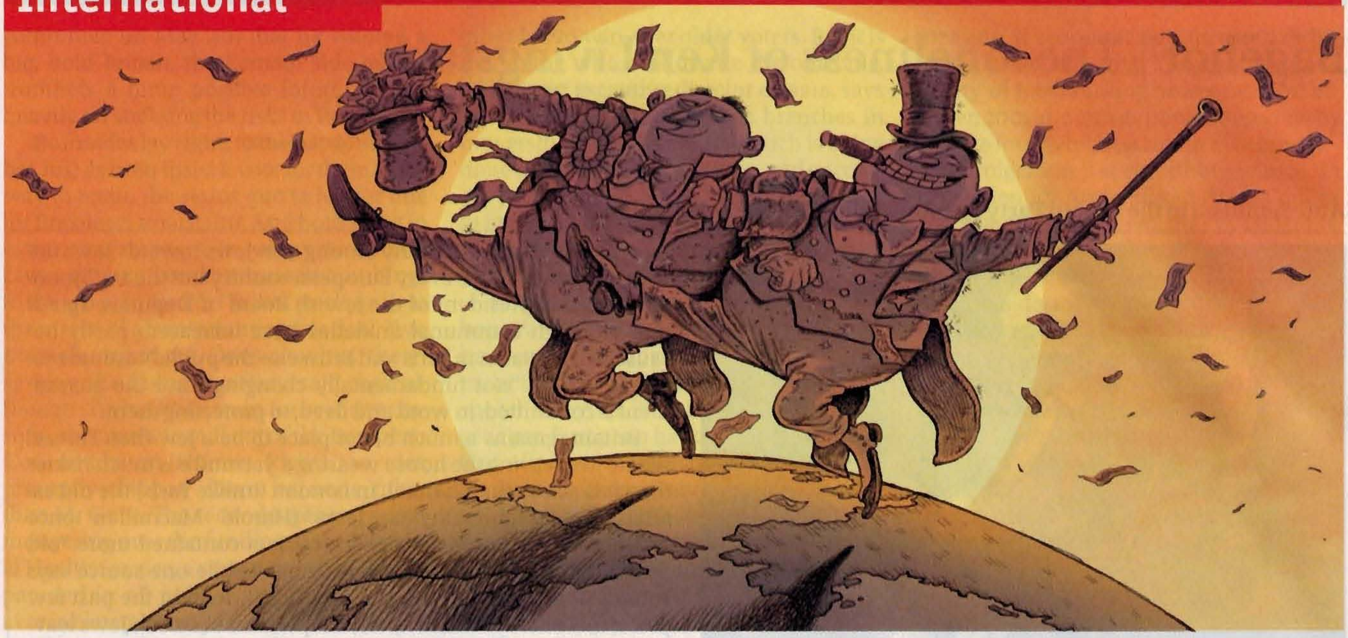


Our crony-capitalism index

The party winds down

Also in this section

[ARTICLE PUBLISHED 5/5/2016, WHICH PROMPTED ANDY'S LETTER TO THE EDITOR, SENT ON 5/15/2016]

Across the world, politically connected tycoons are feeling the squeeze

TWO YEARS ago *The Economist* constructed an index of crony capitalism. It was designed to test whether the world was experiencing a new era of "robber barons"—a global re-run of America's gilded age in the late 19th century. Depressingly, the exercise suggested that since globalisation had taken off in the 1990s, there had been a surge in billionaire wealth in industries that often involve cosy relations with the government, such as casinos, oil and construction. Over two decades, crony fortunes had leapt relative to global GDP and as a share of total billionaire wealth.

It may seem that this new golden era of crony capitalism is coming to a shabby end. In London Vijay Mallya, a ponytailed Indian tycoon, is fighting deportation back to India as the authorities there rake over his collapsed empire. Last year in São Paulo, executives at Odebrecht, Brazil's largest construction firm, were arrested and flown to a court in Curitiba, a southern Brazilian city, that is investigating corrupt deals with Petrobras, the state-controlled oil firm. The scandal, which involves politicians from several parties, including the ruling Workers' Party, is adding to pressure on Brazil's president, Dilma Rousseff, who is facing impeachment on unrelated charges.

