Rent-Extraction, Liberalism, and Economic Development

April 22, 2010

Roger D. Congleton

Center for Study of Public Choice
George Mason University
Fairfax, VA 22030

Abstract:

This paper argues that liberalism enabled the West to escape from long-standing rent-extracting regimes and created long term institutional sources of competitive advantage in trade and economic development.

The rent-extraction model of the state predicts that mercantilist policies will be adopted, rather than free trade. There will be numerous internal and external barriers to trade, and the distribution of income will be skewed in favor of government officials and their families. Economic and political liberalization tends to reduce opportunities for rent extraction and promote economic development

The rent-extraction model of the state also implies that the politics of liberalization tend to be problematic. This allows liberal reforms, once adopted, to be nearly permanent sources of comparative advantage that affect patterns of economic development and long-run trade flows. Strategies of export-led growth, however, can be politically feasible within rent-extracting regimes, which makes them a likely first step in economic and political liberalization.

JEL H11, D60, F10,

I. Introduction: Liberalization and Economic Development

This paper provides a rent-seeking and rent-extraction based explanation for the association between liberalization and economic development, and for the durability of the economic advantages associated with liberalization. The analysis begins by connecting strands of the literature on rent-seeking, rent-extraction, and constitutional political economy which together provide a public choice explanation for the slow rate of adoption of liberal economic and political institutions throughout the world. Simply put, the persons that have sufficient authority to adopt major and minor institutional reforms often benefit from unproductive forms of political and economic competition. This, together with institutional conservatism, makes liberal reforms less likely to be copied than other organizational and economic innovations. As a consequence, liberal reforms can be a nearly permanent source of competitive advantage that affects long-run trade flows, patterns of international investment, and economic development.

A possible exception to this rule occurs in the area of export-led growth, where rent-extraction rates may be adjusted to encourage growth. Reductions in the rate of rent extraction in the export sector may increase, rather than reduce, total rent extraction in the short and medium run, as demonstrated below. In the long run, the economic growth encouraged through export led growth strategies may indirectly support liberalization of other sectors of the economy and of the political system.

II. Rent Seeking, the Rules of the Game, and Competitive Waste

Most methods of obtaining wealth and status are competitive to some extent, because of the scarcity of wealth, status, and authority. Scarcity induces persons from all walks of life to invest their scarce time and attention in activities that protect and/or increase their holdings of scarce economic and social resources (Congleton 1980, 1989).

Individual decisions to invest in such contests can be modeled in a number of ways. Suppose, for example, that there are m contests and that the expected payoffs from contest j have the form:

$$R_{ij} = s_j(f_j(x_{ij}), gj(x_{oj}))\, P_j - c_i(x_{ij}) \tag{1}$$

where xij is the investment by the i-th rent seeker in contest j and xoj is the investment of all rent seekers other than i. P_j is the prize or profit at stake, f_j and g_j are influence production functions. The individual's cost of participating in rent-seeking activities, C_i , varies with the resources committed to the game and the opportunity cost of i's resources in non-rent-seeking activities, such as farming and leisure. Function sj is a sharing rule or probability function for contest j, and j's anticipated share of the prize is determined by his or her effort and that of all other persons in the game, $S_j = s_j(F_j, G_{0j})$.

For the purposes of this paper, I assume that the various contests resemble extended forms of the Tullock contest in which relative effort, rather than absolute effort, generates one's share of the "prize" (wealth or status) or probability of winning. In that case, the typical rent seeker, i, will invest in rent-seeking contest j so that the expected (risk-adjusted) marginal rate of return is the same in all contests.

$$Pj\ Sj_{fj}\ Fj_{xij} = Ci_{\ xij} \tag{2}$$

for all j in all games.

In rent-seeking societies a very large fraction of personal resources are invested in such contests. Whether the results are a disaster in which all these resources are wasted—as assumed in much of the rent-seeking literature—or increase total wealth—as assumed in much of the economics literature—depends on the nature of the contests (Congleton 1980).

When the contests are such that *relative influence*, rather than absolute influence, determines the shares of a preexisting prize or the probability of winning the entire prize, considerable waste results unless the contest produces benefits for nonparticipants. Because relative rather than absolute effort determines expected payoffs, all players could simultaneously halve their efforts to influence the outcome without affecting their shares of the "prize" or probability of winning. This would free resources for activities that directly or indirectly increased the stock of knowledge, comfort, or health. Excessive investments in rent-seeking contests are nonetheless sensible whenever the expected net benefit of participation is at least as great as that associated with other activities.

Law and culture largely determine the extent to which resources are wasted in the contests in which people invest, because law and culture largely determine the nature of the competition that take place in societies contests, through affects on the rates of return from different activities. If the most likely routes to personal wealth and status require political contacts and favors, prudent persons will spend time seeking such contacts and favors. If the most likely routes to personal wealth and status are produced through military prowess, such persons will invest in the discipline and destructive skills required to be good soldiers. In liberal societies, the most likely routes to personal wealth and status involve pleasing consumers and/or voters by creating attractive products or policies, and so "upward bound" persons invest in product and policy refinement and innovation—activities that benefit persons outside the competitive arena.

In the model above, such factors determine the magnitude of the prize, the sharing rule, and the influence functions, which jointly determine s_j, F, and F_{xij}. As a consequence, the intensity and manner of competition in society's contests can be said to be determined by the formal and informal "rules of the games," because the rules determine s_j, F, and $F_{j\ xij}$ for each game.

