



# IMPACT OF CRONY CAPITALISM ON INCOME INEQUALITY: AN EMPIRICAL STUDY

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**Abstract:** *Around the world, economies are experiencing significant growth, each adhering to its own economic strategy. Over the past few decades, there has been a notable surge in crony capitalism across all nations. This empirical study investigates the impact of crony capitalism on income inequality through a comprehensive analysis of secondary data from various research paper, magazines literature books, thesis etc. Crony capitalism, characterized by close relationships between business elites and government officials, has been identified as a significant factor influencing income distribution. Using a comparative approach, this study analyzes the extent to which crony capitalism contributes to income inequality and explores the mechanisms through which this relationship operates. This is attributed to various factors, including preferential treatment and regulatory advantages granted to crony businesses, which result in a concentration of wealth among a small elite. By understanding the impact of crony capitalism on income distribution, policymakers can develop targeted strategies to mitigate its negative effects and promote more equitable economic systems. Additionally, the study identifies corruption and lack of transparency as key drivers of crony capitalism, further exacerbating income disparities. This paper highlights the characteristics of crony capitalism, including collusion between business and government, preferential treatment, corruption and rent-seeking behavior, lack of transparency, and regulatory capture. It also discusses the impact of crony capitalism on income inequality, emphasizing the need for policymakers to address this issue to promote a more equitable economic system.*

**Key Words:** *Crony Capitalism, Income inequality, Government-Business relation, Corruption.*

## 1. INTRODUCTION :

Crony capitalism describes a situation where businesses use close relationships with government officials to gain an unfair advantage in the market. This often involves practices like lobbying, political donations, or even outright corruption. These relationships lead to preferential treatment for favored businesses, hindering fair competition and exacerbating income inequality. The research paper by Shleifer and (Shleifer et al., 1993) analyzes corruption, a key element of crony capitalism. It explores how government officials might seek bribes or use their power for personal gain, leading to inefficient resource allocation and reduced economic growth. (Haber, 2013) characterizes crony capitalism as an economic setup that generates economic benefits for politically affiliated individuals by granting them exclusive subsidies, monopoly privileges, or shielding them from international competition. These monopolistic advantages in economic sectors are also influenced by variations in credit terms, legal frameworks, and the protection of property rights, which differ between established entities and new participants (Acemoglu, 2008). The driving force behind crony capitalism is rent-seeking, a term coined by economist to describe the pursuit of government favors by well-organized interest groups. The key insight was that economic benefits such as tariffs, subsidies, and preferential regulations are not simply granted by the government without effort. Instead, they are typically obtained through concerted efforts by interest groups that invest real resources to influence government decisions in their favor. As long as the cost of lobbying for favorable treatment is lower than the expected benefit, interest groups will continue to divert



resources from productive activities that benefit society and the economy towards lobbying efforts aimed at redistributing wealth in their favor. Economists have long understood the phenomenon behind "crony capitalism," even if they didn't use that specific term. It's essentially a catchy way to describe situations where businesses use special interest legislation and regulations to their advantage. The analyzed how governments can benefit businesses through direct subsidies, restricting competition (like tariffs), manipulating rules around substitutes and complements, and even direct price controls. These tactics are the building blocks of crony capitalism. This concept also falls under the umbrella of "rent-seeking," where businesses lobby for policies that give them an unfair edge. This idea, arguing that such cronyism can lead to national decline. These medieval and early modern organizations essentially created a system where businesses and political elites could team up to grab a bigger share of the economic pie for themselves, at everyone else's expense. This stifled economic progress in some parts of Europe. The main difference between "crony capitalism" and the usual economic analysis is the focus on specific individuals. When we talk about crony capitalism, we tend to point fingers at the particular "cronies" involved in these unfair deals. Traditional analysis, on the other hand, stays impersonal, discussing faceless "interest groups." This personal touch of "crony capitalism" might be more effective for bringing about political change, even though ultimately both approaches deal with the same underlying issue (Rubin, 2016).

