The Political Economy of Rent Creation and Rent Extraction

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I. Introduction: Rents and Rent Extraction

A. On the Nature and Origins of Rents

The theory of rent was among the first to be worked out in economics. Ricardo (1817) noted that above average returns were realized by owners of land that is especially productive or well located. The use of such land generates an extra profit beyond that required to bring the marginal piece of land into production. Ricardo referred to the extra return or profit on high-quality or well-situated land as a rent. Ricardo's idea was generalized to characterize the notion of "economic rent," which is the amount paid to owners of any factor of production beyond that required to keep it in its current use(s). In other words, it is the extent to which one's reward or rate of return above that of one's best alternative. Although both the reward and alternative are at least partly subjective assessments, rent in this sense can be approximated as accounting profit less the return typically earned by comparable persons, occupations, firms, or industries. Rent and economic profit thus have identical meanings, and both differ from accounting measures of profit, except in the odd case in which one's opportunity cost rate of return is zero. [1]

[1] There is some confusion about the proper meaning of opportunity cost rate of return. Insofar as one could always sell a stream of net revenues for the present value of that stream, it can be argued that profit is always (and tautologically) zero. An asset's current resale value can be regarded as the opportunity cost of holding onto that asset. However, if an owner's rate of return is calculated relative to other investments that could have been made at the time that his or her investment was in fact made, positive profits are clearly possible. For example, an asset's resale value might rise much faster than that of other assets that could have been purchased, or a new product might sell at a much higher markup than others that could have been brought to market. In such cases, owners clearly realize above average returns and so realize positive economic profits or rents. It is the second meaning of opportunity cost that is used throughout the present chapter.

An implication of Hobbes' (1651) characterization of anarchy is that it is ultimately the protection of the state that allows rents to be realized. In the absence of such protections, conflict over productive resources would tend to consume any differences in profits or net benefits associated with controlling them.[2] Ownership is an ancient legal institution and is, as noted by Hobbes, the ultimate foundation of civilized society. State protection of ownership rights discourages (most) persons from attacking or otherwise taking properties that generate above-average returns or net benefits from their owners. Without protection of ownership rights, contests for control would ensue, and the rents would be fully dissipated by efforts to defend (or take) possession of all valuable resources. In this sense, essentially all rents are products of government policies.

Rents in the private sector are largely consequences of laws that define what can be owned and the use and transfer rights associated with ownership. Ownership is largely determined by chains of transfers from original owners that are ultimately sustained by the coercive power of government. Laws in civil societies tend to limit forms of conflict to ones that tend to be productive, as with competition in markets, elections, and sporting events. Many of the laws defining the rights associated with ownership and contract are ancient and unchanging, although not all of them. As a consequence of the latter, rents can often be obtained by modifying existing or creating new rights in a manner that increases the returns of particular persons, firms, resources, or industries. The creation and extraction of rents are thus inextricably related to one another.

Rent extraction is simply the activity or activities necessary to realize rents. The simplest form of rent extraction is that associated with the ownership of an especially productive or desirable property: a fertile farm field close to market, a spring in a desert, a productive oil well, a house with an attractive view, and so forth. The rents created by various forms of ownership are extracted by their owners, which provides the foundations and motivation for most private economic activity. That rents can be created and extracted through public

[2] There is evidence that Hobbes's characterization of life before civilization is roughly correct. XXX (xxxx) presents extensive evidence of warfare among early tribes, that was not all encompassing, but absorbed significant human and capital resources.

policy innovations implies that prospects for rent extraction also motivates much of politics and policy formation.

B. Rent and Rent Extraction

The process of attempting to profit from policy reforms is often referred to as rent seeking. Rent seekers may, for example, lobby government officials for the creation of barriers to entry in otherwise competitive markets that increase or protect their current and future profits. Such policies, in effect, generate rents by creating new ownership rights in the revenue streams associated with the sale of particular goods or services. Such policies give recipients the right to exclude others from "their" market or service area, much as a land owners can exclude their neighbors from their fields.