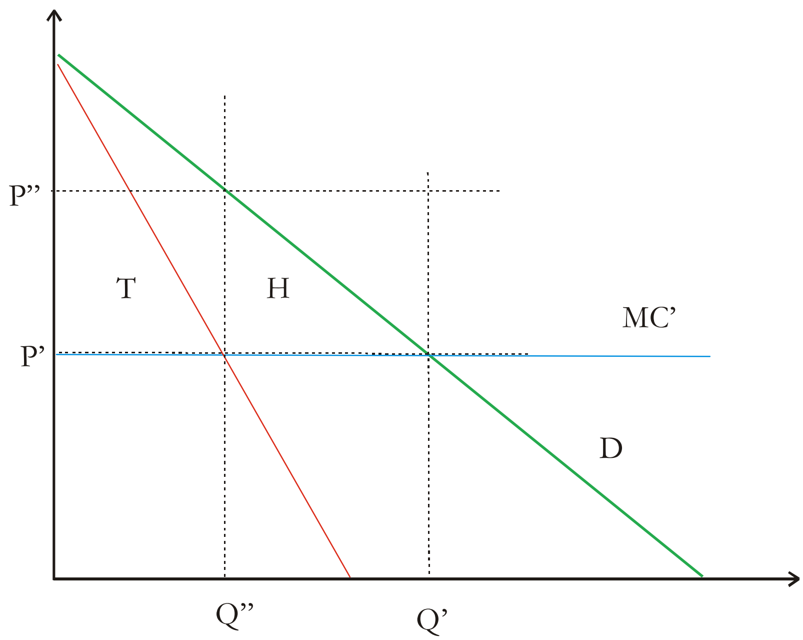
III. Rent Extraction: Creating Rent-Seeking and Status-Seeking Contests

Most of the rent-seeking literature assumes that the number and nature of a society's contests are determined exogenously. This is a reasonable place to start in most cases, because so many rent-seeking and status-seeking contests emerge spontaneously, or are grounded in quasi-constitutional rules such as the civil law and a nation's constitution. Many contests, however, are products of design. Within firms and academic institutions, for example, contests for raises and promotion are designed to increase productivity of "team members" and to solve team-production problems. Well-designed contests can simultaneously increase the efforts of team members, the production of useful outputs, and the profits of firm owners.

Similar contests may also be devised by government officials with similar gains (profits, revenues, deference) in mind. For example, government can create special privileges, barriers to entry, exclusive rights to buy or sell, etc. that are available to only a subset of the persons who might wish to obtain them. It may also determine who is eligible to compete for those prizes and the procedures through which such privileges can be obtained by interested persons and organizations. In this manner, government officials may create a complex series of nested contests.

Figure 1 illustrates the simple microeconomics of a contest to obtain a government-created monopoly in a market in which it is difficult to discriminate among buyers. It bears noting that monopoly "profits" are not always monetary, but may also include "social rents" in the form of status, deference, and political authority.

Figure 1
Monopoly Profits and Rent Seeking Effort



Tullock (1967) pointed out that the prospect of gaining monopoly profit (area T) can induce a good deal of political activity to obtain such market privileges. He also pointed out that resources used to obtain such policies can often be regarded as additional sources of deadweight loss, because the resources used to seek monopoly privileges from government reduce social net benefits and have an opportunity cost. They could have been used to increase social net benefits by producing other products that could be sold at mutual advantage. The resources invested in many personal wealth and status increasing contests tend to be value-decreasing, rather than value-increasing for society at large. In macroeconomic terms, they reduce national income rather than increase it.

The use of such rent-extracting contests and of government monopolies as sources of government revenue is historically important in most societies. For example, during the

Hang Dynasty, a state monopoly on salt was a major revenue source for the imperial government. (Chen 1911: 542). State monopolies were also important sources of revenue in the Ottoman empire (Mansfield 2004: 66). Revenues from state monopolies and sales of office were also important in medieval and late medieval Europe, as in France and England. Efforts to establish private monopolies were, in turn, often discouraged through punishments of various kinds.[1]

Efforts to obtain state monopoly privileges like the one illustrated can produce government revenues (and other forms of support) with a value of up to area T. Welfare economics implies that government "sales" of monopoly privileges reduces social net benefits by triangle H. The cost of generating revenues from rent-seeking contests is thus at least area *H* and can be as much as *H+T*, an amount exceeding the revenues, as implied by the analyses of Tullock (1967), Hillman and Katz (1984), and Nitzan (1991).

The extent of the deadweight losses from such contests depends on how much the effort of rent-seekers benefits government officials (e.g. the rents extracted by government officials) and the extent to which the contests produce benefits for other non-contestants. These are affected by the procedures through which rents are obtained and rules that affect participation in the contests (Congleton 1980, Aidt and Hillman 2008).

A. Rent-Extracting Authority

It bears noting that the efforts of rent-seekers normally produce benefits for government officials, as well as governmental revenues. A common strategy for those who hope to benefit from entry barriers is to lobby government officials who control parameters of existing contests or who have the authority to create new rent-seeking contests that restrict eligibility to persons and firms similar to themselves. Once criteria for contest participation are established, similar strategies are employed to persuade officials that they qualify for participation in the contests and/or to change the eligibility rules.

The authority of government officials as “gate builders” and “gate keepers” allows government officeholders to benefit from the deference, gifts, and bribes paid by those wanting “new gates” to be constructed, old gates to be removed, or simply to be allowed through the “gate” into preexisting games of interest. Because government officials benefit from most government sponsored rent-seeking and status-seeking contests, they have good personal reasons to create such contests and to maintain (and seek) their authority to create contests in which they can determine winners and losers.

The creation of rent-seeking contests in order to “profit” from the rent-seeking activities elicited is called rent extraction (McChesney 1997). Rent-extracting contests are more or less efficient according to the value of the services extracted by government officials relative to their value to the participants in the rent-seeking contests. The greater is the extraction, the lower is the deadweight loss of the contest, other things being equal.

B. Intra-governmental Rent Seeking and Anticorruption Laws

The ability of government officials (policy makers) to create competitive contests for “outsiders” indirectly creates higher levels of contests among insiders. Government officials will compete for positions of authority where rents are extracted and for additional authority to create new rent-extracting contests. That is to say, the rents associated with positions of authority induces competition among insiders. Such intra-governmental contests may be designed used to increase governmental efficiency or may evolve in a manner that tends to undermine it, as office holders compete for larger shares of a smaller pie. Hillman and Katz (1987) provide an early analysis of such intra-governmental rent-seeking contests in which government rents are entirely dissipated by competition among insiders.