## 2. LITERATURE REVIEW :

This research paper is related to various strands of literature. Rubin (2016) elaborate a Crony capitalism, often associated with non-western economies, exists globally. The term's ambiguity complicates identifying efficient policies, warranting further research for solutions, including limiting government scope. According to James (2008) crony capitalism is spinouts often lead to business group formation, notably family business groups. Future research should model and empirically examine the process of equity holdings between parent firms and spinouts. Zywicki (2016) explain Rent-Seeking, Crony Capitalism, and the Crony Constitution, Supreme Court Economic Review- Mancur Olson's 1982 diagnosis of America's economy highlighted rent-seeking by corporations and interest groups, yet subsequent deregulation sparked innovation. Today, crony capitalism dominates, intertwining big government, business, and labor, challenging change. Aligica (2015) Instead of adopting the monopolistic assumption, we have yet to grasp the full, long-term risks of regulatory capitalism and the most effective institutional methods to mitigate them. Khalid (2019) elaborate that in societies marked by profound inequality, we must question the origins of such disparities. The dilemma between fostering genuine competition or consolidating monopolies is crucial for national prosperity. Crony capitalism, deeply entrenched, presents a formidable challenge, perpetuated by powerful business and political interests. However, fostering economic inclusivity demands its eradication for sustained growth and prosperity. Idowu (2016) Governments should enact policies to encourage responsible investment, benefiting both investors and society. Disciplinary measures should deter investors from violating collaboration policies. Capitalists should adopt longer-term investment perspectives and reinvest profits into the economy. Citizens should support and monitor these efforts, fostering a conducive business environment and deterring economic sabotage. Sinha (2022) This paper addresses a gap in mixed oligopoly models by integrating electoral dynamics into subsidy and privatization decisions. The model highlights the interaction between private firms and the incumbent party, illustrating how private sector donations influence policy outcomes. Sen (2017) elaborate the issue is complex and deeply ingrained, requiring a collective effort from various actors. Addressing these issues necessitates the gradual alignment of diverse interests against crony capitalism.

The paper builds on research examining how income inequality can influence government policies. Our study specifically looks at how high inequality creates an environment where the very rich and the very poor might join forces to support policies with high redistribution of wealth and restrictions on new entrants (possibly into a certain industry or social class).

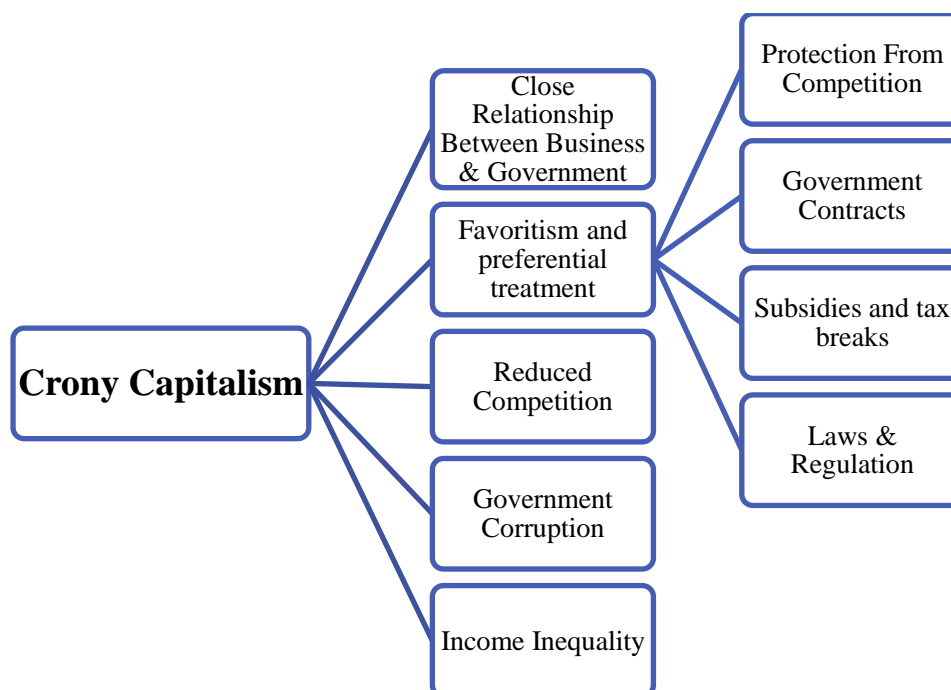
- **Collusion between Business and Government-** At the heart of crony capitalism lies the collusion between business and government. This collusion can manifest itself in various ways, such as government officials granting special privileges to certain businesses in exchange for personal favors or financial benefits. It often leads to distorted markets, limited competition, and a lack of level playing field for all participants.
- **Preferential Treatment-** Crony capitalism thrives on favoritism and preferential treatment. Government officials, motivated by personal gains, may give advantages to certain businesses, such as access to subsidies, tax breaks, or exclusive contracts. This preferential treatment allows these businesses to outcompete others in the market, leading to an unfair distribution of resources and wealth.