This effect is magnified by economic growth in markets for services for normal or superior goods. As population and average income increase and prices rise for consumers and profits increase for those protected by barriers to entry.

C. Rent Sharing and Rent Extraction

This is not to say that current asset or firm owners realize all the rents associated with a new barrier to entry. The rents may be shared in various ways. For example, a privileged taxicab company's rents may be shared with its drivers or with the politicians who graciously adopted the policies that produced their rents. In some cases, rent sharing may reflect the generosity of the rent owner, but rent sharing may also be a consequence of rent seeking and extraction by others. Drivers may threaten to strike for higher wages or benefits. Those who supported the monopoly may expect campaign contributions (legal) or cash kickbacks (illegal) in return.

A monopoly firm's employees may form a union and aggressively bargain for a share of the firm's rents: average wages and benefits. If they succeed they will have wages above their opportunity cost and share in the rents created by their firm's protection from marketplace rivals. Similarly, politicians may threaten to reduce a monopolist's profits by allowing other firms to enter the market, raising taxes, or increasing regulatory costs unless campaign contributions are made or kickbacks are paid. Insofar as such threats generate larger campaign contributions and thus an increased probability in holding office, politicians will share the monopolist's or protected industry's rents. They will have more resources available and thus more secure political careers than they would otherwise have had.

Rent creation, rent seeking and rent extraction are often possible and can be profitable in both the public and private sectors. It is the potential for rent extraction that induces all rent-seeking efforts.

D. Rent Extraction and the Origins of Rent Distributing Contests

In the standard theoretical analyzes of rent-seeking contests, (i) the rents are created, (ii) sought after and (iv) awarded. After that, (v) the winners extract their rents. The focus of analysis is normally the second step, the contest phase of this process. Variations in the assumptions about the contests allow the effects of institutions (contest design) on the efforts of rent seekers to be carefully studied. However, the usual analysis abstracts from both the creation of rents and the reason why contests are used to distribute the rents created.

With respect to government policy makers, these are likely to be matters of choice rather than accident. The rent extraction literature suggests that it is the government official's expectation that he, she, or they will profit from creating the rents or the contest for those rents that motivates the entire process. It is the efforts of governments and government officials to extract a share of any rents created that was termed rent extraction by McChesney (1987, 1997).

This remainder of this chapter explores various relationships among rent creation, rent seeking, and rent extraction. It focuses for the most part on efforts by government officials to extract some share of rents created by them but also discusses rents that emerge in the private sector. The broad topic of rent extraction extends well beyond that undertaken by governments and government officials, but many of these are beyond the scope of the public choice literature and so are beyond the scope of this chapter.[3]

Section II provides a short overview of private and public-sector efforts to create rents. Section III provides an overview of the politics of rent creation and rent extraction. Section III analyzes the welfare implications of different forms of extraction with the aim of explaining why some forms of extraction are illegal and should be. Section IV summarizes the discussion and makes a few suggestions for future research.

II. Rent Creation

A. Privately Generated Rents

As a point of departure, imagine a setting in which all assets are purchased at time zero in perfectly competitive markets. In such a market, every asset sells for the full risk-adjusted present value of future returns, including any Ricardian rents. At these competitive market prices, every asset earns the same (risk-adjusted) return and so there are neither economic profits nor economic rents. Given this point of departure—a world without rents—economic rents may nonetheless emerge in a variety of ways. They may be created privately under a stable civil law or publicly through refinements of existing laws, regulations, and other policies.[4]

In an environment in which all buyers have the same information and imagination, extraordinary profits (rents) are simply a matter of luck. Some assets increase in value because of unanticipated increases in demand or reductions in supply. Unanticipated new demands for scarce locations or minerals will generate unanticipated Ricardian rents. An accident in a lab may lead to a new antibiotic or new material, as with penicillin and nylon.

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[3] For example, one strand of the efficient auction and contract literature attempts to characterize contracts that can reduce employee rents and increase those of firm owners. Such contracts extract employee rents. See for example, Cremer and McLean (1988) or Hua (2007).