The Hillman and Katz analysis implies that there is a conflict between the interests of lower and upper officials with respect to rent extraction. The more rent extraction that takes place at low levels of governance, the less remains for top officials to "harvest." As a consequence, upper-level rent-extracting officials have incentives to adopt rules and regulations that restrict the types of rent extraction permitted by lower-level officials. Such rules *define corruption.* They are supported by significant penalties, including the death penalty.

The rules against "corrupt forms of rent extraction," however, do not always apply to the senior officials who draft "anticorruption" laws, who can often continue selling favors for cash and political support. Rent extraction thus remains of interest in societies that have well-enforced anticorruption laws both as sources of state revenue and senior official wealth. Well-designed and enforced anticorruption laws tend to reduce the deadweight losses from intra-governmental rent-seeking, although not necessarily the magnitude of investments in rent-seeking contests by outsiders.

C. Rent Extraction by Well-Run Governments

In rent-extracting governments with tough well-enforced anticorruption laws, senior officials are, in effect, residual claimants on "their" country's economic production analogous to Olson's (1993) model of stationary bandits. This has predictable effects on the extent to which senior officials will extract rents from various sectors of their national economy. Senior officials will take account of the deadweight losses of rent-seeking contests and their overall effect on the economy (at least for their term of office), because these affect their net receipts from rent-seeking contests. In such polities, rent-extracting contests may resemble an auction analogous to those modeled by Helpman and Grossman (1994). The effect of rational rent extraction, nonetheless, is to reduce national income and wealth below levels that might otherwise be achieved (Congleton and Lee 2009).

In countries in which corruption runs throughout the bureaucracy, rent-seeking activities inside government reduces the revenues generated at the same time that rent-seeking activities outside of government reduce average income to near-poverty levels (Hillman and Katz 1984, 1987; De Soto 2003). As rent extraction "taxes" increase, a nation tends to become poorer, because fewer open-market transactions take place, more relatively inefficient black-market transactions take place, and because productive resources are wasted in unproductive rent-seeking activities (De Soto 2002, Schneider and Enste 2002, Tullock 1967). Governments that carefully craft their rent-extraction systems tend to have higher average income than less well-run rent-extraction regimes, because the "rent-extractors" take better account of losses from excessive rent extraction and harvest more rents from their contests in the long run (North, Wallis, and Weingast 2009; Mesquita et al. 2003; Hillman and Katz 1987; Tullock 1967).

The distribution of income in both sorts of rent-extraction states tends to be skewed, because of the implied net income differences among rent extractors, rent recipients, rent seekers, and rent payers.[2] Rent-extracting governments tend to reduce the rent-paying and rent-seeking parts of society to near subsistence levels of income, while the rent-extracting sector becomes relatively wealthy, particularly in well-run rent-extraction states.

IV. Escape from Rent-Extracting Regimes through Liberal Reforms

Before the nineteenth century, during most times, and in most places, governments were rent-extracting regimes, although the efficiency of rent extraction varied among governments. Domestic and international barriers to trade were allocated on the basis of family, political support, and cash payments. Privileged persons and organizations had exclusive rights to sell, produce, import, and export particular goods and services. Occupations and positions in government were reserved for privileged members of privileged families, often living in privileged locations. State-sanctioned privileges created "elites," whose interests were well advanced in most medieval societies. These include relatively prosperous ones such as France, Spain, Turkey, Japan, Korea, and China. Such societies have been called rent-seeking societies (Ekelund and Tollison 1982), and their governments "natural" states, (North, Wallis, and Weingast 2009), although the term rent-extracting states is more descriptive of their governments and policies.

European medieval society gradually disappeared in Europe during the eighteenth and nineteenth century as political and economic reforms were adopted that favored more open and productive forms of economic and political competition. The general direction of reform came to be referred to as "liberal," their philosophical foundations as liberalism, and the persons advocating the reforms as liberals (Congleton 2011).

Liberals developed arguments that favored productive forms of competition that had previously been suppressed.[3] That is to say, liberal reforms did not reduce social conflict, perse, but rather increased prosperity by shifting resources from economic and political contests that reduce average wealth to ones that increased average wealth.[4]

A. Examples of Economic Reforms that Reduce Rent-Extraction

Reforms that reduce governmental discretion and "gate-keeping" authority tend to reduce total investment in rent seeking, other things being equal. For example, making land easier to sell, a major consequence of the enclosure movements of the eighteenth and nineteenth centuries, allowed voluntary exchange to more easily shift resources from lower- to higher-valued uses without the government's (the king's or parliament's) intervention. Recording property titles also reduced the extent to which resources were consumed through private and public disputes over the control of particular pieces of land, by reducing the ability of neighbors and governments to shift property boundaries without compensating owners.

Opening up domestic markets to greater price and quality competition also tended to reduce opportunities for rent extraction. The optimal rate of rent extraction is lower when firms face more or less competitive markets, because competition tends to increase the price elasticity of both demand and supply curves. The "open door" policies advocated by economic liberals reduced barriers to imports as well as exports, which tended to make both domestic and international markets more competitive and reduced opportunities for rent extraction by firms and governments.

B. Liberal Economic Reforms Rewrote the Economic Constitution

The gains from liberal reforms did not emerge simply because private contracts and private property were better enforced, as modern Coasians might argue. Contracts and property rights (privileges) were well-enforced in most earlier periods as well. In many cases, liberal reforms redefined economic and political property rights. Some preexisting property rights were reduced and some opportunities for exchange were also reduced. Monopolies became more difficult to own and government positions became more difficult to sell. Liberal economic reforms changed the domain of contract, property, and public policy in a manner that reduced the transactions costs of value-increasing activities (trade and production) and increased them for value-reducing activities (obtaining government favors).