A Malaysian investment fund, 1MDB, that is answerable to the prime minister, is the subject of a global fraud probe. Supporters of Rodrigo Duterte, the front-runner to win the presidential election in the Philippines on May 9th, hope he will open up a feudal political system that has allowed cronyism to flourish. In China bosses of private and state-owned firms are now routinely interrogated as part of Xi Jinping's purge of "tigers" (a purge that has left Mr Xi's family well alone). Worldwide, tycoons' offshore financial cartwheels have been revealed through the Panama papers.

The economic climate has been tough on cronies, too. Commodity prices have tanked, cutting the value of mines, steel mills and oilfield concessions. Emerging-market currencies and shares have fallen. Asia's long property boom has sputtered.

The result is that our newly updated index shows a steady shrinking of crony billionaire wealth to $1.75 trillion, a fall of 16% since 2014. In rich countries, crony wealth remains steadyish, at about 1.5% of GDP. In the emerging world it has fallen to 4% of GDP, from a peak of 7% in 2008 (see chart 1). And the mix of wealth has been shifting away from crony industries and towards cleaner sectors, such as consumer goods (see chart 2 on next page).

Despite this slowdown, it is too soon to say that the era of cronyism is over—and not just because America could elect as president a billionaire whose dealings in Atlantic City's casinos and Manhattan's property jungle earn him the 104th spot on our individual crony ranking.

Behind the crony index is the idea that some industries are prone to "rent seeking". This is the term economists use when the owners of an input of production—land, labour, machines, capital—extract more profit than they would get in a competitive market. Cartels, monopolies and lobbying are common ways to extract rents. Industries that are vulnerable often involve a lot of interaction with the state, or are licensed by it: for example telecoms, natural resources, real estate, construction and defence. (For a full list of the industries we include, see the link below*.) Rent-seeking can involve corruption, but very often it is legal.

Our index builds on work by Ruchir Sharma of Morgan Stanley Investment ▸▸

* Go to economist.com/cronyindex2016

Management and Aditi Gandhi and Michael Walton of Delhi's Centre for Policy Research, among others. It uses data on billionaires' fortunes from rankings by *Forbes*. We label each billionaire as a crony or not, based on the industry in which he is most active. We compare countries' total crony wealth to their GDP. We show results for 22 economies: the five largest rich ones, the ten biggest emerging ones for which reliable data are available and a selection of other countries where cronyism is a problem (see chart 3). The index does not attempt to capture petty graft, for example bribes for expediting forms or avoiding traffic penalties, which is endemic in many countries.

The rich world has lots of billionaires but fewer cronies. Only 14% of billionaire wealth is from rent-heavy industries. Wall Street continues to be controversial in America but its tycoons feature more prominently in populist politicians' stump speeches than in the billionaire rankings. We classify deposit-taking banking as a crony industry because of its implicit state guarantee, but if we lumped in hedge-fund billionaires and other financiers, too, the share of American billionaire wealth from crony industries would rise from 14% to 28%. George Soros, by far the richest man in the hedge-fund game, is worth the same as Phil Knight, a relative unknown who sells Nike training shoes. Mr Soros's fortune is only a third as large as the technology-derived fortune of Bill Gates.

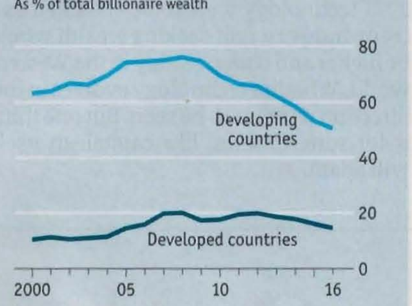
Developing economies account for 43% of global GDP but 65% of crony wealth. Of the big countries Russia still scores worst, reflecting its corruption and dependence on natural resources. Both its crony wealth and GDP have fallen in dollar terms in the past two years, reflecting the rouble's collapse. Their ratio is not much changed since 2014. Ukraine and Malaysia continue to score badly on the index, too. In both cases cronyism has led to political instability. Try to pay a backhander to an official in Singapore and you are likely to get arrested. But the city state scores poorly because of its role as an entrepot for racier neighbours, and its property and banking clans.