[4] McCormick et al. (1986) note that the full capitalization of streams of rents generated by past policies can reduce interest in deregulation. Here the assumption is that both public and private sources of rents from the past are fully capitalized into asset values, wages, and prices of services. The policy-based rent-capitalization argument was first developed in Tullock (1975).

Economic profits in perfectly competitive markets can only be realized, as Knight (1921) argued, because of uncertainty and associated luck, but not intent.

In a setting in which people differ in their abilities and information, rents may be intentionally created through various actions and investments. For example, relatively well-informed explorers may discover and purchase new mineral deposits that were overlooked by the average prospector. An especially insightful inventor may imagine and create new products with high potential demand that were overlooked by others. The inventors of new drugs, better driving or more economical automobiles, or smarter cell phones tend to realize monopoly profits because at the instant of invention no similar product is available from others. Similarly, an artist that invents a new attractive form of painting may earn rents on his or her invention (or talent) insofar as there is a significant demand for his or her paintings, sculptures, etc. A firm that works out a new less-costly method of producing a well-known product may also realize well above-average returns because of its lower production costs for familiar products, as with Alcoa's implementation of the Hall-Héroult process for refining aluminum, which led to Alcoa's near monopoly position in the aluminum market in the early twentieth century. Well informed speculators may purchase assets of various kinds that they have reason to believe will rise in value in the near future, and realize profits when they do.

Such innovators realize monopoly profits from their greater insight or knowledge. Their higher-than-market returns are not always realized at the instant of genius but accumulated as production is organized and products brought to market. Markets reward persistence as well as insight, as with Edison's lightbulb and Marcus's, Benz's, and Ford's automobiles. Successful innovations generate monopoly power, which allows higher than normal profits to be realized.

Many of these rents from innovation are temporary and are competed away as other entrepreurs follow their lead. In a few cases, rents may be permanently realized by producers that enter markets that are too small to support more than one efficiently sized firm, or because of first mover advantages. Speculators may anticipate changing patterns of living that tend to increase the value of various locations, and purchase land in such places. Such natural monopolists realize above-average returns because of the lack of competition from good substitutes. Moreover, even especially talented innovators or well-informed speculators bear the risk that their relatively more accurate expectations will be disappointed. The pursuit of rents through experimentation and other forms of research consume time and energy, and is not always rewarded.

Most of the innovation that occurs in the private sector can be regarded as productive or welfare-enhancing forms of rent creation and rent extraction. Consumers benefit from new products brought to markets by innovators and from the lower prices induced by prospectors bringing new minerals (inputs) to market and innovations that a reduce production costs. Successful speculators drive prices toward their appropriate levels, which encourages a more efficient use of the resources repriced. Resources are shifted from lower to higher valued uses. Such forms of rent creation, seeking, and extraction reflect the boundaries set by well-functioning systems of civil law.

Nonetheless, some forms of private rent seeking tend to reduce the aggregate net benefits from market transactions. For example, a talented organizer may assemble an effective cartel or an especially cooperative group of firm owners may coordinate their pricing and output decisions to function as if they were a cartel without a formal organization. Such groups of producers create and profit from monopoly power, without benefiting consumers. Indeed, the standard Harberger diagrams of losses from Monopoly indicate that deadweight losses often are generated.

Civil law may or may not enforce cartelizing contracts, but when they are enforced or work without government support, rents are clearly created for producers. Cartels and other monopolists profit by capturing some of the net benefits previously realized by consumers of their products. Unfortunately, according to static textbook models of monopoly pricing, consumers lose more consumer surplus (net benefits) than cartel participants gain in additional profits.

B. Government-Created Rents

Government policies can also create rents in both productive and unproductive manners. They can do so through innovations (unexpected changes) in regulatory, tax, and expenditure policies. New policies, like new products, can create new rents. They often increase returns in some locations and industries relative to others, or for some activities relative to others, in a manner not previously capitalized into the value of assets such as stocks, bonds, land, and housing.

Government policies may have global effects on rents or relatively narrow ones. For example, an unanticipated improvement in the enforcement of contracts and protection of property claims tends to increase the net benefits associated with all transactions and private assets. Such policies create new unanticipated gains from trade (both consumer surplus and profits) by reducing risks, transactions costs, and the extent of unproductive forms of competition (fraud and theft). New Ricardian and monopoly rents are created as the breadth and depth of market transactions increase.

