)	0.8	3.3
Likelihood that collateral is demanded for financing (%)	89.8	73.5
Sales lost due to delivery delays (% total)	2.1	0.8
Sales not paid for at delivery (% total)	30.6	20.2
Senior management time spent dealing with regulatory requirements (%)	9.5	7.4
Annual sales paid in bribes (% sales)	2.4	0.9
Bribes paid for government contracts (% contract value)	4.1	2.5
Firms that consider public services efficient or very efficient (%)	5.7	11.6

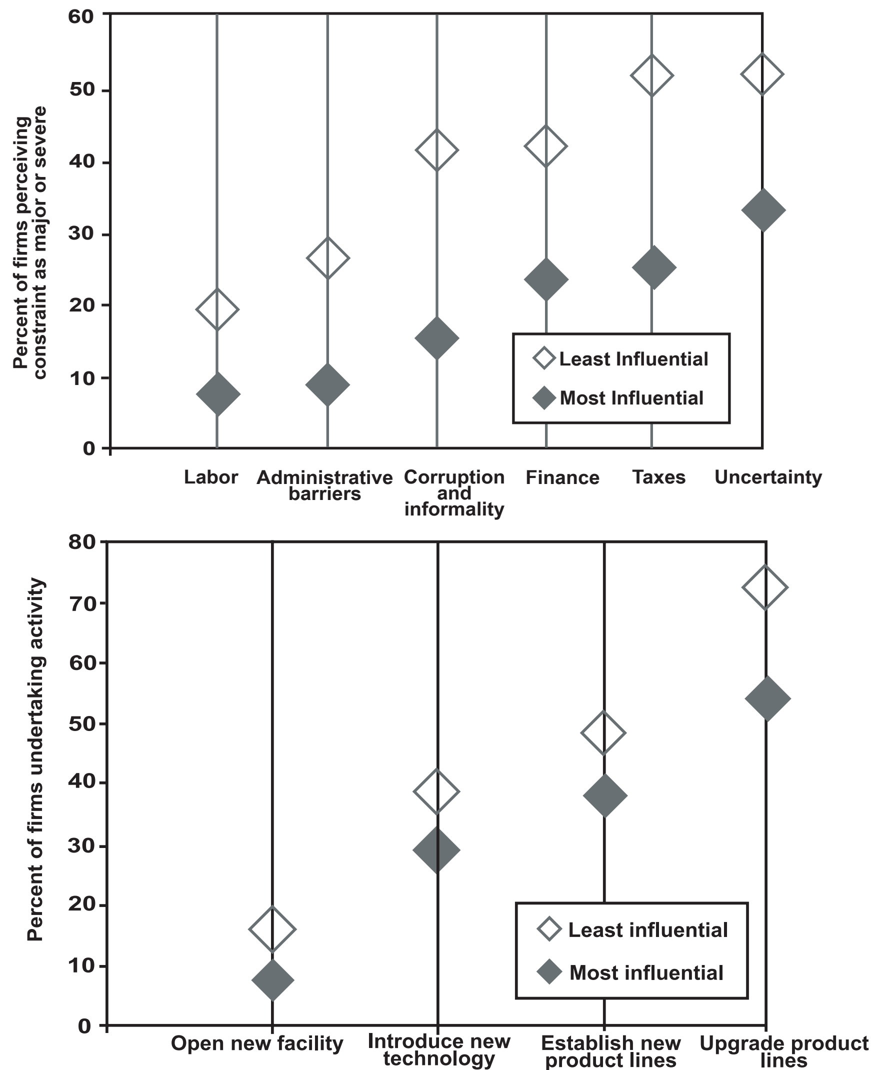
Source: Investment Climate Surveys

Notes: "Influence" is measured as the difference between the firm's own ability to affect laws and regulations and the firm's perceptions of the ability of other domestic firms to do so. All estimated values in this table, as well as in subsequent tables and figures, are derived from stochastic simulations of regression models controlling for country, firm size, and industrial sector. All variables, with the exception of the explanatory variables of interest, are set at their sample means.

Under these conditions, the natural response of entrepreneurs and investors is to "buy" influence—to cultivate ties to key politicians and public officials—in order to acquire these privileges. Bargaining and lobbying often require significant expenditures of effort, time, and money. Although many firms seek to influence the content of relevant laws and regulations (more than 20 percent of the sample of firms, e.g., claim to have lobbied the government over a two-year period), lobbying itself does not yield the kind of favors that influence does. In fact, firms that lobbied the government do not report any of the advantages shown in table 1, and actually report paying more in bribes than firms that do not lobby. The irony is that, in economies characterized by cronyism, more firms will try in vain to influence their political leaders, but lobbying itself does not pay these firms dividends even as it diverts greater amounts of resources from productive activities.