Encouragingly, India seems to be cleaning up its act. In 2008 crony wealth reached 18% of GDP, putting it on a par with Russia. Today it stands at 3%, a level similar to Australia. A slump in commodity prices has obliterated the balance sheets of its Wild West mining tycoons. The government has got tough on graft, and the central bank has prodded state-owned lenders to stop giving sweetheart deals to moguls. The vast majority of its billionaire wealth is now from open industries such as pharmaceuticals, cars and consumer goods. The pin-ups of Indian capitalism are no longer the pampered scions of its business dynasties, but the hungry founders of Flipkart, an e-commerce firm.

Seek and ye shall find 2

Billionaire wealth from crony sectors

As % of total billionaire wealth



Sources: *Forbes*; IMF; *The Economist*

In absolute terms China (including Hong Kong) now has the biggest concentration of crony wealth in the world, at $360 billion. President Xi's censorious attitude to gambling has hit Macau's gambling tycoons hard. Li Hejun, an energy mogul, has seen most of his wealth evaporate. But new billionaires in rent-rich industries have risen from obscurity, including Wang Jianlin, of Dalian Wanda, a real-estate firm, who claims he is richer than Li Ka-shing, Hong Kong's leading business figure.

Still, once its wealth is compared with its GDP, China (including Hong Kong) comes only 11th on our ranking of countries. The Middle Kingdom illustrates the two big flaws in our methodology. We only include people who declare wealth of over a billion dollars. Plenty of poorer cronies exist and in China, the wise crony keeps his head down. And our classification of industries is inevitably crude. Dutch firms that interact with the state are probably clean, whereas in mainland China, billionaires in every industry rely on the party's blessing. Were all billionaire wealth in China to be classified as rent-seeking, it would take the 5th spot in the ranking.

The last tycoons

A possible explanation for the mild improvement in the index is that cronyism was just a phase that the globalising world economy was going through. In 2000-10 capital sloshed from country to country, pushing up the price of assets, particularly property. China's construction binge inflated commodity prices. In the midst of a huge boom, political and legal institutions struggled to cope. The result was that well-connected people gained favourable access to telecoms spectrum, cheap loans and land.

Now the party is over. China's epic industrialisation was a one-off and global capital flows were partly the result of too-big-to-fail banks that have since been tamed. Optimists can also point out that cronyism has stimulated a counter-reaction from a growing middle class in the emerging world, from Brazilians banging pots and pans in the street to protest against graft to Indians electing Arvind Kejriwal, a maverick anti-corruption campaigner, to run Delhi. These public movements echo America's backlash a century ago. The Gilded Age of the late 19th century gave way to the Progressive Era at the turn of the 20th century, when antitrust laws were passed.

Yet there is still good reason to worry about cronyism. Some countries, such as Russia, are going backwards. If global growth ever picks up commodities will recover, too—along with the rents that can be extracted from them. In countries that are cleaning up their systems, or where popular pressure for a clean-up is strong, such as Brazil, Mexico and India, reform is hard. Political parties rely on illicit funding. Courts have huge backlogs that take years to clear and state-run banks are stuck in time-warps. Across the emerging world one response to lower growth is likely to be more privatisations, whether of Saudi Arabia's oil firm, Saudi Aramco, or India's banks. In the 1990s botched privatisations were a key source of crony wealth.

The final reason for vigilance is technology. In our index we assume that the industry is relatively free of government involvement, and thus less susceptible to rent-seeking. But that assumption is being test-

The crony-capitalism index 3

Billionaire wealth as % of GDP, 2016

Ranked by crony-sector wealth

Sources: *Forbes*; IMF; *The Economist* *Includes territories ed. Alphabet, the parent company of Google, has become one of the biggest lobbyists in Washington and is in constant negotiations in Europe over anti-trust rules and tax. Uber has regulatory tussles all over the world. Jack Ma, the boss of Alibaba, a Chinese e-commerce giant, is protected by the state from foreign competition, and now owes much of his wealth to his stake in Ant Financial, an affiliated payments firm worth $60 billion, whose biggest outside investors are China's sovereign wealth and social security funds.

If technology were to be classified as a crony industry, rent-seeking wealth would be higher and rising steadily in the Western world. Whether technology evolves in this direction remains to be seen. But one thing is for sure. Cronies, like capitalism itself, will adapt. ■

Corporate ownership and corruption

How to crack a shell

Ownership registries could help to end the corporate secrecy that fosters corruption. But current plans are not promising

JOHN CHRISTENSEN runs the Tax Justice Network, a group that campaigns against tax evasion and corruption. A decade ago, its message fell on deaf ears. No longer. After the Panama papers leak last month, Mr Christensen says international media were camped at his door for days, seeking his views on how to stop dodgy dealings.