More localized rents are often generated by unanticipated increases in the production of public services, specifically those that create new scarcity and locational rents. For example, properties near new governmental office buildings generally increase in value, because secondary service providers, such as restaurants and gas stations, are more likely to be frequented if they are near clusters of persons rather than distant from them. As a consequence, firms are willing to pay a premium for such locations. Similarly, extensions and improvements of public transport systems tend to reduce transportation costs in a manner that generate new locational rents and increase property values. This is, for example, occurs near highway interchanges and metro stations, where population density often increases and locational rents skyrocket. Such rent-generating policies tend to increase aggregate net benefits by extending the size of markets, but in an uneven way that favors some locations over others.

As in the private sector, however, not all rent-creating activities generate increases in aggregate net benefits. New rents can be created through various policies that reduce productive forms of competition in a manner not fully capitalized into asset values. Cartel agreements may be better enforced, regulatory barriers to entry may be erected, or new monopoly privileges created. Patent rights may be over extended or broadly enforced in a manner that reduces rather than increases rates of innovation. Governmental purchasing decisions may create monopolies in various specialized markets such as those for military aircraft or regional highway construction. Exclusive service and sales agreements may be negotiated with venders of various kinds. State universities, for example, often sell the right to be exclusive providers of soft drinks and snacks on their campuses. Some towns sell off exclusive rights to trash collection, cable services, and mass transit.

Other policies make it more difficult to enter pre-existing markets, which extends the period in which existing firms can profit from both temporary and permanent increases in demand. Entry costs may be increased, for example, by requiring time-consuming and costly licensing and permits, or by formally excluding a subset of potential rivals, as with tariffs and import restrictions. New rents can also be created through grandfathering provisions, which exempt existing companies from new regulations or licensing requirements. The latter gives older firms a cost advantage relative to new entrants and so creates economic profits unavailable to new suppliers as demand increases.

Unanticipated changes in tax law can also create new rents. New rules that treat some types of income and some types of expenses differently from others can often increase the relative value of skills, assets, and organizations. For example, a tax reform that causes firms in one industry to pay a lower corporate income tax than otherwise similar firms in other industries, increases net of tax profits and stock values in the favored industry, generating rents for owners of stock in the favored firms and often higher salaries for their employees, as rents are shared. Developing particular skill sets may be rewarded with special tax rates or deductions. Small business owners may be granted new tax deductions that employees lack and so face a lower tax on income than otherwise similar persons who undertake similar tasks, increasing the rate of return earned in and thereby the value of small businesses beyond those anticipated by those heretofore creating and purchasing such businesses.

Tax law changes may also favor some activities or types of assets over others and so increase consumer surplus or after-tax rates of return for the beneficiaries and increasing the demand for related goods and services. Indeed, even increases in taxes can create new rents by changing the value of tax exemptions and deductions. For example, unanticipated increases in tax rates tend to increase the tax savings associated with the deductibility of interest on mortgages, which increases the demand for and value of residential housing relative to other assets for current home owners. Government expenditures can also create rents by excluding a subset of firms from competing for government contracts and/or paying above-market prices for services rendered. The rents created need not be permanent to have profitable effects on market prices for assets or salaries paid to particular professions in the short and medium term.

It is the possibility that new rents may be created or old rents diminished that induces relatively informed, creative, well-connected, and energetic persons to form groups and lobby for policies that produce rents, as argued by the economic interest group and rent-seeking literatures. (See chapters 25 and 28.)

If government officials expect to realize a share of the rents created, they will be more inclined to accept the policy recommendations of interest groups that lobby for government privileges. Moreover, innovative government officials may create both new rents and rent-seeking contests without any prodding by private rent seekers, if their anticipated share of the rents created is larger than the political cost of such policies (reductions in good will, votes, and campaign contributions from those bearing the losses associated with such policies).

