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Rent Seeking and Profit Seeking

Rent seeking, as a specific term, emerged in applied economic theory only in the 1970's. The behavior that it describes, however, has been with us always, and there is surely no prospect that it will fade away. Behaviorally, rent seeking has become more important because institutional changes have opened up opportunities that did not exist in the nineteenth and early twentieth centuries.

What is *rent seeking*? The words seem clear enough at first reading, but economists will sense the ambiguities. Rent seeking does not refer to the behavior of landlords who collect rents on real property. This everyday usage of the word *rent* had best be put in the closet. We move somewhat closer to understanding when we introduce the definition of *rent* found in standard textbooks of economic theory. Rent is that part of the payment to an owner of resources over and above that which those resources could command in any alternative use. Rent is receipt in excess of opportunity cost. In one sense, it is an allocatively unnecessary payment not required to attract the resources to the particular employment. This textbook definition contains ambiguities, some of which will be discussed briefly in this introductory chapter. Nonetheless, the basic definition offers a starting point for any attempt to clarify the meaning of *rent seeking* as a general concept.

So long as owners of resources prefer more to less, they are likely to be engaged in rent seeking, which is simply another word for profit seeking. Traditional economic models of social interaction are based on the presumption that persons seek to maximize present values of expected income streams, and a central demonstration of economic theory involves the rela-

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tionships between such individual profit seeking and desired social results. Since Adam Smith, we have known that the profit-seeking activity of the butcher and baker ensures results beneficial to all members of the community. Only through such activity do markets work in getting resources allocated efficiently among competing uses, in getting production and distribution organized, and in establishing prices as standards of comparative value. In an idealized model of market order, profit seeking as an activity produces consequences neither predicted nor understood by any single participant, but "good" when evaluated as a characteristic of the order itself. In such respect, therefore, profit seeking in an ordered market structure generates external economy; in Pigovian terminology, the social marginal product of profit seeking exceeds private marginal product.

In the preceding paragraph, I have deliberately shifted the terms from *rent seeking* to *profit seeking* as the discussion proceeded. My purpose was to call to mind the familiar proposition that the behavior of persons in trying to maximize returns on their own capacities or opportunities can be socially beneficial in an ordered market structure, behavior that we may here describe to be "profit seeking." The self-same behavior under a different set of institutions, however, may not produce socially beneficial consequences. The unintended results of individual efforts at maximizing returns on opportunities may be "bad" rather than "good." The term *rent seeking* is designed to describe behavior in institutional settings where individual efforts to maximize value generate social waste rather than social surplus. Again I should emphasize that at the level of the individual decision makers, the behavior, as such, is not different from that of profit seeking in market interactions. The unintended consequences of individual value maximization shift from those that may be classified as "good" to those that seem clearly to be "bad," not because individuals become different moral beings and modify their actions accordingly, but because institutional structure changes. The setting within which individual choices are made is transformed. As institutions have moved away from ordered markets toward the near chaos of direct political allocation, rent seeking has emerged as a significant social phenomenon.

Economic Rent

It is useful to return to the definition of *rent* or *economic rent* found in the textbooks. If the owner of a resource unit is paid more than the alternative earning power of that unit, more than opportunity cost, there seems to be no allocative necessity for such excess. The resource unit would have been directed toward the observed employment for any payment above cost, even an infinitesimally small sum. "Economic rent," viewed in this perspective, seems to be a genuine "social surplus," and, indeed, it is this apparent characteristic of rent that has spawned monumental confusion among those who do not fully understand the market process.

In an ordered market structure, the potential attractiveness of economic rents offers the motivation to resource owners and to entrepreneurs who combine resources into production. And it is the action of entrepreneurs that must drive the system. By seeking always to find new opportunities to earn economic rent and to exploit more fully existing opportunities, profit-seeking entrepreneurs generate a dynamic process of continuous resource *re*allocation that ensures economic growth and development, again as an unintended consequence. The role of economic rent in a market structure cannot be properly understood apart from this dynamic.

