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The Origin Rent-Seeking Concept

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Abstract

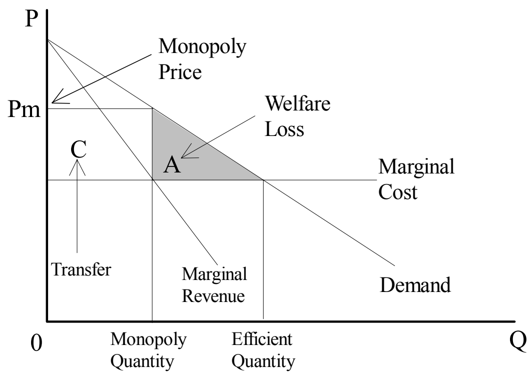
Possibly as a prelude to a mini series of critical review essays, this short paper is intended to revisit and clarify Tullock's contributions to the concept of rent-seeking. Some subsequent contributions are highlighted, so are its implications on social costs and wealth transfers.

Key words: rent-seeking; social costs; transfers; political economy

JEL classification: B30; D61; D72

This is an essay on my contribution to the rent-seeking concept. It describes the context of my original papers on social cost and wealth transfers and the recognition of these papers by subsequent writers on the rent-seeking concept. I begin now by discussing the origin of the concept. A complete history of the phenomenon would have to begin by discussing Egyptians and Babylonians thousands of years ago. This essay, however, is about the concept of rent-seeking as it evolved in the literature of political economy.

Figure 1



[*]This essay is based on a lecture given at Feng Chia University, Taichung, Taiwan.

I begin with the early 1960s by discussing certain papers which raised a problem in economics to which the concept of rent-seeking was a solution. At that time, monopoly power was being severely criticized using a diagram like Figure 1. The shaded welfare triangle labeled A was called the welfare loss from monopoly; the rectangle C was said to be a transfer and hence not a social cost.

Figure 2

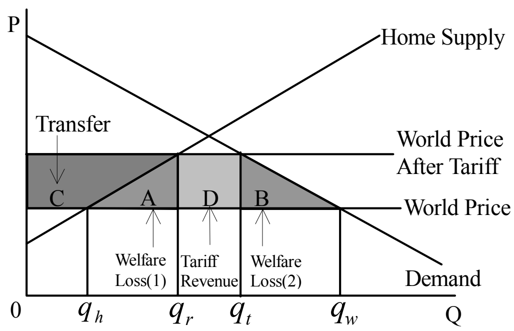


Figure 2 is a diagram of a similar nature, which was used in international trade theory to show the welfare effects of tariffs. In this case there are two welfare loss triangles A and B. The first is a welfare loss similar to that of triangle A in Figure 1 while the second is a net waste of resources due to the inefficient shift of resources to other industries. In this case there are two types of transfers: (1) a transfer from consumers to producers (the trapezoid C) and (2) a transfer of tax revenue from buyers of the lower-priced foreign-made goods to the government in the form of tariff revenue.

Table 1. Calculated "Welfare Loss" as Percentage of Gross or Net National Product Attributed to Misallocation of Resources

Study	Source	Country	Cause	Loss
A. C. Harberger	*A. E. R.* 1954	U. S. A. 1929	Monopoly	.07 percent
D. Schwartzman	*J. P. E.* 1960	U. S. A. 1954	Monopoly	.01 percent
T. Scitovsky	(1)	Common Market 1952	Tariffs	.05 percent
J. Wemelsfelder	*E. J.* 1960	Germany 1958	Tariffs	.18 percent
L. H. Janssen	(2)	Italy 1960	Tariffs	max .1 percent
H. G. Johnson	Manchester School 1958	U. K. 1970	Tariffs	max 1.0 percent
A. Singh	(3)	Montevideo Treaty Countries	Tariffs	max .0075 percent

Sources: (1) [29]; (2) [16]; (3) unpublished calculation made by A. Singh based on data found in A. A. Faraq, *Economic Integration*: *A Theoretical*, *Empirical Study*, University of Michigan, Ph. D. Thesis, 1963. With written permission generously granted by the American Economic Association on March 25, 2003, the table on p.393 in Leibenstein (1966) is hereby reproduced above.