In either case, anticipated rent extraction can motivate a good deal of policy innovation. Once created, most new rents are contestable and tend to attract resources into games of conflict, as emphasized by the rent-seeking literature.

III. The Political Economy of Rent Sharing and Rent Extraction

Rents are extracted by those who own or effectively control the rights to them. In cases in which the rents are created through public policy, that control is implicitly shared between private sector beneficiaries and the government officials and agencies that created them. Given that joint control, it is very likely that the rents created will be shared with government officials. The actual division of the rents reflects the bargains reached, which are constrained by pre-existing agreements, civil and constitutional law, and precedent. Not all such distributions are stable, but those that are can be thought of as Nash equilibria to various rent-seeking and bargaining contests that emerge under a society's legal and political institutions. The remainder of this chapter focuses on some commonplace methods for bargaining over and extracting rents.

C. Extracting Rents by Selling Rents

The public policies that create rents vary in the extent to which they are reversible, which affects the durability of the rents created. At one extreme are properties conveyed via normal civil law and durable physical structures. A transfer of mineral rights or EM spectrum from the government to private parties is much like ones between private parties and tends to be protected by civil law. Major new buildings and improvements to highways, railroads, airports, and seaports are not likely to be undone in the near future. Although policy reversals are physically possible even in such cases, such costly "mistakes" are obvious to voters and undoing them is costly to taxpayers. The rents associated with such policies thus tend to be long lasting.

Other policies such as minor provisions of tax and regulatory codes can be easily reversed during the next legislative or regulatory cycle. The rents created by such policies are ephemeral and need to be constantly renewed or defended. In between are policies that tend to be durable but that can be adjusted at many margins. Examples include policies regarding land use, building codes, standards for accreditation, environmental quality, and licensing. Rents established by their core rules and regulations are fairly stable but may be increased or decreased by small changes at the margins of those regulations.

The permanence of the rents and transfer of control over them has effects on the resources that rent seekers are willing to invest in contests for those rents and the prices rent seekers are willing to pay in auctions for such rents. The more durable a stream of rents is, the more valuable it is to potential rent seekers, other things being equal. Durability implies limits to the strategies that governments and government officials can use to increase their share of the rents after they are awarded to particular groups and individuals.

The simplest method of extracting rents is simply to sell them to rent seekers. For example, rights to rents may simply be sold off at public auction. Grossman and Helpman (1994) developed a model of international trade protection in which rent seekers make conditional offers for various degrees of protection, and government officials attempt to maximize their own utility defined over social welfare and the rents extracted. The more weight that pivotal government officials place on rent extraction, the greater is the extent of the protection sold. Competition to benefit from the protection sold causes all the rents at the margin to be extracted by government officials, although the extent to which inframarginal rents are captured is less clear and presumably varies with the extent of the competition for rents.

Congleton and Lee (2009) note that all-pay actions can be used as a revenue source. Many governments sell off monopoly privileges. In the medieval period, this was a significant source of revenues for European kings and remains a nontrivial source of revenue for local governments. They demonstrate that full rent extraction is possible and that the pattern of monopoly power generated resembles a Ramsay tax, with more protection provided for markets with relatively inelastic demand curves and in markets in which innovation is most likely to occur. Surprisingly, their analysis implies that the aggregate deadweight loss associated with a perfectly organized mercantilist state can be less than that associated with contemporary revenue systems.

Of course, not all public policies and their associated rents can be sold in this way. The sale of public policies, per se, is illegal and often violates social norms important to voters or other critical supporters.

D. Other less profitable modes of rent extraction

A variety of methods for extracting rents are possible in cases in which explicit sales of rents are ruled out by law, precedent, or custom. That governmental shares of such rents are smaller in most such cases does not imply that opportunities for rent extraction have no effect on public policy.

For example, an elected official that has advance knowledge of exactly where a new highway or office building is to be built may purchase land adjacent to the project. After the siting becomes known, property values tend to increase, creating rents for government officials and other land holders.[5] Such rent extraction is analogous to that available to persons in firms who trade on insider knowledge, which is not always legal but is difficult to police.[6]

In other cases, an elected official's own long-standing holdings of wealth may be affected by a policy proposal and he or she may vote in a manner that generates or protects rents for themselves, while providing rents for those with similar interests.[7] In such cases, office holders typically extract only a very small fraction of the total rents created, although even small shares of large rents may influence policy decisions.

