



Short Article

# Challenges to Classical Liberalism

Juan Lara

University of Puerto Rico at Río Piedras, San Juan, Puerto Rico

[juan.lara@upr.edu](mailto:juan.lara@upr.edu)

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## Takeaways

The free-market system is exposed to challenges that skew motivation for entrepreneurs and can cause serious damage to a country's economy.

Laws that create incentives and preferential treatment for certain types of economic activity lend themselves to rent-seeking and other corrosive practices.

The impact of rent-seeking, nepotism, clientelism, cronyism, and corruption in Puerto Rico has not been scientifically studied.

These improper practices often thrive in the shadows of real productive activity, like weeds that threaten to displace and suffocate good harvests.

## Article

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Free-market economy is an economic system with proven effectiveness in coordinating the efficient use of a society's resources and promoting productive innovation but, like any human institution, it faces challenges that can hinder its proper operation and warp its results. An array of improper, and even illegal, behaviors divert the legitimate business goal of making profits toward a pursuit of profit that is disconnected from productive activity and focused on the exploitation of advantages and privileges. These practices include rent-seeking, clientelism, nepotism, cronyism, and—in extreme cases—corruption.

All these practices make up part of what the prominent economist William Baumol characterized as “unproductive entrepreneurship,” which is the redirection of entrepreneurial initiative towards the search for and enjoyment of undue advantages instead of channeling it towards the exploitation of genuine economic opportunities, as is the case with “productive and creative entrepreneurship.” In addition to its intrinsic immorality, this phenomenon imposes economic costs for society as it leads to the misuse of resources and the waste of opportunities to create wealth, instead of simply redistributing it.

Classical liberalism, which is the philosophy of economic freedom and the free-market system, is continually exposed to the corrosive effect of these challenges, which pervert the motivation of economic agents and foster a regime in which political opportunism is rewarded and the figure of true entrepreneurship is discouraged. If not stopped, these practices can turn a dynamic economy into a stagnant and even decadent economic ecosystem.

Rent-seeking is the pursuit of profits that do not come from the production and sale of goods or services, but from exploiting an advantage that is not equally available to all members of society; for example, a businessman or businesswoman who manages to obtain favorable tax treatment for his or her business may earn a higher profit than his or her competitors, without making a productive contribution to justify it. The excess profit that comes from that special tax benefit is an example of what economists call a “rent.”

When the possibility of obtaining income from “rents” exists, which is usually when existing legislation creates the conditions for negotiating and obtaining favorable treatment in tax or regulatory matters, there is a strong motivation for businessmen to compete with each other to secure these *favours* from the government. This tends to foster unethical relationships between private entities and government officials and can degenerate into acts of corruption; but even if it does not get to that extreme, the habit of *political investment* (supporting candidates for elective office with money and other resources in the expectation of a future benefit) grows and undermines the environment of healthy competition that a free-market economy entails. Political investment uses up resources that are no longer available for productive investment; it is invested in gaining influence, instead of investing in assets that stimulate the competitiveness of companies and the economy as a whole.

In addition to rent-seeking, clientelism is another practice that promotes political investment and weakens free competition among economic agents. In this case, government officers in positions of authority channel contracts to people with whom they have political or business relationships, thus blocking the way to others who could offer the same products or services under more favorable conditions for the treasury. This practice often leads to corruption, as has been seen in multiple procurement cases in Puerto Rico government agencies.

Nepotism is similar to clientelism, but in this case the favored individuals have family ties with the authority granting the contract, employment, or benefit, which typically is someone in a government position, but can also be an influential person in a private entity. Unfortunately, this practice has been very common in government and public corporations in Puerto Rico, and its effect has been to deny employment and contracting opportunities to many people and entities that do have the capabilities and merits to provide quality services at a fair cost to taxpayers.

Another practice is cronyism, which is similar to clientelism and nepotism, but consists of favoring a select group of friends and relatives when granting contracts and employment opportunities. In some societies, this practice is so widespread that it becomes a dominant feature of the economic system. This has been called “crony capitalism,” which is an ironic expression because true capitalism, which is another name for the free-market system, means the success of the most capable in a space of competition without favoritism.

Many economists have studied the harmful effect of these forms of undesirable behavior. In a well-known study in the early 1970s, Anne Kruger illustrated the economic inefficiency caused in India by rent-seeking fostered by the existence of selective benefits in the access to opportunities to import products into the country. In Puerto Rico, not many studies have been conducted on this subject, but there is no doubt that rent-seeking is a common practice in our economy that should be carefully analyzed, given the widespread existence of incentives for multiple forms of economic activity.

Each of these practices deserves a dedicated essay, especially to document their operation and their impact on Puerto Rico’s economy. Future writings will present real examples of rent-seeking, nepotism, clientelism and cronyism to illustrate the prevalence of this behavior on the Island and how it obstructs the economic development of our society.

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