

Crony Capitalism
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Good morning members of the John Randolph Club. Today I shall take you on a virtual overview of Washington, D.C. that reveals how the people in these monuments to empire exert their powers through "crony capitalism".

In Robert Higgs' recent revisitation of the growth of federal government titled "Against Leviathan" the Independent Institute economist devotes three chapters to the centralization of economic power that created the foundations of "crony capitalism". We shall touch upon a majority of the enigmas that perplex Americans who sense that they have been mugged and their heritage stolen. In composite, we shall see how "crony corporations" serve only their owners and the federal lackeys that feed them at the expense of our citizenry.

The Civil War provided unprecedented power and money, which enabled supply from a host of Crony Capitalists, and subsidy of railroad expanded. The federal land grants for transportation entrepreneurs and later for state colleges were the product of bribes and "pork barrel" gratuities respectively. Burton W. Folsom Jr., in his "Entrepreneurs vs. the State: A New Look at the Rise of Big Business in America", observes that the land grants were *not* a necessary condition of building the vitally important arteries of transportation in populating the West. The "political predator entrepreneurs" – Leland Stanford, Collis Huntington, Charles Crocker and Mark Hopkins, who headed what became Southern Pacific – and Henry Villard, promoter of the Northern Pacific – were primarily financed by land grant subsidies to compete with Cunard's steamship line. The Cunard Line itself was aided by subsidies from the British Parliament in establishing transatlantic steamships. However, Cornelius Vanderbilt went head to head successfully against subsidized steamships without subsidies, as well his competition James J. Hill, a Canadian, built the Great Northern Railroad successfully without federal subsidies. "Crony Capitalism" subsidies in reality supported inefficiencies and greed rather than necessities.

The Progressive Era in the early 20th Century saw the legal adoption of personal and corporate income taxes, plus inheritance taxes to finance the growth of centralized federal U.S. government, while regulation of commerce was a high priority of the "reforms" adopted. Regulation of transportation, banking, plus food and drug purity were primarily exercised at the federal level, while utilities were regulated at the state level. However, large interstate utilities, such as dams for electric power and irrigation were socialist federal projects which are still operated by the federal government. Federal antitrust law was also adopted under the Sherman laws broad coverage of remaining unregulated commerce making illegal any contract, trust or conspiracy in restraint of trade or creation of monopoly.

The historical roots of "crony capitalism" planted earlier in government have since grown to become a mighty forest. The most obvious manifestation has been sturdy branches of what Cato Institute calls "The Corporate Welfare State: How the Federal Government Subsidizes U.S. Business", most recently updated by Stephen Silivinski. This report identifies nearly \$100 billion of federal subsidies, primarily to big business, as of fiscal year 2006. At the top of the list is an estimated \$44 billion of Department of Agriculture subsidies paid principally to millionaires or corporate farmers, increasingly owned overseas from investment of the U.S. overseas dollars spent on our chronic trade deficit. Next in size are the Department of Defense with \$12 billion of "applied R&D" fundings which subsidize military contracting, and an

equal amount spent by National Institutes of Health on biomedical and clinical R&D which primarily subsidizes drug and medical services companies. The Department of Transportation provides \$4 billion for airport “grants in aid” that the private airlines should shoulder as expenses of their services, and subsidy in excess of \$1 billion dollars for Amtrak rail transport that should be privatized. A “modest” \$2 billion subsidy for Department of Energy for corn ethanol alternative energy can be expected to burgeon, as the underwriting of facilities and fifty cent subsidy per gallon for ethanol bioenergy from corn alone is expected to quadruple in the current fiscal year, with other crony domestic sources of energy sure to follow. Temptations to invade the Mideast to protect U.S. oil companies’ participation in marketing of their oil certainly played a good part in why the U.S. has pursued its Iraq quagmire.

Tax subsidies are major crony privileges comprising two categories, namely, those directly to the benefit of the privileged corporations, or indirect subsidies to their customers that enhance corporate sales revenue. U.S. Real estate valued in total at \$22 trillion provides good examples of both. Residential home ownership, (\$12 trillion in value) receives tax subsidies of \$87 billion annually in the form of home mortgage interest deduction, and \$48 billion of capital gains taxes waived upon sale, expanding single family ownership for increased dollar value of construction and home sales aiding contractors and real estate agents, who together form a very powerful lobby. Commercial real estate owners secure tax subsidies of avoided capital gains taxes provided by rollover of sale proceeds into 1031 exchange trusts, and “carried interest” real estate income for partnerships taxes at 15 percent capital gains rate instead of at higher personal income tax rates. Subsidizing real estate investors and REITS.

For no explicable reason, hedge funds and private equity funds get the same “carried interest” 15 percent capital gains rate, without double taxation of corporate income at 33 percent rate which is the justification for lower 15 percent capital gains and dividend tax rates. Wall street’s power is derived from the profits of marketing to households \$21 trillion of security assets and \$11 trillion of household liabilities, and from generous donations to bother political parties. The same can be said for “depletion allowance” tax deductions for oil and gas producers, or, for employers who secure tax deductibility for group medical, disability and life insurance for their employees, a \$161 million tax subsidy each year, not provided for individual families which are not eligible for a group plan. Medical care and services are increasingly organized as “not-for-profit” for a \$2 trillion dollar per year tax exempt sector of the U.S. economy as of 2005, over 50 percent of which is paid for by government (including the group plan tax subsidy). Does this result in lower medical cost to the public, or the more evident effect of higher incomes for medical personnel at taxpayers’ expense?