Other rent sharing occurs through informal bargaining among elected officials and potential campaign donors, as when public policy positions are adjusted to increase campaign contributions or other forms of support that increase an elected official's prospects for re-election. Such forms of rent sharing do not directly increase the wealth of government officials but may indirectly do so.[8] A higher probability of re-election increases

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[5] In extreme cases, now illegal in the United States, legislators may be given stock (or sold stock at below market prices in the companies that will benefit) in exchange for their votes on policies favoring those firms or asset sales to them at below-market prices, as in the infamous Yazoo land sale scandal of the late 18th century (Teachout, 2014, ch. 4). Querubin and Snyder (2013) provide evidence of the increased wealth of Congressmen during the Civil War and Reconstruction, which they attribute to rent extraction.

[6] Such trading evidently accounts for a good deal of the wealth of members of the U. S. Senate and House of Representatives, who often enter office with more or less upper middle-class levels of wealth and leave as millionaires.

[7] Griffin and Anewalt-Remsburg (2013), for example, find that legislators with above-average wealth are more likely to support repeal or reduction of estate taxes.

[8] Unspent campaign contributions can be kept by retiring government officials and used for post-office expenses.

an elected official's expected future profits from insider trading and also any other rents associated with the authority, status, and esteem associated with high office.

In democratic polities, it is often assumed that office holders are motivated entirely by nonpecuniary benefits of high office, which presumably increases as their policies confer benefits on voters. In models of office holders that include the possibility of rent extraction, such subjective benefits of high office are supplemented by the pecuniary benefits of various forms of rent sharing and rent extraction.[9]

The methods for sharing rents and the extent to which rents are captured by office holders vary widely. These are jointly determined by the influence over policy that officeholders have and the interests of the officeholder (including fear of scandals and imprisonment), who may place more or less weight on the pecuniary and nonpecuniary benefits of his or her office. Majority rule tends to reduce a typical official's opportunities for individual rent extraction because there are many possible majorities that can be formed and so a single member is less likely to be pivotal in forming a majority coalition (Congleton, 1984). Nonetheless, rationality implies that pecuniary and career interests are rarely ignored and thus some degree of rent extraction is likely to be directly or indirectly associated with public policies that create or transfer rents.

E. Corruption

Many forms of rent extraction are legal or nearly so. Others are not. Government officials have a variety of statutory duties and are subject to a variety of social norms that other persons are not. A private citizen can trade a favor with his or her neighbor, but in his or her role as a public official, a person cannot legally trade a public policy favor for a private one. Such quid-pro-quo agreements conflict with duties accepted at the time that governmental authority is acquired. Such duties are often spelled out in formal oaths of office and by the laws and codes of conduct that characterize the office in question.

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[9] Such rents tend to increase the competition for high office and the resources invested in those contests, which is one possible explanation for the trend in campaign expenditures.

A member of the legislation cannot lawfully sell his or her vote on particular bills or for inserting particular language into a bill. A person with security clearance cannot legally sell national secrets. A member of a regulatory commission cannot lawfully sell his or her vote on new regulations. An environmental or building inspector cannot lawfully turn a blind eye to violations of the law in exchange for money or other favors. A police officer should not ignore a violation of speed limits or other rules of the road in exchange for cash.

Yet such illegal bargains do take place. Such illegal bargains—corruption—are also forms of rent sharing and rent extraction, and bribery a possible method of rent seeking.

F. *Ex Post Facto* Renegotiation of Rent Sharing Agreements, Extortion

Not all rent sharing involves voluntary transactions among those creating the rents and those benefiting from rent creation. Many of the bargains reached are informal ones and subject to endless renegotiation. This tends to make rent extraction an ongoing affair, rather than a once and forever transaction. For example, threats to reduce a stream of rents achieved in the past through favorable legislation will induce those whose benefits are at risk to increase the share of rents handed over to government officials. In addition, there are cases in which policy reforms and false accusations can be used to extort payments for policy reversals or ending court proceedings based on such accusations. Legislators can threaten to raise taxes or pass new onerous regulations unless campaign contributions are increased. A building code inspector or highway patrolman may simply invent infractions and threaten to fine builders or drivers unless payments are received.