This was the theory at the mid 20th century. In the 1950s, economists began making greater use of statistics and trying to actually measure things, including the welfare loss. A number of these produced measures of the monopoly and tariff welfare loss. In 1966, Harvey Leibenstein collected some of these measures; his collection is shown in Table 1. The two estimates of loss due to monopoly are .01 and .07 percent of Gross National Product, as shown in the first two rows.

These estimates seemed to be very small—indeed, almost impossibly small in light of the number of economists who had denounced monopoly on the basis of the theory. The various estimates of welfare losses due to tariffs in different countries, as shown in the other rows, are also small.

Let us return to the early 1950s, when the first of the monopoly studies listed in Table 1 was made. In the paper containing his study, Arnold Harberger wrote that he was amazed at his results, pointing out that "it seems to me that our literature of the last twenty or so years reflects a general belief that monopoly distortions are much greater than they seem in fact to be" (1954, p. 86). Because of these surprisingly small estimates of the welfare loss of monopoly, other economists undertook to provide further estimates. Broadly speaking, the further estimates confirmed Harberger's statistical results, as shown in the table.

In the above-cited paper, Leibenstein not only reported the results, he also attempted to reconcile these small estimates with most economists' beliefs that the monopoly problem is serious. In the process, he coined a new term: "X-efficiency."[1] This refers to a hypothetical loss in efficiency due to the failure of a monopolist (or, more generally, firms with monopoly power) to maximize profit. Leibenstein seems to have thought up this idea by considering data from a paper by Peter Kilby (1962). Kilby had reported very substantial improvements in physical productivity to firms in less developed countries that were given certain technical advice by the International Labor Office's Productivity Demonstration Mission. Before the advice, such low-productivity firms had apparently been sufficiently profitable to stay in business in spite of their low productivity. Leibenstein interpreted this report to suggest that even very cost inefficient firms could survive if they were protected by tariffs. The data also suggested to Leibenstein that protected firms have a low incentive to maximize profit by raising physical productivity and thereby reducing their production costs. If this was true for firms protected by tariff, perhaps it was also true of firms in industries where there are substantial barriers to entry, such as those in the Harberger study. Leibenstein pointed out that if the firms in the Harberger study *did not attempt to maximize profit*, both their profits and the Harberger's estimates of welfare loss due to monopoly would be low. He wrote that "[t]he level of unit cost depends in some measure on the degree of X-efficiency, which in turn depends on the degree of competitive pressure, as well as on other motivational factors" (1966, p. 412). The final sentence of his paper says that "[t]he data suggest that in a great many instances the amount to be gained by increasing allocative efficiency is trivial while the amount to be gained by increasing X-efficiency is frequently significant" (p. 413).

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[1]See the comment by Robert Mundell on pp. 580-1 in Robert Tollison's 1982 survey of rent-seeking.

Leibenstein's theory apparently reconciled the low monopoly profit with economists' theoretical beliefs that the monopoly problem was serious. The statistics produced by Harberger and others were correct; nevertheless, there was still a large welfare loss due to monopoly. This loss came from companies not being under competitive pressure and hence not operating at optimal efficiency. The firms allowed their costs to be higher than necessary; they chose an inefficiently high or low price-quantity combination, or both.

There was no great enthusiasm for this reconciliation, since it suggested that firms would earn less money than is possible. For a while, however, there was nothing else to put in its place. Since I am about to report my critique of Leibenstein, I should say that, except for its main conclusion, Leibenstein's article was a very good one. He collected and arranged data with great ingenuity and care. And his hypothesis of X-inefficiency was carefully reasoned and quite consistent with the data.

Shortly after Leibenstein's paper appeared, I wrote a rather short critique of X-efficiency and proposed an alternative interpretation of the data. It seemed to me that entrepreneurs would work hard to maximize profits even if they were to some extent sheltered. After all, under the usual assumption that the firm owner receives all of the profit, a dollar earned by the entrepreneur is, after taxes at least, a dollar he can spend. I sought to explain the low profit of monopoly by reasoning that a firm that has monopoly power due to an entry barrier may have had to invest in achieving that barrier and in keeping it high. Such an investment would eat up part of the profit earned. Correct accounting would require the cost of the entry barrier investment to be subtracted from the profit.