Corruption has flown up policy agendas, thanks to the work such crusading groups have done to reveal the extent of hidden offshore wealth to angry voters facing austerity. On May 12th Britain will host an anti-corruption summit. Officials from around 30 countries, including America, Brazil and Nigeria, will attend.

Discussion will range from secret ownership of offshore firms to corruption in sport. It will, no doubt, end with a forceful declaration; commitments may be harder to extract. Campaigners are hoping for progress on corporate transparency, disclosure of payments in oil, gas and mining, and cooperation in cross-border corruption cases.

Cracking open shell companies is the most important of these. There is a correlation between graft and these anonymous vehicles: take investigations into a suspected multi-billion-dollar theft from 1MDB, a Malaysian state fund, which are focused on shell companies in the Seychelles and Caribbean. Tracing illicit funds to a shell's bank account is of little use if you cannot identify the individuals who control it. This worries business people as well as policymakers: a recent survey of corporate leaders in 62 countries by EY, an accounting firm, found strong support for more openness in ownership; legitimate firms want to know whom they are trading with.

International standards on "beneficial" owners (the real people, as opposed to other firms, behind firms) have been tightened, but remain quite loose. The information should be collected somewhere, whether in registries or by company-formation agents, and made available to "competent" authorities when requested.

Practice varies greatly. Some offshore centres, including Jersey, have had (non-public) registries for years, having set them up under pressure after scandals—though they rely heavily on regulated formation agents to collect, verify and update information. In America, by contrast, agents are not licensed, and ownership information is not collected, let alone verified.

Momentum is shifting towards central registries. A new European Union directive calls on members to set these up and to make the data available to police, tax authorities and others with a "legitimate interest" (such as investigative journalists). Britain has gone further: it launched a public registry last month. Other countries, including Australia and the Netherlands, plan to do the same.

In principle, openness seems a fair exchange for the privilege of limited liability. But there are problems in practice. Those registries already up and running tend to be purely archival: they do not verify incoming information because of the cost. This tempts money-launderers to lie.

Britain plans criminal penalties for false declarations. But unless declarations are checked—and resources are stretched already—ne'er-do-wells may take their chances. Formation agents have little incentive to push for accurate information: monitoring of the industry, which falls under HM Revenue & Customs, is scant.

Britain's overseas territories argue against public registries, partly on privacy grounds but also because they consider their "gatekeeper" model to be more robust. This places a duty on law firms, trust companies and other registration agents to collect and certify beneficial owners' identity documents. The offshore centres argue that leaning on regulated entities, close to the client, is more practical and effective than relying on registries, which are further removed from the action and do not face the threat of licence suspension.

In Jersey, ownership information and the source of funds must be verified at registration. The regulator also makes checks, including to ensure that formation agents update information when ownership changes. By comparison, vetting on the British mainland is "rubbish", says a regulator who has worked in both systems.

There are problems with the gatekeeper model, to be sure. Ownership information can get lost along chains of intermediaries. Some (though very few, it seems) conspire with crooks. Enforcement is patchy: Jersey has jailed rogue formation agents, but the British Virgin Islands does no more than pull licences, and even then only rarely.

Nevertheless, research suggests that, for all the criticism, offshore financial centres have done more to comply with beneficial-ownership rules in recent years than their onshore peers. That may be surprising in the light of the Panama papers and other leaks—but much of what they contain is 15 or even 20 years old. The most comprehensive study, "Global Shell Games" by Michael Findley, Daniel Nielson and Jason Sharman, was conducted in 2012. The authors e-mailed 3,773 formation agents around the world, posing as consultants looking to set up untraceable firms. Agents in offshore centres, they found, were much less willing to deal with them than service providers in OECD countries. Not a single one in Jersey or the Cayman Islands took the bait; dozens did in America.

The authors concluded that blacklisting had forced offshore centres to get tougher, whereas OECD countries had never faced equivalent pressure and could get away with being laxer. That could change with public registries—if more big countries follow Britain's lead, and if both policing and punishment are strong. But Mr Sharman is not reassured by the blueprints on the table. Self-declaration without verification is, he reckons, the public-registry model's weak point. As currently designed, it risks being "completely ineffectual". ■