- **Corruption and Rent-seeking Behavior-** Crony capitalism is often associated with corruption and rent-seeking behavior. Rent-seeking refers to the pursuit of profits through manipulating the political and regulatory environment, rather than through productive activities that generate value. Both businesses and government officials engage in rent seeking behaviors to extract benefits from the system, further exacerbating economic inequality and inefficiency.
- **Lack of transparency-** Weak governance structures, opaque decision-making processes, and lack of accountability provide opportunities for corruption and favoritism.
- **Regulatory capture-** Industries or sectors exert influence over policymakers, steering regulations and policies in their favor, often at the expense of competition and public welfare.

Crony capitalism refers to a form of economic system in which close relationships between business elites and government officials lead to the unfair and often corrupt allocation of resources and benefits within a country's economy. In this system, individuals and businesses gain advantages and influence over government policies and regulations through their personal connections rather than through fair competition in the open market. Crony capitalism refers to a form of economic system where individuals or businesses form mutually beneficial relationships with influential government officials or politicians for personal gain (Mazumdar et.al., 2008). In this system, political connections and favors play a significant role in securing economic advantages, often leading to unfair competition and market distortions. Crony capitalism undermines the principles of a free-market economy by allowing privileged access to resources, contracts, and regulations, creating an uneven playing field for businesses and perpetuating income inequality. The cozy relationship between business leaders and government officials, often tinged with corruption (crony capitalism), is raising red flags for economists. This system can create an uneven playing field, giving unfair advantages to some businesses and worsening income inequality. Income inequality, the gap between rich and poor, is a major concern with broad social and economic consequences. Understanding how crony capitalism fuels income inequality is critical for policymakers and economists who want to tackle economic disparities and achieve long-term economic growth.

Figure 1: Framework of Crony Capitalism Elements



Source; Compiled by researcher

- **Close ties between businesses and government-** This includes political contributions, lobbying, or personal relationships between business leaders and government officials.



- **Favoritism and special treatment-** Crony businesses receive advantages such as:
  - Government contracts- Often awarded without fair bidding processes.
  - Subsidies and tax breaks- Providing financial aid and unfair advantages.
  - Regulatory favors- Laws and rules crafted to benefit specific companies or limit competition.
- **Protection from competition-** Measures like tariffs or restrictions can shield favored businesses.
- **Suppression of competition-** Crony capitalism limits fair competition, hindering innovation and efficiency. Small businesses and startups struggle against established players with political connections.
- **Corruption-** Illegal practices like bribery are used to influence government decisions and secure benefits.
- **Income inequality-** Crony capitalism widens the wealth gap. Favored businesses benefit more, while consumers and workers face higher prices and stagnant wages.

Figure 1 State that income inequality is one of the major elements of crony capitalism, Income inequality refers to the unequal distribution of income among individuals or households within a population. It essentially measures how wealth is spread out, highlighting the gap between the rich and the poor. The influential book by economist delves into the historical trends of income inequality across developed nations. Piketty uses extensive data analysis to show how income distribution has changed significantly over time, with the gap between rich and poor widening in recent decades (Piketty et al.,2014). Crony capitalism leads to systemic inequality and is widely seen as undesirable because it hinders competition that drives productivity. It also distributes economic opportunities and rewards based on political connections rather than merit (Holcombe, 2013). The two contrasting views of capitalism challenge the common perception that capitalism perpetuates inequality while government corrects it. This perspective suggests that such a characterization is largely based on misunderstandings. Capitalism is often seen as a system that benefits the elite at the expense of others (crony capitalism), rather than as a system that promotes economic freedom and opportunity for all. Similarly, government is often viewed as a benevolent corrector of market failures and provider of public goods, rather than as a political entity whose actions may be influenced by self-interest rather than public welfare. These misunderstandings not only lead to a distorted understanding of capitalism's institutional structure and income distribution mechanisms but also result in misguided reform proposals that undermine capitalism's ability to improve individual and societal well-being. A theory is proposed that connects an economy's institutions to the type of capitalism, entrepreneurship, and inequality that emerge in society. Institutions that limit government discretion encourage productive entrepreneurship and support free market capitalism, leading to a market-driven income distribution and opportunities for economic advancement. Conversely, institutions that do not restrict government discretion encourage unproductive entrepreneurship and support crony capitalism, resulting in structural inequality and limited economic mobility.