Liberal reforms allowed some assets to be traded more easily (land) and made others (people and government positions) less tradable. The enclosure movements of the eighteenth and nineteenth centuries made property a more tradable asset. On the other hand, the abolitionist movement made people less so. Slavery was eliminated, rather than slave markets made to function more efficiently. Many long-standing monopoly privileges for towns, firms, and families were reduced. Political reforms reduced the inheritability and private sale of government offices, which reduced the capital value of the rents associated with many government offices, and also often created new merit-based contests for those offices. Cartel agreements and many other "contracts" between private persons and public officials (purchasing votes and governmental positions) were outlawed or not enforced.

C. Political Liberalism Limits Rent Extraction by the Senior Office Holders

In the absence of elections, high officials need only please each other. Within such hereditary or elite governments, efforts to reduce rent extraction tend to reduce, rather than increase, one's prospects for retaining high office, because other senior officials lose both economically and deferentially from efforts to limit rent extraction.

In contrast, most voters are consumers and few benefit from rent extraction. They, consequently, tend to favor low rates of rent-extraction, other things being equal. Electoral competition thus induces candidates to oppose "corruption" and privilege (even if it reduces the income of elites). Corrupt senior officials who engage in rent extraction may also be removed from office through elections after the political reforms, whereas this was rarely the case (for top officials) before liberal political reforms are adopted.

As the opportunities for market opportunities expanded and the scope of governmental discretion and potential prizes diminished, rent seekers realized smaller marginal benefits from rent-seeking activities and shifted their attention to market contests. The elimination of slavery and extension of land-ownership rights allowed labor and capital to move more easily from unproductive to more productive activities. Reductions in the sale of government offices tended to make governments more responsive to the average (typical) member of society.

Together the economic and political reforms reduced the extent to which government revenue could be generated through rent extraction, and induced policymakers to replace rent extraction with new or expanded formal tax systems.[5]

V. Evidence in Support of The Liberalization Hypothesis

By changing the rules of the economic and political game, liberal reforms shifted resources from unproductive to productive competitive contests and reduced the number of rent-seeking contests. As a consequence, the countries that "liberalized" became the most wealthy and powerful countries on Earth, using technologies and methods of political and economic organization that had never been seen before.

In places where liberals and liberal arguments were less successful, fewer liberal reforms were adopted. Some of these countries "modernized" by adopting a subset of the

West's technological innovations in manufacturing, communication, and transportation that emerged in the West. Rent-extracting states "modernized" by adopting the railroads, telegraphs, air travel and the internet. However, their policymakers could not adopt the West's system-wide political and legal innovations without undermining their ability to extract rents, and consequently, "modernization" only modestly increased the growth rates of the old rent-extraction societies.

Table 1 provides evidence that supports the hypothesis that liberalization tends to increase national income by reducing rent-seeking losses (e.g. the misallocation of national resources). It lists 25 countries with the highest per capita gross domestic product, calculated using World Bank data. The list includes 22 countries that adopted more or less liberal economic and political institutions during the late nineteenth and early twentieth centuries. Of the three others—Singapore, Cyprus, and Equatorial Guinea—two may also be said to have adopted liberal legal institutions during that period: Singapore was established as a British trading post in 1819, and so has had British legal institutions for nearly two centuries. Cyprus was administered by Great Britain from 1878 until 1960, and its Greek half is presently a member of the European Union. All but five of the listed countries have very liberal economic policies by Heritage Foundation's measures. All but three have very low levels of corruption (locally illegal forms of rent seeking). The outlier in the table—Equatorial Guinea—has very large oil sales relative to its population and is the only country on this high-income list without liberal economic and political institutions.

Table 1
The World's Highest Income Countries and
Indices of Their Political and Economic Liberalism

Rank	Per Capita GDP	Civil Liberties Index	Economic Free-dom Rank	Corruption Rank
1	Luxembourg	1	15	11
2	Norway	1	28	14
3	Singapore	4	2	4
4	United States	1	6	18
5	Ireland	1	4	16
6	Switzerland	1	9	5
7	Austria	1	23	12
8	Netherlands	1	12	7
9	Iceland	1	14	7
10	Sweden	1	26	1
11	Denmark	1	8	1
12	Canada	1	7	9
13	Australia	1	3	9
14	Belgium	1	20	18
15	Finland	1	17	5
16	United Kingdom	1	10	16
17	Japan	2	19	18
18	France	1	64	23
19	Germany	1	25	14
20	Greece	2	81	57
21	Spain	1	29	28
22	Eq. Guinea	7	142	171
23	Italy	2	76	55
24	Cyprus (Greek)	1	24	31
25	Slovenia	1	68	26
Average		1.48	29.28	23.04

The GDP per capita rankings (using purchasing power parity international dollars) come from the *World Development Indicators* database (2008) assembled by the World Bank. Civil liberty data from the *Freedom House* 2009 website (downloaded June 2009), economic freedom rankings from the Heritage Foundation's *2009 Index of Economic Freedom* (downloaded July 2009), and corruption rankings from the *2008 Corruption Perceptions Index* (downloaded from Transparency International's website July 2009).

Other lists of high per-capita GNP nations include more oil countries than the one used above, but are otherwise broadly similar. Oil-rich nations tend to have lower scores on economic and political liberalism. These countries are not of interest for the purposes of this paper, because high per-capita geological endowments are largely matters of geological luck, rather than public policy or institutions that can be improved.[6]

Table 2 lists the 25 poorest countries and associated indices of political and economic liberalism and corruption using the same data sets as in table 1. Note that all but four of these countries exhibit very illiberal political environments (CLI > 3). All but four also exhibit very illiberal economic environments (EFR > 100). All but three have very high levels of corruption (CR > 100).