A system of policymaking that rewards political influence often punishes the most dynamic companies. While the most influential firms face fewer obstacles to business, they also innovate less (World Bank 2004). The World Bank's *Investment Climate* Surveys show that the most influential firms—regardless of their size or sectoral location—are less likely to see various business and labor regulations, informal practices, taxes, finance, and uncertainty as major/severe obstacles. But these rewards do not produce more innovation. The most influential firms are also consistently less likely to expand facilities, products, and technologies (figure 1).

Figure 1: The influence gap



Source: Investment Climate Surveys

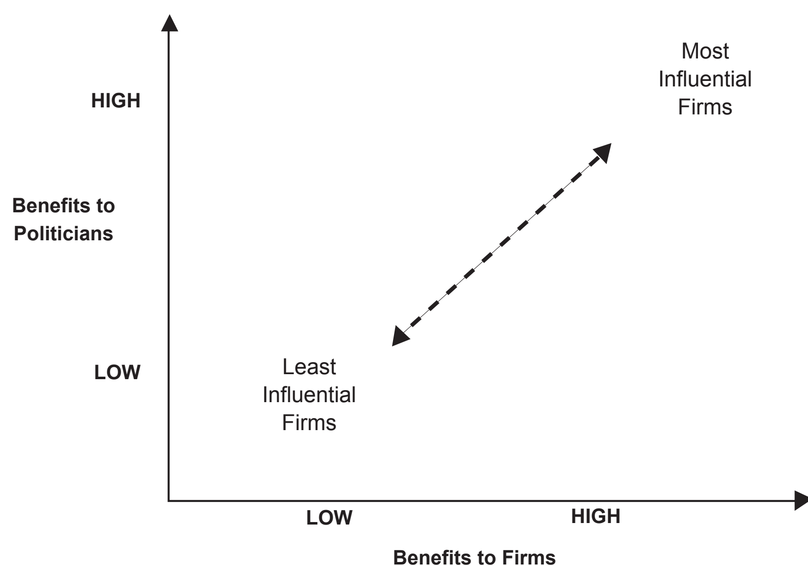
The Value of Influence

What, then, explains "influence" if not lobbying? Firms do not become influential simply because they spend resources on pressuring politicians. They become influential because they are valuable to politicians and bureaucrats—at both the national and sub-national level—who reward those firms from which they can extract political benefits. Many governments mistakenly believe that the provision of selective rewards to certain firms will encourage these firms to invest and grow. But there is reason to believe that these firms do provide two things that all governments want: employment and tax revenue.

First, influential firms tend to have bloated payrolls. Influential firms are more than 35 percent likely to indicate that, if they could, they would reduce the number of regular full-time workers. The specter of unemployment haunts many political leaders—particularly in countries whose economies are undergoing rapid changes. Keeping employment levels artificially high is, consequently, a valuable service to politicians who are less likely to face large numbers of unemployed workers at the polls or in the streets.

Second, influential firms are less likely to hide earnings from tax authorities. They report approximately 11 percent more of their sales for tax purposes. Revenues from corporate taxes are another major benefit for public officials who control the public purse. And it is to be expected that the least influential firms—those that are unable to strike deals for tax exemptions and holidays—will be more likely to hide their earnings.

Figure 2: Cronyism as mutual benefit



As shown in figure 2, cronyism is a two-way street. Influential firms obtain numerous privileges from their political connections, but they also provide significant rewards to politicians. It is for this reason that crony systems are so long-lived even though they are bad for growth, investment, and equity. One would expect that, since cronyism ultimately depends on the personal connections of firms, that the promises made by governments to these firms are only credible as long as a particular government is in power. Yet each government, regardless of ideology or state objective, confronts the same dilemma: if it does not create entitlements to a select group of firms, it will give up the political benefits that these firms provide. The unfortunate result is that most cronyistic arrangements are re-made after a government changes, and are very durable.

How can economies break out of these cycles of bad governance and bad policy? A combination of domestic will, political openness, and well-crafted reform efforts can reduce cronyism by shrinking the influence gap, and do so in ways that enhance both confidence among investors and legitimacy of markets in the eyes of citizens.

How to Limit Cronyism in the Investment Climate

- **Strengthen accountability and restraint**

  Competitive legislatures permit disenfranchised groups to challenge the authority of incumbents. Strong legislatures also make it more difficult for executive-branch policymakers to engage in cronyistic practices without legislative approval. More importantly, effective restraints on arbitrary governmental behavior can limit the appeal of specific promises by individual public officials to small groups of firms (Keefer and Vlaicu 2005). Cronyism can also be limited by increasing the transparency of decisions made by public officials. Standards of public conduct and conflict-of-interest laws, monitoring and evaluation mechanisms (including whistleblower protections), and a free and independent media can make the public aware of the costs of cronyism.