IV. Welfare Consequences of Rent Extraction

Unlike most voluntary transactions in markets, transactions between rent seekers and officials in positions to create and distribute rents often generate broad externalities. In some cases, these are positive, as when a new useful service is provided that generates rents as a byproduct, and others are negative, as when a policy is adopted that generates a deadweight loss or encourages unproductive forms of competition. In either case, there are distributional and procedural issues that are relevant for voters and other potential recipients of rents.

We begin by analyzing the welfare effects of policies that create new rents. This is followed by cases in which pre-existing rents are to be redistributed. As might be expected, the normative implications of the two cases can be quite different.

A. Normative Aspects of Rent Creation

As a point of departure, assume a competitive equilibrium in which there are no rents as such, all rates of return are just sufficient to attract resources to their current uses and all assets are valued at the risk-adjusted present value of their expected net incomes. Wages make all, or at least marginal employees (including government officials) indifferent between their current positions and their best alternative.

Now suppose that a new highway is to be built in a new location that joins two major urban centers. Prices rise for land along the entire course of the highway, although not always immediately adjacent to it, as commuters and shoppers realize shorter driving times and most merchants along the route realize increased business, although some may experience reduced sales because of increased competition from rivals in the commercial centers. The greater convenience of commuting and shopping along the highway may induce new residential and commercial construction, which further increases rents and land values. Assume that those rents exceed the cost of the highway right of way and construction and any associated externalities.

In such cases, rent creation clearly increases the economic output of the region of interest and social net benefits as well, which according to welfare economics makes such rent-creating policies desirable. Similar conclusions would be reached by many other normative theories as well. Note that this remains true, at least for welfare economics, regardless of the distribution of new rents created. If they are largely captured by governments as revenues or government officials as bribes, kickbacks, and campaign contributions, an aggregate increase in net benefits is still realized.

Disputes over the distribution of the rents created tend to consume the net benefits created and thus are to be avoided. In the limit, conflict over the distribution of rents can consume the entire surplus created, as repeatedly demonstrated in the rent-seeking and contest theory literatures. (See, for example, chapters 25 and 26.) Such disputes can be minimized by, for example, relying upon the impersonal forces of market competition to distribute rents, or otherwise minimizing the ability of government officeholders to directly influence that distribution of rents by using lotteries or independent commissions of engineers to choose siting and the location of interchanges.

Voters will prefer that such projects be constructed and financed in a manner that benefits them and so would tend to oppose procedures through which either firms or government officials capture all the rents. Nonetheless, voters may benefit from modest forms of rent sharing insofar as they encourage government officials and firms to discover and implement such policies. Financing the project would ideal rely on tax systems based on the rents extracted. Together such systems tend to maximize the net benefits of the typical voter by assuring that net-benefit producing projects are undertaken, while avoiding fiscal commons problems. Such funding is also consistent with many theories of fairness and with contractarian theories of policy formation.

The distribution of any new rents created remains relevant for government officials, land owners, and voters and also for most normative theories.

B. Normative Aspects of Rent Redistribution

If we return to our assumed zero-rent status quo, the redistribution of rents is impossible, because none exist. New rents may be created through public policies as above or through innovation in the private sector. Once created, rents can be redistributed, which tends to attract efforts by rent seekers to increase their share of the available rents. Again it is the prospect for realizing rents (extracting rents) that motivate both actions that create rents and efforts to obtain a larger share of the rents created.

In many cases, the rents created are smaller than the net benefits lost by others. In such cases, social surplus is reduced by public policies rather than increased, and contests over the distribution of the rents created simply add to the losses already introduced by such policies, as pointed out by Tullock (1967) and emphasized by the rent-seeking literature. Additional deadweight losses may arise in extreme cases where ownership rights themselves become uncertain as property and prices shift willy-nilly, and long-term planning becomes more risky or impossible.