Table 2
The World's Lowest-Income Countries and Indices of Their Political and Economic Liberalism

Country	Bottem Per Capita GDP Rank	Civil Liberties Index	Economic Freedom Rank	Corruption Rank
Rep. of Congo	1	5	166	158
Burundi	2	5	153	158
Liberia	3	4	157	138
Guinea-Bissau	4	4	165	158
Eritrea	5	6	175	126
Niger	6	4	128	115
Sierra Leone	7	3	158	158
CAR	8	5	156	151
Malawi	9	4	129	115
East Timor	10	3	149	145
Ethiopia	11	5	135	126
Mozambique	12	3	113	126
Togo	13	5	154	121
Rwanda	14	5	124	102

Madagascar	15	3	73	85
Uganda	16	4	63	126
Nepal	17	4	133	121
Mali	18	3	114	96
Burkina Faso	19	3	85	80
Guinea	20	5	144	173
Comoros	21	4	172	134
Tanzania	22	3	93	102
Gambia	23	4	112	158
Bangladesh	24	4	160	147
Haiti	25	5	147	177
Average		4.12	134.32	131.84

The GDP per capita rankings (purchasing power parity international dollars) are computed from *World Development Indicators* (2008) data base assembled by the World Bank. The civil liberties data come from the *Freedom House* 2009 website (downloaded June 2009), economic freedom rankings from the Heritage Fund's *2009 Index of Economic Freedom* (downloaded July 2009), and corruption rankings from the *2008 Corruption Perceptions Index* (downloaded from Transparency International's website July 2009).

Together, tables 1 and 2 clearly support the liberalization hypothesis. The tables suggest that democracy tends to reduce, although it does not eliminate, corruption and rent seeking as a fraction of GDP. Policies that reduce corruption, promote open competitive markets and politics, rather than closed monopolistic markets, tend to promote economic development. The distributions of political and economic liberalism and corruption in tables 1 and 2 overlap only for oil-rich Equatorial Guinea, which exhibits a degree of ill-liberality similar to those of countries in table 2.

VI. Export-Led Growth: Improved Rent-Extraction or Economic Liberalism?

Incentives to adopt and maintain liberal reforms vary somewhat with the type of government, because political institutions indirectly affect the interests of senior government officials. The interests of government officials in rent-extraction states provides them with incentives to encourage monopolization and rent-seeking activities, rather than economic and political liberalization. In such cases, economic liberalization may require changes in political institutions that realign governmental interests, e.g. political liberalization.

An exception to this general rule occurs in the export sector in countries that use more or less uniform rates of rent extraction.

A. "Neutral" Rent Extraction and Reductions in International Trade

The optimal tax literature, perhaps surprisingly, has implications about how a rent-extracting government extracts rents. In a setting in which economies are relatively simple, rent-extraction systems tend to resemble Ramsay tax systems, with greater "protection" provided to markets with the least elastic supply and demand functions (Congleton and Lee 2009). As economies become more complex, devising entry barriers with market elasticities in mind becomes increasingly difficult. As a consequence, one can imagine that "neutral" rent extracting systems may be adopted. More or less uniform systems of rent-extraction have far lower informational requirements than Ramsay extraction systems and are easier to administer. For example, "participation fees" might be assessed at every stage in production in a manner analogous to a VAT.

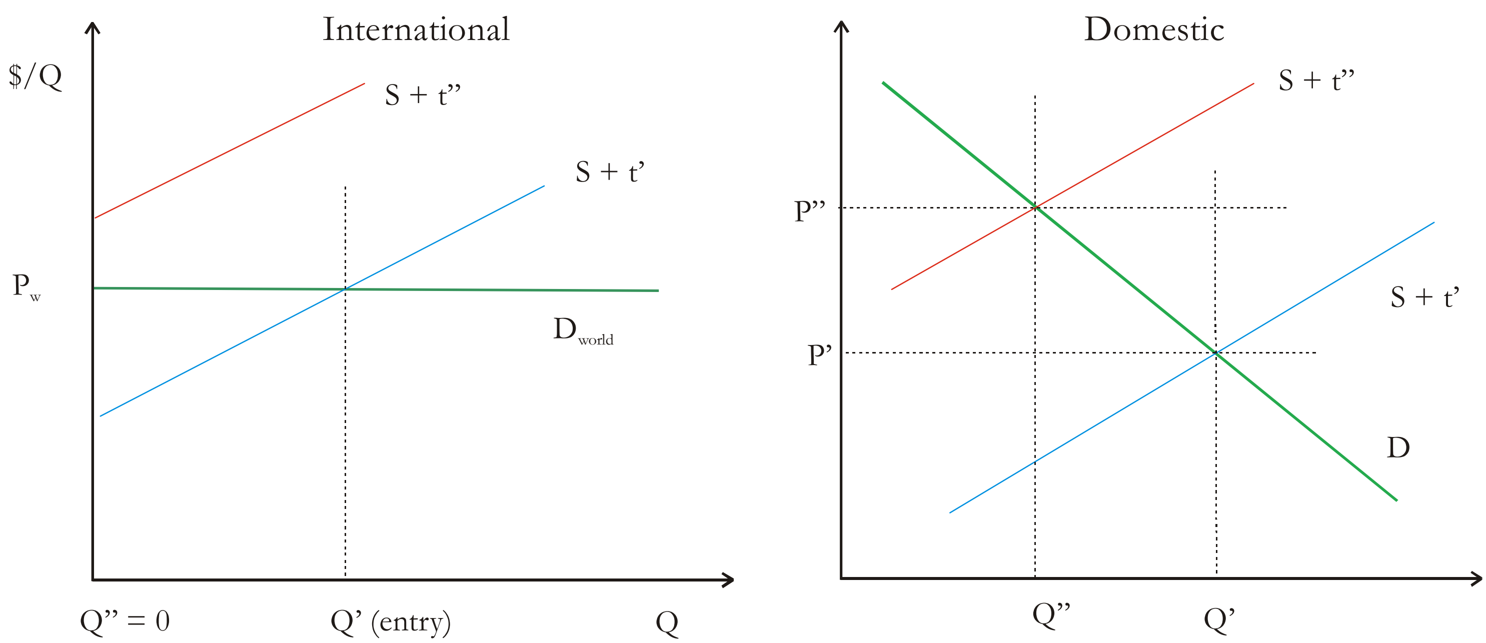
Under a "neutral" rent-extraction regime, the rate of rent extraction in some sectors of the economy will be above their revenue-maximizing levels. One such sector is likely to be the export sector.