To see this more clearly, consider a firm that currently faces severe competition. Its economic profit is near zero. Assume further that if all of the other firms were to suddenly drop out of the industry, the firm would earn a monopoly profit of $100. Now assume that the firm can force the other firms out of the industry by investing $99. Then, assuming that there is no uncertainty, it would maximize profit by making the investment. In an economic model like that shown in Figure 1, its monopoly profit would be $100. But proper accounting practice would record a profit of only $1. Under the circumstances, the greater monopoly power would be associated with only a small accounting profit. If this theory accurately reflected the facts, it would explain the statistical finding of low social cost due to monopoly.

In the industrial organization literature, economists had already recognized that firms would invest in building barriers to entry. A good example is advertising. However, the focus of my article—and the part that was to be most important in the development of the concept of rent-seeking—was investment in the activity of securing protection *from the government* (Tullock 1967, p. 231). This is why I felt it was important to include a section on theft. In the case of theft, there are typically two classes of investment: that of a prospective thief and that of a prospective victim. Similarly, it seemed to me that we should account not only for the prospective monopolist's investment but also of the potential investment by consumers to block the monopoly. The seeking of protection through a tariff is similar. In describing the wasteful investment of resources related to monopoly privilege-seeking, I did not use the term "rent-seeking," which had not yet been invented, but my argument was a fairly straightforward application of it.

I entitled my comment "The Welfare Costs of Monopolies and Tariffs" and submitted it to the *American Economic Review*, which turned it down on the grounds that it was wrong. The referee recommended that before I send it to another journal, I take the theft part out. Apparently, he either did not see the rent-seeking implications or did not regard them as relevant. In looking over my submission I realized that if I deleted the first two paragraphs referring to Leibenstein and made a few other minor changes I could convert what was merely a comment on someone else's work into an independent article introducing "rent-seeking." I did not use that term because it had not been invented. I sent the slightly changed paper to the *Journal of Political Economy*. I received a letter signed by George Stigler, who I think actually read the article. He turned it down on the grounds that the ideas in it were already well-known. Once again I resubmitted, going a step downward to the *Southern Economic Journal*. They also rejected it, this time on the grounds that it was wrong.[2]

While I was contemplating this rather disappointing response, I received a letter from the new editor of the *Western Economic Journal* asking me to submit something. I sent the article to them, which they immediately accepted with great enthusiasm. They changed the title by adding "Theft." To my knowledge, there was no response to my article at all, probably because the journal was new and relatively obscure at the time.[3] On the other hand, in 1969 the article was reprinted in a collection of papers for undergraduate price theory students, edited by Donald Watson (1969).

A year later, I co-authored a paper with James Buchanan which dealt with a problem that is the opposite of rent-seeking (Buchanan and Tullock, 1968). Let us suppose that the government has already created a monopoly. Then the capitalized value of the welfare loss would be substantially less than the capitalized value to consumers of abolishing the monopoly. We discussed various reasons why consumers would lose in the game of trying to get the monopoly abolished.

Recall that I initially submitted my paper on monopolies and tariffs to the *American Economic Review*. In 1974, seven years after my paper was published, that journal published a paper that presented what was, in all essentials, the same theory (Anne Krueger, 1974). Probably the most important difference between the papers was the introduction of the term "rent-seeking" to refer to actions aimed at obtaining special government privilege. Krueger did not explain why she used this term, but it quickly caught on and it has been used ever since. There were other differences, however, which may help to explain the latter's success.

First, whereas I was interested in monopolies and tariffs in more developed economies like the U.S., Krueger focused mainly on the quantitative import restrictions in less developed economies. She specifically chose India and Turkey. Her

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[2]I should add parenthetically that several other articles I had written had already been published by these journals. *The Journal of Political Economy* had already published four over a twelve year period and *The American Economic Review* had published three.

[3]This journal is now called *Economic Inquiry* and is quite respected.

benchmark case was the quota. A quota implies profit for firms that can import at the low world price and sell at the higher domestic price. Firms compete for this profit by competing for the limited rights to import, which are rationed by government. Krueger assumed that the government would manage this competition by means of a licensing system. In this case, the rents would accrue either to those who obtained licenses or to government administrators who obtained bribes to grant the licenses. In a competitive situation, maximizing rent-seekers would presumably be willing to invest an amount in bribes up to the amount of the expected rent.