Another lucrative category of subsidies to “crony capitalists” is invisible federal (and federally sponsored) guarantee of debt obligations that convert them, good or bad, into legal (or apparently legal) obligations of the U.S. federal government if the borrowers fail to pay. The largest and best example of federal guarantees as subsidies is found in the residential mortgage market totaling currently at \$13.5 trillion of mortgage obligations, reported by the Fed as of first quarter of 2007. The better credit risk half of these obligations are held by banks, life insurers and individuals without requirement of or benefit from guarantees. The other half with greater credit risk is held by federal or “federally sponsored” agencies, in mortgage pools or trusts from which interests are sold to investors and financial institutions as guaranteed “mortgage backed obligations” derivatives called (MBO’s). The federal agencies, which importantly provide legal guarantees as federal obligations include “Ginnie Mae” and FHA. The “federally sponsored” agencies principally include “Fannie Mae” and “Freddie Mac”. Fannie Mae and Freddie Mac are privately owned federally sponsored and regulated corporations, whose guarantees are *not* legally federal obligations, but who are “federally sponsored agencies” processing half the government agency mortgages are universally

considered "to big to fail" and are rated quasi-federally guaranteed as such. Dump into the Federal Funding Bank with \$35 billion of bad loans.

Probably the worst example of federal corporate guarantee giveaways is the role of a little heard of agency, the Overseas Private Investment Corporation (OPIC) that guarantees private investment in utilities for overseas developing nations. Market financing of an unreliable country at best might demand a "junk bond" rate of perhaps nine percent or more for a twenty year amortization. But a federal U.S. guarantee enables marketing the bond. The "crony capitalist" gets the windfall and Uncle Sam swallows any loss due to default. At least federal guarantees on Small Business Administration (SBA) loans only partially guarantee along with bank participation, and the beneficiaries are U.S. corporations producing and employing in the U.S.

Another form of subsidy is the manner in which the Federal Reserve subsidizes financial emergencies due to follies of banks, underwriters, hedge funds, and the like, flooding the economy with excess money creation. This lowers interest rates as the expense of investors in general, then debauches the value of their fixed dollar investments due to inflation, while giving windfalls to debtors by reducing the real value of their dollar denominated obligations. To virtually view the Federal Reserve it must be seen as the Godfather of Wall Street and major financial institutions, and their guarantor at whatever cost necessary to U.S. *citizens* – sub prime mortgages and perpetual Third World bank lended alms included. The functions of the Federal Reserve Banks combined comprise conflicts of interest. Its most important functions are long term – providing a stake and sufficient growth of money; prevention of excessive debt creation causing inflation, speculation or instability of the dollar; and preservation of a sound dollar that is a reliable store of value. Other than lender of last resort to banks by temporary funding, short term stabilization of "the economy's" or stocks and bonds markets compromise the Fed's long term obligations by unwholesome political interventions.

FCC control of media smiles upon local monopolies of TV, radio and newspapers as long as they communicate the prevailing wisdom of Washington, D.C. Often regulatory boards are peopled with former executives of the companies they monitor, and dispense crony protection for their corporations' interests rather than those of the public. Those corporations free from regulatory oversight are theoretically, but rarely held answerable to antitrust charges from Attorney General. In general, regulation of commerce traditionally leans in favor of commerce and versus consumers, while lacking enforcement against violation of rights of intellectual property by foreign piracy of patents and copyrights. Whereas patents and copyrights are required to disclose what is unique for general advance of innovation, software has quietly secured the protection of making "reverse engineering" illegal without the requirement of disclosure in exchange for protection. The result is government protection of software for corporations like IBM and Microsoft and their extraordinary profit margins as well.

The stagnation of both blue and white collar American workers' compensation over the past four decades can in large measure be traced to excessive and illegal immigration serving crony capitalism in agriculture and low skilled services. The growth of price sensitive services versus other sectors has been due to low wages and welfare that in effect has replaced labor saving investment and subsidized these employers. In answer to these Strombolli's' pleas that "we can't find Americans to take these jobs", it must be restated "not at these lousy wages". Again, we find crony capitalists making profits at the expense of the public.

Despite the massive costs of "crony capitalism" as discussed thus far, that total in no way matches the loss of value in our U.S. manufacturing sector as a consequence of the tax advantages of "border adjusted taxes" (primarily VATs) allowed foreign, multinational and

offshore American producers versus American manufactured products. Such tax reform as has been adopted by the Bush administration would lead us in the wrong direction to the "flat tax", a single rate income tax which is *not* border adjusted. What is needed is a border adjusted consumption tax that will counter the 18 percent average tax rebates of foreign competitors VATs which subsidize exports to the U.S., with no offsetting U.S. tax on their products; and the 18 percent average VAT tax levied upon U.S. exports to foreign markets without offsetting U.S. tax rebates given to our producers.

At the roots of our disappearing manufacturing sector we find "crony capitalism" that serves the greed of Wall Street, "big box" retailers, and offshore American producers given federal priority over the long term viability of American industry and an equitable distribution of the fruits of our economy with labor. The loss of our manufacturing sector and its employment, further maldistribution of incomes, and the chronic massive trade deficits undermining the dollar causing "America for Sale" are directly due to failure to provide American producers with equivalent taxation enjoyed by overseas competitors. Excessive immigration that depresses workers compensation is not an equitable alternative, while direct corporate welfare, tax and guarantees, only add to the citizens' burdens. If the subsidies of crony capitalism cited are not remediated, we shall witness continued growth of income distribution of crony capitalists at the expense of stagnant blue and white collar employees, and the future will inevitably find the U.S. facing a social revolution, which possibly might be even worse than the New Deal of the Great Depression.