Public Choice **113:** 97–125, 2002.

Corruption and rent-seeking

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Accepted 14 July 2001

Abstract. The rent-seeking theory was one of the first economic instruments developed to model corruption in the public sector. Comparing corruption with lobbying, it proposes that the former is the lesser of two evils, since lobbying entails the wastage of resources in the competition for preferential treatment. This study shows that the traditional rent-seeking theory misunderstands three factors: first, the impact of a corrupt monopoly on the rent's size; second, corruption as a motivation for supplying preferential treatment and third; that corruption involves a narrower range of interests than those of competitive lobbying. Taking these factors into consideration, the opposite argument is valid: corruption has worse welfare implications than alternative rent-seeking activities.

1. Introduction

> Corruption is bad not because money and benefits change hands, and not because of the motives of participants, but because it privatizes valuable aspects of public life, bypassing processes of representation, debate, and choice.
>
> (Thompson, 1993)

A definition of corruption is often derived from a principal-agent model. Based on this, corruption is deemed to take place when an agent trespasses on the rules set up by the principal by colluding with third parties and promoting his own benefit. Negative welfare effects can be assumed if the principal strives to maximize public welfare while the agent does not.[1] Improving public welfare and fighting corruption then often go hand in hand. The principal will provide incentives so as to assure welfare-maximizing behavior by the agent. But the principal-agent model commonly assumes that a benevolent principal has full control over the legal framework, over rewards and penalties. This type of approach may be too narrow. Particularly in societies where

* The author is grateful to H.-J. Jarchow and B. Mukherjee for helpful comments. He would like to thank C. Schinke, M. Schinke and C. Ernsting for assistance.

corruption permeates any and sometimes all public institutions, the assumption of a benevolent principal appears unjustifiable. There is no convincing reason why those who control the legal framework and the various operations of government should be immune to corruption. Legislation as well as its enforcement and the imposition of penalties may suffer from corruption. This can result either in a powerful principal who is not benevolent (for example a corrupt autocrat) or in one who cannot fully control the legal framework (for example the parliament or the constituency). In case the principal is not benevolent, a definition of corruption as a violation of rules would be misleading. This can be illustrated by a case study from Thailand. From the tropical forest in Thailand it is reported that strict rules prohibit ordinary citizens from taking away anything, even leaves or pebbles. But the Forestry Department was largely in power to make regulations so as to benefit its own interests. What should have been protected was officially converted into tourist attractions or destroyed for gas pipelines, for the benefit of the department.[2] There is no convincing way of applying the principal-agent theory to this case. Either the Forestry Department is considered to be the principal – not a benevolent one certainly. Or other organizations (parliament or constituency) are considered to be the principal – but apparently with limited control.

The principal-agent approach to corruption therefore appears to be too narrow, particularly for the case of large-scale political corruption. Some broader theory must be applied to distinguish between legitimate and illegitimate behavior, as well as between welfare-enhancing and destructive activities. Rules restricting those who govern often do not exist or are insufficient. This is because governments usually do not have incentives for restricting themselves. Definitions of what may constitute corruption must therefore relate to some broader concept of the public interest, (Heidenheimer, Johnston and LeVine, 1989: 10). In this respect, welfare economics can be a starting point since this discipline allows a distinction to be made between useful and wasteful political actions. Furthermore, some theory must be developed covering how deviations from first-best solutions may actually come about. This will usually require an assessment of the public decision-making process. The resulting deviation between optimal solutions and actual decisions can lead to a useful definition of corruption.