- **Punish anti-competitive behavior**

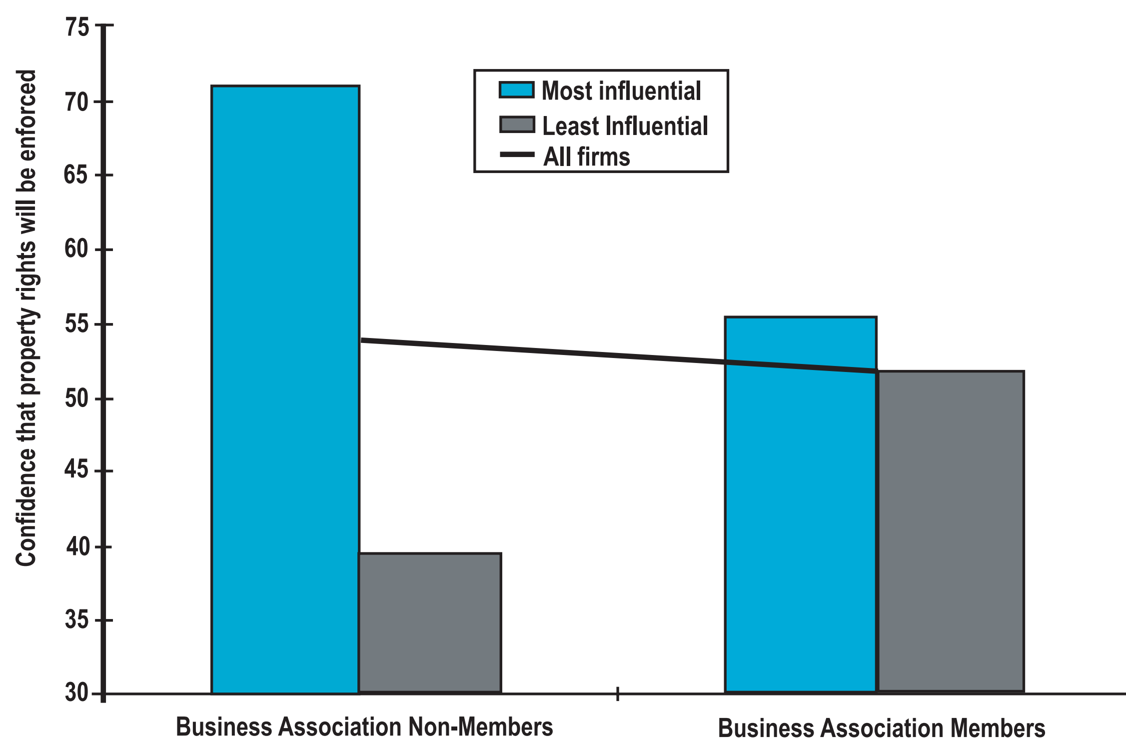
  The concentration of market power in a few firms or industries is both a consequence of cronyism and a source of economic distortions. One of the trademarks of crony systems is that monopolies and oligopolies exist in industries where competition should prevail. When asked what their customers would do if they increased the prices of their goods by ten-percent, fewer than 8 percent of the most influential firms expected that their customers to go elsewhere (compared to 40 percent of the least influential firms). In these sectors, opportunities will be denied to entrepreneurs who have the requisite skills and abilities, yet lack political connections. Concentration of economic power can be tackled by deepening price and trade liberalization, increasing transparency in the ownership structure of firms, introducing greater competition by lowering barriers to entry, and through competitive restructuring.

- **Give more firms a voice**

  Business associations can serve as a "leveler." Of firms who are not members of business associations, the most influential firms were more than twice as likely as the least influential firms to be confidence that their contractual rights would be upheld. But among firms who are members of business associations, this gap disappears (figure 3).

  Business associations, however, can quickly become additional instruments of cronyism. For this reason, effective business associations should be characterized by their inclusiveness as well as their ability to obtain input from their core membership (Herzberg and Wright 2005). Broadening policy dialogues to include representatives of a wider range of interests, including consumers, taxpayers, as well as owners and employees of smaller businesses can also enfranchise previously excluded groups in policymaking.

Figure 3: Business associations can level the playing field



Source: Investment Climate Surveys

Notes: The figure estimates the likelihood that firms are confident that courts will be uphold their contractual and property rights.

References

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