The impact of crony capitalism on income distribution is multifaceted and far reaching. One of the primary consequences is the exacerbation of income inequality within societies. By manipulating policies, regulations, and market mechanisms, cronies can distort competition, hinder upward mobility, and maintain their advantages, further concentrating wealth in their hands (Zywicki, 2016). As a result, the majority of the population remains impoverished or struggles to improve their financial status. Moreover, crony capitalism tends to stifle innovation and entrepreneurship (Holcombe, 2020). When well-connected individuals or companies dominate sectors, aspiring entrepreneurs and innovative ideas encounter significant barriers to entry or face unfair competition. This diminishes the potential for economic growth, job creation, and income opportunities for a broader population (Idowu, 2016). Crony capitalism also undermines public trust in institutions and the government. When the public perceives a system where privileged elites receive preferential treatment and disproportionately benefit from economic policies, it erodes the belief in fairness and equality of opportunity (Bergh, 2010). This can lead to social unrest, political instability, and an erosion of social cohesion. Crony capitalism has profound effects on income inequality within a society.

**Unequal distribution of wealth:** The concentration of resources and opportunities among a small politically connected elite exacerbates income disparities, widening the gap between the rich and the poor.

**Limited social mobility:** Crony capitalism creates barriers to entry and upward mobility for individuals and businesses without political connections, impeding economic development and social progress.

**Inefficient allocation of resources:** Crony capitalism diverts resources towards unproductive activities, such as rent-seeking and corruption, reducing overall economic efficiency and hindering long-term sustainable growth.





**Erosion of trust:** When individuals witness the collusion between political and economic elites, their trust in institutions and the fairness of the economic system diminishes, potentially leading to social unrest and political instability.

Critics of capitalism are deeply concerned about income inequality, which has become a prominent policy focus among influential public figures. Capitalism is often portrayed in one of two ways: first, as a system that fosters ongoing economic growth, universally improving living standards; and second, as a system that 'creates arbitrary and unsustainable disparities. Crony capitalism influences income inequality through various mechanisms that favor the wealthy and well-connected at the expense of others. One key way is through preferential treatment and regulatory advantages granted to cronies, which can lead to a concentration of wealth among a small elite (Faccio, 2006). For example, studies have shown that crony capitalism leads to increased market power for politically connected firms, resulting in higher profits and greater income inequality. Furthermore, crony capitalism can distort competition, hindering the ability of smaller businesses and startups to compete with larger, politically connected firms. This can lead to a less competitive market environment, where wealth is concentrated in the hands of a few powerful entities. Research has found that industries with higher levels of cronyism tend to have higher levels of income inequality. Moreover, crony capitalism can lead to corruption and rent-seeking behavior, where individuals and businesses use their political connections to extract wealth from the economy (Husted & Kenny, 1996). This can further exacerbate income inequality by diverting resources away from productive uses towards rent-seeking activities. Studies have shown that countries with higher levels of corruption tend to have higher levels of income inequality. Crony capitalism can have a significant impact on income inequality by favoring the wealthy and well-connected, distorting competition, and promoting corruption (Mauro, 1995). Addressing crony capitalism is therefore crucial for reducing income inequality and promoting a more equitable society.

### 3. CONCLUSION :

The income inequality doesn't signal capitalism's failure, but rather a problem with "crony capitalism. The issue is powerful people using political connections to gain unfair advantages, not the core principles of capitalism. Increasing government control to fight cronyism might actually worsen it, by reducing economic freedom and creating opportunities for unproductive businesses to thrive through political connections. The best way to limit cronyism and promote a fair, dynamic economy is by strengthening institutions that support free markets and limit government discretion. While some redistribution might occur with larger governments, fostering economic freedom through sound legal and monetary institutions ultimately leads to both economic growth and a more meritocratic distribution of wealth. Mainstream economics education often overlooks this issue, leading to public misconceptions about the different forms capitalism can take and the critical role of institutions in promoting fair competition. India's shift from a state-controlled economy to a free market was bumpy. Weak institutions meant to regulate the new system couldn't keep up. This created fertile ground for crony capitalism. The initial goal was to break state monopolies and encourage private investment. But the focus shifted. These sectors offered huge profits, and a system emerged where politicians, businesses, and bureaucrats colluded to share those riches. This wasn't just basic corruption; it fundamentally changed how power worked in India. This includes reforming political funding, making policymaking more transparent, strengthening oversight agencies, and improving the business environment to make cronyism less profitable. There's no easy solution. Crony capitalism is deeply rooted, and no single group can fight it alone. Only by uniting various forces opposed to this system can India hope to overcome it.

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