Rent extraction tends to have relatively larger effects on international trade flows than on domestic markets, because international markets include more supply choices than domestic markets. Insofar as rates of rent extraction vary among countries, consumers and producers will tend to favor the products of countries with lower rates of rent extraction, because products from those nations tend to have lower (total) production costs and prices. This provides another explanation for trade flows among industrial nations that complements the Krugman (1983) model.

Indeed, high rates of rent extraction from national firms and industries with significant international competition can prevent domestic firms from participating in world markets. Figure 2 provides a micro-economic foundation for this hypothesis. For the purposes of illustration, rent extraction is treated as an excise or profits tax on firms in the market of interest, which is a reasonable first approximation for rent-seeking games in which government officials squeeze a more or less uniform level of bribery, deference, and political support from all domestic firms and industries.

In the absence of international trade, a uniform rate of rent-extraction has many of the same economically desirable effects as a neutral tax. It produces revenues for government officials without distorting patterns of trade. Unfortunately, as figure 2 indicates, when relatively high rent-extraction rates such as t" maximize domestic rent-extraction, they may eliminate foreign trade by domestic firms, because the full burden of such quasi-taxes in competitive markets falls entirely on the shoulders of domestic producers, rather than being (partly) shifted to consumers.[7] The burden of quasi-tax t is shared with consumers in the domestic market, but this is less possible in the more competitive international markets.

Figure 2
Competitive Limits on Rent Extraction



As a consequence, the "usual" domestic rate of rent-extraction may prevent even relatively efficient domestic firms from selling their products in competitive international markets. It is simply not profitable to do so given their country's rent-extraction quasi-taxes. Thus, government's that adopt relatively high uniform rates of rent-extraction accidently cause "their" firms to fail in international markets. Exceptions to that rule may occur for domestic firms that sell unique natural resources (easily mined oil, gold, diamonds) and countries in which the revenues generated through rent-extraction are used to reduce production costs in some way (education and infrastructure).

The same logic applies regardless of whether domestic firms are price takers or oligopolists in the relevant markets, as long as foreign consumers have a broader range of substitute suppliers than domestic consumers.

Figure 2 also illustrates how relatively high rates of rent extraction can reduce national income. Relatively high rates of rent-extraction reduce both the number of domestic and international transactions, which reduces national output and income. These reductions are partly offset by greater spending by governments and government officials and by the emergence of black markets, but not completely so. In cases in which rent-extraction is illegal, many bribes and kickbacks flows to foreign banks, rather than to public services or domestic producers of luxury goods. Black markets tend to rely on relative less than efficient capital-labor ratios in order to avoid detection.

B. Export Led Growth as Improved Rent Extraction

Rent extraction tends to reduce the size of both domestic and export sectors, but the logic of figure 2 implies that this effect is larger in export sectors than in domestic sectors of the economy. In such cases, "liberalization" of the export sector may create additional revenues from rent extraction, rather than reduce them. This is, however, tends not to be true of import barriers, which reduce competition within domestic markets and increase opportunities for rent extraction. As a consequence, the export sector may be the only sector "liberalized" by rent-extraction states.

A rent-extracting regime that became aware of this difference between domestic and foreign markets is able to increase its total revenue from rent extraction by reducing the rate of extraction in the export sector. This asymmetric form of trade "liberalization" was adopted, for example, among the Asian Tigers (Japan, Taiwan, Korea, and China).

Consistent with this hypothesis, Kang (2002: 161-63) shows that revenues from quasi-taxes in Korea increased as its export-led strategy was implemented. Kang (2002: 102–3), argues that informal "quasi-taxes" emerged in Korea through which "voluntary" donations of 10-20 percent were made to political parties and other well-connected organizations in exchange for government-allocated loans. These quasi-taxes were legal contributions, so tax records are available for them. Kang (2002: table 4.1) reports that approximately 150 billion won were devoted to such purposes in the 1970s. He also provides some anecdotal evidence, noting, for example, that "Hyundai founder Chung Ju-yong admitted [that] 'I personally handed to the ruler about 1 billion won yearly during the 3rd republic, about 5 billion won yearly during the 5th republic, and 10 billion won yearly in the 6th republic' (2002: 163)."

Corruption in Japan and Korea have been modestly increasing in the post war period according to the Heritage Foundation's Economic Freedom subindex on freedom from corruption during the relatively short period of that index. Evidence of increased corruption (e.g. rent extraction) during the period of export-led growth in China is provided in Pei (2007) and Ngo and Wu (2009).

The success of export-led growth strategies of the "Asian Tigers" together with increases in corruption suggest that the export sector had previously been overtaxed relative to what would maximize rent extraction from exports.

C. Secondary Liberalizing Effects of Export-Led Growth Strategies

Figure 2 suggests that rent extraction is potentially greatest when domestic firms are relatively more efficient than the average firm in the relevant world market, because this increases potential profits for domestic firms. This efficiency effect aligns the incentives of government officials with efficiency in export markets, because the more efficient a country's exporters are, the more rents can be extracted from them.

To reward efficiency may require changes in the procedures through which, for example, capital is allocated by the central government. Rather than favoring high-bidders and/or the well-connected, the potential efficiency of the sector seeking preferential access to capital (domestic or foreign) should clearly be taken into account. By shifting capital to the export sector and reducing quasi-taxes (i.e., adopting relatively liberal practices that promote economic efficiency in the export sector), rent extraction from that sector can be increased relative to more restrictive practices.

Adopting relatively liberal practices in export sectors indirectly tends to induce modernization and increase the efficiency of related domestic markets. For example, successful exporters will tend to use their more efficient organizational methods and production techniques to produce products for domestic markets. This may increase an exporter's domestic market power (from which rents may be extracted) or may induce their domestic competitors to adopt more efficient production methods. The former increases opportunities for (net) rent extraction, insofar as the result is greater domestic monopolization of domestic production and sales, rather increased domestic competition. This provides another reason for policymakers to support liberalization of the export sector.