In the process described, two relevant features of rent require special mention. First, in market systems, all economic rent tends to be eroded or dissipated as adjustments take place through time. Above-cost payments to any entrepreneurs or resource owners must attract other profit-rent seekers to enter identical or closely related employments. As such entry proceeds, rents earned initially are driven down and, in the limit, disappear altogether. In the conceptualized equilibrium of market adjustment, economic rents are eliminated, and all resource owners, including those who have entrepreneurial capacities, earn rates of return established competitively in the whole market system. Second, in the dynamic adjustment process, which, of course, never attains the conceptualized equilibria of the models, economic rents may be negative as well as positive. Resource owners and entrepreneurs who err in their predictions or who overadjust to apparent opportunities that do not materialize may earn less than opportunity costs. This existence of negative rents or losses adds symmetry to the adjustment process and, of course, accelerates resource reallocation.

For completeness, the time dimension of economic rents should be discussed briefly. Economic rent to the owner of a resource that is explicitly locked in to a single use because of its physical characteristics (a particular machine, building, or human talent) may be positive in some short-run sense, but the resource may have little or no prospect of earning an alternative return comparable to that earned in the particular usage. Hence, the owner will have no incentive to reallocate. At the same time, however, the particular investment may be earning negative economic rent in some long-run or planning sense. The earnings may be less than comparable investments could earn in alternative uses. In such a setting, despite positive "quasi-rents," to use a Marshallian term, the negative economic rent applicable to initial allocation will ensure that no additional resources shift toward the particular usage. Reallocation away from the usage will take place via disinvestment as physical facilities wear out and are depreciated.

The Dissipation of Rents in Markets

We are concerned with the net attractiveness of opportunities for new investment. It will be useful to examine in elementary detail the process through which economic rents arise and are dissipated through time in ordered market structures.

Consider a situation where some person, a potential entrepreneur, discovers a use for a resource or a combination of resources that had not been previously discovered.[1] No one else in the economy is aware of this potential opportunity. The entrepreneur organizes production and commences sale of the new commodity or service. By definition, he is a pure monopolist during the initial period. He may be able to secure a return over and above what he might earn in any alternative employment. He receives "economic rent" on his entrepreneurial capacity. And, indeed, it is the prospect of such rent that motivates the activity in the first place. It is important to emphasize, however, that the rent reflects the *creation* of added value in the economy rather than the diversion of value that already exists. The entrepreneurial activity of *rent creation* is functionally quite different from that of *rent seeking*. The fact that the innovating entrepreneur is observed to be receiving rent sends out signals to other noninnovating but potentially imitating producers of the new commodity or service. Unless overt barriers to entry exist, other producers will enter the market and sell the new commodity or a close substitute for it. Output on the market will expand; price will fall. The initial monopoly

1. See Israel Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973), for a thorough discussion of the entrepreneurship role.

position, and hence the economic rent, of the innovator is eroded to the benefit of consumers generally. In the ultimate equilibrium, the consumers secure the full benefit of the new product. Rents received by producers are dissipated in the dynamics of competitive market adjustment. Resources come to be allocated efficiently between the production of the new commodity and other uses in the economy.

Freedom of entry is critically important in the generation of allocative efficiency in a developing, changing economy. If the entry of those producers who are attracted by the rents of the innovating entrepreneurs is effectively blocked, there will be no dissipation of rents, and, of course, no shift of resources toward the production of the new product. Output will not be forced above monopoly limits, and price will not fall.

Rent Seeking without Social Return

To this point, the analysis has been straightforward elementary economics. Where does "rent seeking" come in? We need only to modify the setting by postulating a particular type of entry restriction. We may do this with a simple, and historically factual, example. Suppose that, instead of discovering a new commodity or service or production process, an innovating entrepreneur discovers a way to convince the government that he "deserves" to be granted a monopoly right, and that government will enforce such a right by keeping out all potential entrants. No value is created in the process; indeed, the monopolization involves a net destruction of value. The rents secured reflect a diversion of value from consumers generally to the favored rent seeker, with a net loss of value in the process.

Suppose that a courtier persuades the queen to grant him a royal monopoly to sell playing cards throughout the kingdom. The courtier so favored will capture sizable monopoly profits or economic rents, and this will be observed by other persons who might like to enter the industry. But their entry is effectively prevented by enforcement of the royal monopoly privilege. What the queen gives, however, the queen may take away, and the potential entrants are not likely to sit quietly by and allow the favored one among their number to enjoy his differentially advantageous position. Instead of passive observation, potential entrants will engage actively in "rent seeking." They will invest effort, time, and other productive resources in varying attempts to shift the queen's favor toward their own cause. Promotion, advertising, flattery, persuasion, cajolery—these and other attributes will characterize rent-seeking behavior.