In cases in which net-benefit increasing rents are created through public policy, it is again the case that contests over their distribution tend to consume resources and reduce the net benefits generated by the policies. In some cases, the rents may be entirely or even super dissipated by the efforts of rivals in contests for rents. Again, distributive conflict should be avoided to the extent possible, as with mechanical methods of distributing rents or by creating productive forms of competition for the rents at stake.

C. Corruption: the normative case against most forms of rent extraction

In cases in which rent-creation generates costs greater than benefits, rent extraction by governments and government officials simply creates incentives for the adoption of poor policies. Ideally, rent-sharing in such cases should be discouraged and authority to adopt such policies limited.

Societies that score well on international corruption indices often have undertaken a variety of measures to reduce such incentives. Examples include the taking's provisions of liberal constitutions and antibribery and anticorruption statutes. Rules that reduce opportunities for overpaying for services also reduce incentives for kickbacks and other rent-sharing by eliminating or at least reducing excess returns from government contracts. Generality laws of the sort advocated in Buchanan and Congleton (1998) also tend to reduce opportunities for trading favors by requiring uniform treatment of individuals, which would (ideally) eliminate favoritism.

V. Conclusions and Possible Extensions

The process of rent extraction is conceptually distinct from two other related processes: rent creation and rent seeking. All three jointly determine the distribution of rents; however, rent extraction is arguably the most important of the three, because the other two are ultimately motivated by the final stage, the extraction of rents. Thus it is rare to find one without the other two. This chapter has focused for the most part on the creation and extraction of rents by governments and governmental officials. Rent seeking and rivate sector parallels have been discussed only in passing.

The simplest explanation for public policies that create rents is that government officials, both elected and unelected, expect to profit from such policies. That is to say, a good deal of the creation of rents and their associated rent-seeking contests is likely to be a consequence of forward-looking officials with sufficient authority to adopt policies that create rents and elicit rent seeking. The expectation of rent extraction, usually in the form of rent sharing, can be a sufficient reason for adopting such policies.

Other interests of officials also play a role. Constitutional and other institution constraints may reduce the inclinations of such officials to create rents through inefficient policies. For example, insofar as opportunities for rent extraction require continuation in office, the interests of the electorate or more senior officials cannot be entirely ignored. The stronger are the latter constraints, the less rent sharing and rent extraction is likely to take place. However, in policy areas and institutional settings in which such constraints are relatively weak, the mere possibility sharing rents can be a sufficient reason for the creation of a broad range of policies (and for threats to create others, not implemented). In such cases, rent-extraction must be included among the causal factors in any complete model of policy formation.

The domain of rent extraction varies among country and regions because both the legal setting and the extent of electoral and social pressures in opposition to (or support of) rent-extracting policies varies. In societies where corruption is taken as a fact of life or is regarded to be an honorable form of self-interested behavior, social pressures encourage, rather than restrain rent extraction and its associated rent-seeking contests. In societies where corruption is regarded to be an especially dishonorable form of self-interested behavior, social pressures restrain rent extraction and its associated rent-seeking contests. Cultural support for or against rent extraction also tend to affect the internalized norms of government officials and the rules that govern their possibilities for engaging in rent extraction. Indirect evidence that law and culture reduce rent extraction is provided by numerous empirical studies of the determinants of corruption.[10]

Research concerning the rules, procedures, and norms that reduce unproductive rent seeking and rent extraction has been undertaken, but much more useful work remains to be done. For example, more could be done to make models of rent seeking and rent extraction more realistic by including the effects of political institutions, legal setting, and culture. These effects are not likely to be unidirectional as institutions and moral maximx may well be adopted with their effects on rent extraction and rent seeking in mind. Such more complete models, in turn, are likely to generate new hypotheses that can be subjected to statistical and laboratory tests.

Although much has been accomplished in the past half century of research, many issues remain to be 3explored.

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[10] See for example Aidt (2003) for an extensive survey of the corruption literature, which is updated in chapter 31.

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