A first such approach has been presented by the traditional rent-seeking theory. This approach considers various forms of seeking preferential treatment by public decision makers, for example, competitive lobbying and corruption. Based on welfare economics, this approach provides a normative framework to determine what type of policy should take place. By applying this theory to the actions of decision-makers, traditional rent-seeking theory focuses on the resulting deviations from optimality. This study follows the traditional rent-seeking theory in viewing corruption as a particular type of rent-seeking activity. This viewpoint has gained wide recognition (Cartier-Bresson, 1997: 152–153; Rose-Ackerman, 1999). But as this study demonstrates, the traditional rent-seeking theory largely fails to adequately compare corruption to alternative forms of rent-seeking. Section 2 describes the traditional rent-seeking theory. Its application to an investigation of corruption is demonstrated in Section 3, which also explains to what extent and why traditional rent-seeking theory favors corruption over competitive lobbying. Section 4 criticizes the traditional rent-seeking approach to corruption, particularly the welfare implications. Traditional rent-seeking theory fails to identify the impact of a corrupt monopoly on the size of a rent, the role of corruption in motivating the supply of preferential treatment, and the involvement of interests in cases of corruption which are even more narrow-minded than those of competitive lobbying. Once these factors are taken into account, the opposite argument is put forward, as in the concluding Section 5: Corruption has worse welfare implications than organized lobbying. This study suggests that a modified rent-seeking theory is needed to adequately deal with corruption and its welfare implications.

2. The traditional rent-seeking approach

One of the pillars of the traditional rent-seeking theory is the identification of transfer costs (Tullock, 1967, 1971). This approach departed from orthodox welfare economics and claimed that welfare losses as a result of monopolization are much larger than the classical Harberger triangle. This was related to costs associated with transferring income. A description of transfer costs and how they relate to competition over rents has been a crucial starting point for the traditional rent-seeking theory.

2.1. *Transfer costs*

With respect to efficiency it appears irrelevant to whom a given stream of income accrues and how given rents are divided. This is a problem of distribution and not one related to economic efficiency. This changes as soon as transfers are costly to make. Tullock (1967) argues, for example, that taxation and tariffs as a means to shift part of consumers' rent to the state require further administrative costs. These transfer costs arise in the form of salaries for tax inspectors or customs officials as well as public costs for containing smuggling and tax evasion. Such costs lower welfare and must be added to the Harberger triangle.

Transfer of income from consumers to producers invokes costs comparable to those of theft. Primarily, theft represents a mere shift of assets without any consequences for economic efficiency, just like a lump sum tax. There is no inefficiency and no Harberger triangle associated with it. There are welfare losses nonetheless, (Tullock, 1971). These occur if investments are made to permit and avoid theft at the same time: investments into locks and picklocks, safes and dynamite, fingerprint identification techniques and gloves. Expenses for such investments do not raise welfare and should be regarded as a form of waste.

A similar problem emerges in the case of subsidies and charities. Recipients may invest in becoming a potential recipient of aid. Self-mutilation by beggars may improve their position as a recipient of charity, but hardly adds to overall welfare. Tullock (1975) reports that some towns in the US were entitled to obtain subsidies from their states for the maintenance of roads. But since the poor condition of roads was emphasized as the reason for subsidies, there was incentive to allow roads to become dilapidated in order to obtain larger subsidies. Or the struggle for obtaining subsidies may require costly political campaigns intended to prevent the resources being allocated to other uses. Any of the resources used for or against such campaigns represent pure waste which neither raises production nor bears any other fruit for third parties. Even if no administrative costs arise for making a transfer, Tullock (1971: 642) argues:

> "The transfer itself may be costless, but the prospect of the transfer leads individuals and groups to invest resources in either attempting to obtain a transfer or to resist a transfer away from themselves."

Expenses for enacting regulation in industry are another example for transfer costs, including salaries to lawyers and lobbyists. Transfer costs link distributional problems to those of efficiency as the existence of rents brings about costly investments into mechanisms for transferring payments, including costs associated with competing for the revenues. The resulting type of competition has been a major concern of the traditional rent-seeking approach.

2.2. *Competition for rents*

Costly transfers should be particularly an issue in the case of a monopoly. As monopolies give rise to rents, these invite disputes regarding their distribution. Shareholders, consumers, competitors and even the state may all engage in attempts to obtain some part of the producer's rent. Investments will be undertaken which are aimed at obtaining or increasing one's share of the producer's rent. Comparable to the case of theft mentioned above, such investments are a part of the transfer costs and represent a form of waste. They are not aimed at increasing production or lowering costs – the standard motivation for making investments. They do not aim at maximizing profit by pleasing consumers with a better or cheaper product. Any revenues that accrue as a result of such activities directly lower revenues of other actors. This type of behavior has therefore been called rent-seeking as opposed to profit-seeking, where investments into production bring about profit only if someone else is better off buying the resulting product, (Buchanan, 1980).