However, this is not the only possibility. Domestic rivals may copy the methods of the exporter in a manner that increases domestic competition and reduces opportunities for rent extraction. Similarly, government investments in infrastructure that improve the efficiency of the export sector may also reduce transport costs for domestic industries, increasing specialization and competition, and reducing opportunities for rent extraction. Government investments in human capital necessary for a competitive export sector may also affect the efficiency and competitiveness of domestic industry. It may also indirectly support the dissemination of liberal ideas, as is evident in Korean, Chinese, and Turkish history. In such cases, diminished revenues from rent extraction may induce governments to rely more extensively on other revenue sources such as income taxes.

Whether rent-extraction rates in the domestic sector increase or decrease as a consequence of export liberalization depends in part on the extent to which exporting firms become important sources of government finance and support, which tends to constrain the government's domestic policy options. Modest support for exports in the form or reduced rates of rent extraction (reduced or less corrupt regulation), are unlikely to produce major declines in domestic rent-extraction opportunities. Nonetheless, the experience of the Asian tigers suggests that export liberalization can gradually induce political and economic liberalization by reducing opportunities for domestic rent extraction and increasing support for other liberal reforms.

VII. Conclusion: Institutions, Rent Extraction, and Competitive Advantage

This paper has demonstrated that the political economy of rent seeking and rent extraction sheds light on a broad range of long term economic and political phenomena that have been broadly neglected by those literatures.

Analysis of the incentives of senior government officials in rent-extracting governments helps to explain why liberal institutions affect economic growth rates and why they have not been universally adopted, although they have broadly increased economic income and the quality of life in essentially every society in which they have been adopted. The poorest places on Earth have barely escaped from the Hobbesian jungle and suffer from the worst problems rent-seeking contests. Per capita income levels, corruption, and other forms of conflict in these countries are consistent with the predictions of the rent-seeking and anarchy literatures. Their unconstrained contests over scarce resources evidently consume most of their national resources (Tullock 1967, Congleton 1980). Escape from the Hobbesian contest may involve the organization of violence, as argued by North, Wallis, and Weingast (2009); in which case, national income may increase. The wealthiest men and women in such rent-extracting societies are often "warlords" and their top officials, rather than successful economic entrepreneurs. The political and legal institutions of relatively efficient rent-extracting states tend to protect the security and wealth of those already in positions of authority, but they often do so in a manner that limits opportunities for economic development (Krueger 1974; Murphy, Shleifer, and Vishny (1991); Congleton and Lee 2009).

In contrast, liberal political and economic systems tend to have fewer state-produced privileges, with the consequence that more resources are invested in more productive contests and fewer unproductive contests remain. Liberal economic policies facilitate price and quality competition in markets and the development of national and international trading networks by reducing entry barriers, transactions costs, and increasing incentives for capital accumulation and economic innovation. Flows of trade tend to be between liberal market-based societies, because firms that operate in societies with greater rates of rent extraction have higher production costs, other things being equal. Liberal legal and political systems facilitate relatively productive forms of competition in courts and among political parties.

Tables 1 and 2 suggest that economic and political liberties and corruption tend to be inversely related. The most economically and politically liberal countries exhibit the least corruption and have the greatest average income. This is not to say that rent seeking and high income are entirely incompatible, as Equatorial Guinea demonstrates. However, significant rent-seeking losses and high income are incompatible in countries in which income is based on production, rather than natural resources.[8]

Liberal system wide reforms are politically more difficult to copy than railroads and telephones, because they reduce opportunities for rent extraction. Senior government officials tend to benefit from rent extraction, and cannot liberalize their economic and political policies, without reducing their incomes, power, and status. The advantages of rent extraction for political elites implies that liberal economic and political reforms can be a long term source of comparative advantage in trade, innovation, and public policy, as is evident in modern international data sets and indices of institutional quality.

Export-led growth strategies are sometimes exceptions to that rule, and may provide a possible route to other liberal reforms, as the recent experiences of Taiwan and South Korea suggest. It bears noting, however, that these countries required substantial liberalization of their economic and political systems before they "took off." Export-led growth was not enough to do so by itself.

End Notes

[1] The idea that monopolists earn higher rates of return than firms with many competitors is an ancient one; examples in Europe go back at least to classical Greece and, in Asia, back at least to the time of Confucius. For example, Aristotle mentions the case of the philosopher Thales, who monopolized the olive press market for a season to prove that philosophers could be wealthy if they wished to (Aristotle 330 BC).

[2] Evidence of the effect of corruption on the distribution of income is provided by Gupta et al. (2002) and Rosser et. al. (2000).

[3] Among well-known liberal theorists prior to 1800 are Locke, Rousseau, Smith, and Madison. Nineteenth and twentieth century liberals include Mill, Wicksell, Von Eucken, Hayek, Friedman, and Buchanan. Among nineteenth-century Asian intellectuals, Fukuzawa, Liang, Sô, and Minobe are often noted. See Congleton (2011) for a more complete discussion of liberalism's role in the European transitions of the nineteenth century.

[4] These rough classifications of states parallel those developed in North, Wallis, and Weingast (2009), but in this paper, states are classified by the extent to which those institutions promote welfare enhancing or welfare reducing forms of competition, rather than their political institutions. Political institutions, however, are correlated with this, because they frame many of the most important contests that take place in a given society as developed below.

[5] Of course, the ability to create rents does not entirely disappear with political and economic liberalization. Fortunately, many of the "new games" encouraged innovation and economic efficiency in the long run. For example, subsidies for transport grids (roads, canals, and railroads) and communication networks (telegraphs and telephones) provided the new entrepreneurs with rent-seeking opportunities (and substantial rents for winners). The subsidies (right of ways, access to government bond markets, and direct payments) allowed new technologies with economies of scale to be employed for production and distribution, which increased both specialization and competition within domestic and international markets.