In her final paragraph, she pointed out that all market economies have some restrictions that generate rent-seeking. However, she did not explicitly state the direct relevance for a more advanced economy like that of the U.S. Indeed, she entitled her paper, "The Political Economy of the Rent-Seeking Society," and introduced it by writing about "market-oriented economies" in which, *unlike that of the U.S.*, "government restrictions upon economic activity are *pervasive facts of life*" (p. 291, italics added). Although she writes that the model has general applicability, she also notes its special suitability for "developing countries, where government interventions are frequently all embracing." This focus probably explains why, unlike my paper, she did not identify the activity of seeking a direct transfer of wealth as rent-seeking. The direct transfer type of rent-seeking is more prevalent in developed countries (see below).

Second, Krueger's paper did not imply, as mine did, that the profession had been misleading its students about the effects of government intervention in a developed economy. This implication was not intended to criticize the orthodoxy but only to suggest that it change. Although we were both proposing a scientific advance and a broadening of the discipline of economics to include the agents of government who allocate privileges, hers was less challenging to the contemporary mainstream orthodoxy.

Krueger did not refer to my article. I assume that neither she nor the AER reviewers had seen it, since the *Western Economic Journal* was rather obscure at that time.

My emphasis on the seeking of privilege in the case of pure redistribution carried out through government was the subject of another article I published before 1974: "The Cost of Transfers" (1971). It was generally assumed in those dark days that income transfers by government were socially costless. One person or group lost and another gained. The cost which I pointed to was the same as I mentioned in my earlier article; namely, resources invested in getting and in attempting to prevent the transfer. I submitted it to the *Bell Journal of Economics*[4] and received a personal rejection from Oliver Williamson. He took the position that it was unimportant. He did not claim that my analysis was wrong or that I had been anticipated. Nevertheless he turned it down.

I was using this paper for lectures at various schools and gave it in Switzerland where the editor of *Kyklos* immediately asked if he could publish it. Note that the

[4]Now the *Rand Journal of Economics*.

1971 date was before Professor Krueger's first publication. Since very few Americans read *Kyklos*, I don't think she can be blamed for not knowing about that article either. Shortly after Professor Krueger's article was published, Richard Posner (1975) wrote a paper discussing these articles, with my original article given priority. Several years later, Robert Tollison (1982) published another general article with my original article given full credit for the rent-seeking idea.

The rent-seeking idea has subsequently been taken up by many scholars and whole books of reprints of articles in journals were put together by several people, including myself and others in the Center for the Study of Public Choice. It has remained an important concept ever since, although I note that it is seldom mentioned in connection with income redistribution.[5] I suspect this is because most economists favor money being taken from the rich and given to the poor or from the young and given to the old or from healthy and given to the sick. The old people in any event, many of whom are ill, are now well-organized in the United States for the purpose of putting pressure on the federal government for large transfers. It is not obvious that these transfers cause a real welfare loss. Most people are now taxed a fair part of their earnings in the years before 65 and then given a pension from then on. The basic transfer is not from the wealthy to the poor, but from the young to the old. Since all of the old were once young and all the young expect to be old, the total social cost is comparatively small. Probably the largest social cost is the concentration of the older population's attention on this one issue. This may or may not make democracy function less well than if there were fewer votes concentrated on transfer rather than on public goods or government efficiency.[6] This change is likely to make the time income profile of people rather odd. Incomes now probably rise until about the age of 55 and then begin going down. Total income, earnings plus pension will, I anticipate, rise to about 55 then slowly go down until 65 at which point they will shoot up. Of course some people will stop working, sometimes as result of preference and sometimes because their health is bad. Still I anticipate that intra-family income distribution will change quite radically.

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[5]Some of my contributions are listed in the references.

[6]I should say that I join with most people in the desire for less rent-seeking transfers, even though I am receiving an old age pension while fully employed at a good salary. When the system was first adopted, various expedients were introduced to prevent people on pensions from continuing to work. In many European countries it was illegal. In United States the government simply took one dollar out of your pension for every dollar you earned up to the full amount, unless you were over 72 in which case there was no deduction. This has been gradually reduced, first to a 1/2 dollar for every dollar earned, then to 1/3, and finally was abolished.

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