The contrast between the unintended consequences of this behavior and that which characterizes profit seeking in the competitive market process is striking. Rent seeking on the part of potential entrants in a setting where entry is either blocked or can at best reflect one-for-one substitution must generate social waste. Resources devoted to efforts to curry the queen's favor might be used to produce valued goods and services elsewhere in the economy, whereas nothing of net value is produced by rent seeking. In the competitive market, by comparison, resources of potential entrants are shifted directly into the *production* of the previously monopolized commodity or service, or close substitutes; in this usage, these resources are more productive than they would have been in alternative employments. The unintended results of competitive attempts to capture monopoly rents are "good" because entry is possible; comparable results of attempts to capture artificially contrived advantageous positions under governmentally enforced monopoly are "bad" because entry is not possible.

Rent seeking, when used in this book, refers to the second model in all of its varieties, to activity motivated by rent but leading to socially undesirable consequences.

Rent Seeking and Governmental Action

At the beginning of this chapter I stated that rent seeking continues to gain importance in modern political economy because institutions have changed and are continuing to change. So long as governmental action is restricted largely, if not entirely, to protecting individual rights, personal and property, and enforcing voluntarily negotiated private contracts, the market process dominates economic behavior and ensures that any economic rents that appear will be dissipated by the forces of competitive entry. Furthermore, the prospects for economic rents enhance the dynamic process of development, growth, and orderly change. If, however, governmental action moves significantly beyond the limits defined by the minimal or protective state, if government commences, as it has done on a sweeping scale, to interfere piecemeal in the market adjustment process, the tendency toward the erosion or dissipation of rents is countered and may be wholly blocked. Rents must remain, however, and the signals emitted to potential competitors remain as strong as they are under standard market adjustment. Hence, attempts will be made to capture these rents, and resources used up in such attempts will reflect social waste, even if the investments involved are fully rational for all participants. Rent-seeking activity is directly related to the scope and range of governmental activity in the economy, to the relative size of the public sector.

The more apparent opportunities are those modern examples most closely analogous to the royal grant of monopoly introduced illustratively above. If supply is arbitrarily restricted and price is allowed to rise to market-clearing levels, rents accrue to those who secure the "rights" to engage in the activity. Governmental licenses, quotas, permits, authorizations, approvals, franchise assignments—each of these closely related terms implies arbitrary and/or artificial scarcity created by government. Whether such scarcity is reasonable governmental policy is not my concern here. Regardless of reason, such scarcity implies the potential emergence of rents, which, in turn, implies rent-seeking activity. Persons will invest genuinely scarce resources in attempts to secure either the initial assignments of rights to the artificially scarce opportunities or replacement assignments as other initial holders are ousted from privileged positions. In either case, and despite individually rational investments ex ante, valuable resources will be wasted in the process.

Few questions will be raised concerning the emergence of rent seeking when governmental action creates and supports monopoly positions and effectively prevents entry. Rents emerge because prices are not allowed to be brought down to competitive levels by expanding supply through the entry of new producers. Rent seeking of a different, but still wasteful, sort emerges, however, when governmental action interferes with markets in order to keep prices below rather than above competitive levels. With simple monopoly, and with the familiar examples noted above, rents emerge because *genuine* supply price falls below the actual price charged, with demand price being allowed to adjust to the latter in order for the market to clear. The surplus, the rent, accrues to the seller, the person who possesses the "rights" to market the commodity or service. Consider, however, the obverse setting, where the *genuine* demand price lies above the actual demand price authorized to be charged, with supply price being allowed to adjust to the latter in order for the market to clear. As in the obverse case, the wedge between the genuine demand price and the genuine supply price, both of which reflect opportunity costs to buyers and sellers, respectively, generates rents. In the second case, the rents accrue, not to sellers (who may, here, be competitively organized), but to purchasers or buyers who hold the artificially scarce "rights" to enter the market on the demand side. In the first case, the potential entrants who are thwarted are on the supply side, potential producer-sellers who will, unless constrained, enter and drive price down, hence dissipating rents. In the second case, there are potential entrants on the demand side, potential buyers who will, unless constrained, enter and drive prices up, hence dissipating rents. The analysis, as such, is fully symmetrical. The assignment of a "right to buy" something at, say, $1,000 below what would be a competitively determined price, has the same value as the assignment of a "right to sell" something at $1,000 above a competitively determined price. The signals transmitted are comparable in the two cases, and they will generate comparable if not identical rent-seeking behavior.