[6] The country rankings are taken from
http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP)_per_capita.m

[7] In monopolistic or monopolistically competitive markets, the burden of such transaction fees tends to be shared by foreign investors and/or consumers, although again the number of transactions tends to fall, and again there are cases in which they fall to zero.

[8] Most of the countries in table 2 score even lower on Freedom House's political liberty index.

References

Aidt, T. S. and A. L. Hillman (2008) "Enduring Rents," *European Journal of Political Economy* 24: 545-53.

Baik, K. H. and S. Lee (2001) "Strategic Groups and Rent Dissipation," *Economic Inquiry* 39: 672–84.

Buchanan, J. M. and Y. J. Yoon (eds.) (1994) *The Return to Increasing Returns*. Ann Arbor: University of Michigan Press.

Chen, H. C. (1911). *The Economic Principles of Confucius and His School.* New York: Columbia University.

Congleton, R. D. (1980) "Competitive Process, Competitive Waste, and Institutions," in J. M. Buchanan, R. D. Tollison, and G. Tullock (eds.), *Toward a Theory of the Rent-Seeking Society*. College Park: Texas A&M Press. (See also, R.D. Congleton, A. L. Hillman, and Konrad [eds.] 2008.)

Congleton, R. D. (1989) "Efficient Status Seeking: Externalities and the Evolution of Status Games," *Journal of Economic Behavior and Organization* 11: 175-90.

Congleton, R. D. (2003). "Economic and Cultural Prerequisites for Democracy," in A. Breton, G. Galeotti, P. Salmon, and R. Wintrobe (eds.), *Rational Foundations of Democratic Politics*. New York: Cambridge University Press, pp. 44–67.

Congleton, R. D. (2011, forthcoming) *Perfecting Parliament: Liberalism, Constitutional Reform, and the Rise of Western Democracy.* Cambridge: Cambridge University Press.

Congleton, R. D., A. L. Hillman, and K. A. Konrad (eds.) (2008) *40 Years of Rent-Seeking Research*. Heidelberg: Springer.

Congleton, R. D. and S. Lee (2009) "Efficient Mercantilism? Revenue-Maximizing Monopolization Policies as Ramsey Taxation" (with Sanghack Lee). *European Journal of Political Economy* 25: 102–14.

De Soto, H. (2003) *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.* New York: Basic Books.

Eckert, J. J., K. Lee, Y. I. Lew, M. Robinson, and E. W. Wagner (1990) *Korea: Old and New, A History.* Cambridge, Mass.: Harvard University Press.

Ekelund, R. B. and R. D. Tollison (1982) *Mercantilism as a Rent-Seeking Society: Economic Regulation in Historical Perspective*. College Station: Texas A&M Press.

Grossman, G. M. and E. Helpman (1994) "Protection for Sale," *American Economic Review* 84: 833-50.

Gupta, S. H. Davoodi, and R. Alonso-Terme (2002) "Does Corruption Affect Income Inequality and Poverty?" *Economics of Governance* 3: 23-45

Hillman, A. L. and E. Katz (1984) "Risk-Averse Rent Seekers and the Social Cost of Monopoly," *Economic Journal* 94: 104–10.

Hillman, A. L. and E. Katz (1987) "Structure and the Social Costs of Bribes and Transfers," *Journal of Public Economics* 34: 129–42.

Kang, D. C. (2002). *Crony Capitalism.* Cambridge: Cambridge University Press.

Krueger, A. O. (1974) "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64: 291-303.

Krugman, P. (1983) "New Theories of Trade among Industrialized Countries," *American Economic Review* 73: 343-47.

Lee, P. H. and D. Baker (1996) *Sourcebook of Korean Civilization: From the Seventeenth Century to the Modern Period,* New York: Columbia University Press.

Lee, S. and K Cheong (2009, forthcoming) "The Political Economy of Financial Structure of Korean Firms," *Journal of Developing Areas.*

McChesney, F. S. (1997) *Money for Nothing: Politicians, Rent Extraction, and Political Extortion*, Cambridge, Mass.: Harvard University Press.

Mansfield, P. (2004) *A History of the Middle East*. New York: Penguin Books.

Mauro, P. (1995) "Corruption and Growth," *Quarterly Journal of Economics* 110: 681-712.

Mesquita, B. B. de, A. Smith, R. M. Silveson, and J. D. Morrow (2003) *The Logic of Political Survival.* Cambridge Mass: MIT Press.

Murphy, K. M., A. Shleifer, and R. W. Vishny (1991). "Allocation of Talent: Implications for Growth." *Quarterly Journal of Economics* 106: 503–30.

Ngo, T. W. and Y. Wu (eds.) (2009). *Rent Seeking in China.* London: Routledge.

Ngo Van Lang and N. Vousden (1987). "Risk-Averse Rent Seeking with Shared Rents," *Economic Journal* 97: 971–85.

Nitzan, S. (1991). " Collective Rent Dissipation," *Economic Journal* 101: 1522–34.

North, D. C., J. J. Wallis, and B. R. Weingast (2009). *Violence and Social Orders.* Cambridge: Cambridge University Press.

Olson, M. (1993) "Dictatorship, Democracy, and Development," *American Political Science Review* 87: 567-76.

Pei, M. (2007). "Corruption Threatens China's Future" *Policy Brief* 55. Carnegie Endowment for International Peace, Washington, D.C.

Posner, R. A. (1975). "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* 83: 807–27.

Rosser, J. B., M. V. Rosser, and E. Ahmed (2002) "Income Inequality and the Informal Economy in Transition Economies," *Journal of Comparative Economics* 28: 156-71.

Skaperdas, S. (1992). "Cooperation, Conflict, and Power in the Absence of Property Rights," *American Economic Review* 82: 720–39.

Schneider, F. and D. H. Enste (2002). *The Shadow Economy, An International Survey.* Cambridge: Cambridge University Press.

Tullock, G. (1967). "The Welfare Costs of Monopolies, Tariffs, and Theft," *Western Economic Journal* 5: 224–32.