If allowed to function within a set of laws and institutions that protect individual property rights and enforce contracts, markets will allocate resources among alternative uses so as to ensure tolerably efficient results. But economists have concentrated far too much attention on efficiency and far too little on the political role of markets. To the extent that markets are allowed to allocate resources among uses, political allocation is not required. Markets minimize resort to politics. Once markets are not allowed to work, however, or once they are interfered with in their allocative functioning, politics must enter. And political allocation, like market allocation, involves profit seeking as a dynamic activating force. It would be absurd to conceive of a market process in which resources are either permanently locked in particular allocations or in which entrepreneurs are not continually searching for more profitable opportunities. Although it is perhaps less apparent, it would, nonetheless, be equally absurd to think that a politically determined allocation of resources could be frozen once and for all and that resource owners and entrepreneurs would not continually seek more profitable opportunities in politics as in markets. The motive force of profit seeking, or rent seeking, does not vary across the two institutional forms. The difference lies in the unintended results. Political reallocation, achieved via rent seeking, does not reduce or eliminate contrived scarcity. In politics, rent seeking, at best, replaces one set of rent seekers with another.

Political Allocation without Rent Seeking?

Earlier I associated the level of rent-seeking activity in a society with the size and scope of government activity in the economy. This proposition can be tested empirically, and the results of such a test would, I think, corroborate the relationship suggested. Such a test would necessarily draw data from the real-world actions of governments rather than from idealized constructions of what governments and politics might be. However, for completeness if for nothing else, I should examine the possibility that direct political allocation might take a form such that rent-seeking activity would not take place.

Rent seeking emerges under normally predicted circumstances because political interference with markets creates differentially advantageous positions for some persons who secure access to the valuable "rights." From this fact, we may derive a "principle." If political allocation is to be undertaken without the emergence of wasteful rent seeking, the differential advantages granted to some persons as a result of the allocation must be eliminated. This principle in turn suggests that all persons in the community must be allowed equal access to the scarcity values created by governmental intervention in the market economy. For example, if government decides to restrict the production or sale of a commodity, thereby creating the opportunity for economic rents, each person in the community must be granted an *equal* share in the prospective rents. If this sharing is announced in advance and becomes generally known, it will not be rational for anyone to invest resources in trying to secure differential advantages. Even this scheme is not certain to eliminate rent seeking, however, since, if it is known that government can assign equal shares, it might also be predicted that unequal shares could be assigned. Only if the equal-sharing rule could somehow be permanently implemented in each-and-all-possible scarcity-value distributions could we predict the total absence of rent seeking, even at the most basic level.

A more plausible means of assigning "rights" to contrived scarcity values would be for government to distribute such "rights" randomly in each situation. In this setting, all persons have equal expected values of rights, and they have little or no incentive to engage in rent seeking. Once again, however, some persons may predict a possible departure from the random distribution process until and unless the process itself becomes widely accepted as an untouchable rule or procedure for all political allocation.

Once we recognize that, under either of the two procedures suggested, much of the political motive for governmental interference with markets would disappear, the presumption of the validity of the empirical proposition relating rent seeking to size of government is strengthened.

Three Levels of Rent Seeking

Rent-seeking activity may occur at several levels, and I shall introduce a single example to indicate this prospect. Suppose that, for whatever reason, a municipal government decides to limit the number of taxicabs. (Whether this decision itself is desirable or undesirable need not concern us here.) If the valued licenses are to be distributed among potential entrants by bureaucratic authority, rent seeking of the most familiar sort previously discussed will, of course, take place. Suppose, however, that, after having settled on the number of taxicab licenses to be issued, the municipal government auctions those valued "rights" among prospective entrants. This procedure will directly and immediately convert the licenses into private property rights, which, we may also assume, are to be fully marketable. No rent seeking of the basic sort previously discussed will take place.

The government will secure the full values of the contrived scarcity, however, and the presence of rents at the level of the municipal budget suggests that rent seeking may shift to a second level. Potential political entrepreneurs may now seek to enter, not the taxicab industry directly, but the set of political-bureaucratic positions or occupations with access to the receipts of the auction. Both politics and the "civil service" will become differentially productive employments if rents are allowed to remain available to those persons fortunate enough to occupy the rent-access positions.

Let us extend our example further, however, to indicate that yet a third level of rent seeking may emerge. Suppose that government officeholders can expect to secure competitively determined salaries and perquisites. Suppose that there are no rent components present in any of the personal rewards to those who hold positions in government. In this setting, the economic rents that arise because of the contrived scarcity, transferred initially to government via the auction procedure, must be returned to all taxpayer-beneficiaries in the community. Unless, however, these rents are returned or passed through the budget in some nondifferential or random manner, rent-seeking activity at a third level will be aimed at securing differential shares in the total values. Suppose that the taxicab licenses are auctioned and that government officeholders are competitively paid, but that funds are returned to citizens in some inverse relationship to income and/or wealth. Even in such a highly restricted model, rent seeking may take a form of attempts on the part of persons to shift into activities that do not generate the type of income or wealth measurable for purposes of qualifying for receipt of rents.

The taxicab example is useful in illustrating at least three levels where rent seeking can occur once a contrived scarcity is created by governmental action. If the "rights to recover" rents are not distributed equally or randomly among all persons and are not auctioned, prospective entrants will engage in rent seeking through efforts to persuade authorities to grant differentially advantageous treatment. The familiar figure of the Washington lobbyist offers the illustration here. Most of the early work on rent seeking involves analysis of this sort of activity. In a broader sense, however, the second level of rent seeking may even be more important. If the salaries and perquisites of government positions contain elements of economic rent, if salaries and perquisites are higher than those for comparable positions in the private sector, prospective politicians and bureaucrats will waste major resources in attempts to secure the favored posts. Excessive education and training (notably, perhaps, among lawyers who are aiming at political office), excessive spending on political campaigns—these offer rent-seeking examples of this second type. Quite apart from the two primary levels at which rent seeking can take place, activity at the third level involves attempts by persons and groups to secure differentially favorable treatment or to avoid differentially unfavorable treatment, defined, not in terms of particular opportunities, but in terms of treatment by the governmental fiscal process. Faced with a prospect of differentially favorable or differentially unfavorable tax treatment by government, a person or group may (1) engage in lobbying effort; (2) engage directly in politics to secure access to decision-making power; and/or

(3) make plans to shift into or out of the affected activity. Resources may be wasted at all three levels simultaneously, despite the rational motivation to engage in such activity at each stage.

Conclusions

As the introductory examples have suggested, analysis of rent seeking is little more than applied price theory of the traditional variety. Such analysis does, however, turn much of modern economics inside out. The latter tends to commence with the presumed structure of an ordered market, and its analysis tends to be concentrated on spinning out even more elegant and rigorous "proofs" or "theorems" about the idealized model of the competitive process. But let us be honest. How much more do we know about market process than Adam Smith knew that is of practical relevance?

The analysis of rent seeking, as the contributions in this book indicate, shifts attention to interactions and to institutions outside of and beyond the confined competitive market process, while applying essentially the same tools as those applied to interactions within the process. The analysis of rent seeking is, therefore, properly designated as *institutional economics* in a very real sense. The analysis also falls within *public choice,* especially if the latter is defined methodologically as the extension of the basic tools of economics to nonmarket interaction. Indeed, the previously used rubric, "theory of nonmarket decision making," allows rent seeking to be included directly under its umbrella. As many critics, both friendly and unfriendly, have noted, public choice theory and the economic theory of property rights have several affinities. Rent-seeking analysis can readily be incorporated within the property-rights approach, and, as with public choice, the theory of rent seeking can be interpreted as an appropriate extension.

The primary purpose of this book is to collect the most relevant contributions to the analysis of rent seeking and by so doing to call more attention to the opportunities for further inquiry. As the contents of this book suggest, the subject remains new, and opportunities for productive and relevant research seem almost unlimited. The book contains the early bits and pieces of a line of inquiry that can be, should be, and will be extensively expanded. In the process, additional institutional and historical detail will be elaborated;

additional empirical tests will be conducted; additional rigor will characterize the formal analysis. We shall come to know much more about rent seeking. As, when, and if we do, we may hope that some contribution may be made in shifting public attitudes toward constitutional reform that will reduce rather than continue to expand rent-seeking opportunities in our society.