Crucial to the rent-seeking approach is the particular marketplace under consideration. Ordinary products or services are not the ones under scrutiny. The focus of rent-seeking is on the interaction between the state and private parties, where the state has the monopoly on allocating property rights, be it by certain laws, regulations, subsidies, taxes, tariffs, import quotas or by awarding contracts in public procurement. Such activities usually entail a certain distribution or redistribution of income. Private firms will try to influence the decision to favor their own benefit. This results in a marketplace where the state offers a certain right or preferential treatment and firms compete against each other in their demand for this. The multitude of goods being traded may be subsumed under the rubric of preferential treatment in public decision-making.

This viewpoint adds another dimension to the usual market competition: firms' ability to use state intervention for their own purposes. The state can be a supplier of physical or financial factors to firms (for example in the case of subsidies or licenses) or demand the firms' products (in the case of public procurement). Irrespective of this question, the actions of the state often give rise to shortages, market disruptions or prices which deviate from competitive prices. This initiates disputes over rents and induces firms to compete for preferential treatment. Maximizing social welfare may not be the objective of the state. Instead, decision-making is largely the result of, or at least heavily influenced by, those seeking rents that arise as a consequence of state intervention. Market restrictions can be offered to those best able to influence decision-makers. Tullock (1967: 228) writes:

> "Generally governments do not impose protective tariffs on their own. They have to be lobbied or pressured into doing so by the expenditure of resources in political activity."

This provides an explanation for the evolution of monopolies which differs from those commonly suggested. Monopolies can emerge as the result of state intervention. The existence of monopolies may result if public decision-makers are in a position to support a monopoly and impede competition by imposing the respective laws and regulations. The producers' rent in a monopoly is therefore not the result of, for example, economies of scale, voluntary cartelization or the ousting of competitors by superior products. Rather, it results from being victorious in the competition over preferential treatment, that is, by finding political support for impeding competitors to enter the market. The resulting welfare effects of a monopoly must be seen in the light of this struggle required to obtain the monopolistic position (Bartsch and Thomas, 1993).

Monopolies require costs for politically defending their position. Potential entrants must be fought with regulation and laws in favor of the monopolist and costs arise as decision-makers must be influenced accordingly. Also potential entrants may try to influence decision-makers and allocate resources for this purpose. Consumers may try to break up a monopoly in an attempt to obtain parts of the producer's rent, providing them with a willingness to pay for political decisions. All these expenses for preferential treatment do not add to total production or welfare. Instead, they must be regarded to be wasteful.

2.3. *A formal model*

It is rational to invest in rent-seeking as long as the marginal input is smaller than the potential output it generates (Tullock, 1980b). The resulting market equilibrium can be determined by a formal model.[3] Assume that firms compete for a monopolistic position created by the state. It is a standard assumption (but questionable as we will see later) that all firms take the total rent (R) to be given exogenously. The probability for winning the competition (p_i) is proportional to a firm's investments into rent-seeking (x_i). Since this applies to all firms equally and all probabilities must add up to one, a single firms' probability decreases with the investments undertaken by its competitors. In case of n firms, this results in:

$$p_i = \frac{x_i}{\sum\limits_j x_j}, \qquad i, j = 1, \ldots, n,$$

with x_i being the expenses for rent-seeking of firm i. The resulting equilibrium can easily be determined once assumptions are introduced that firms are risk-neutral, act symmetrically and are unable to influence their competitors' level of rent-seeking x_j. Maximizing the expected profit, $E(p_iR–x_i)$, then requires:

$$\frac{d(p_iR - x_i)}{dx_i} = \frac{d\left(\frac{Rx_i}{\sum x_j} - x_i\right)}{dx_i} = \frac{R}{\sum x_j} - \frac{Rx_i}{(\sum x_j)^2} - 1 = 0 \qquad (1)$$

Function (1) can be solved by introducing symmetry, $x_i = x_j = x$. This brings about the Cournot-Nash-equilibrium and the following optimal level of rent-seeking:

$$\frac{R}{nx} - \frac{Rx}{n^2x^2} = 1 \Leftrightarrow nR - R = n^2x \Leftrightarrow x = \frac{n-1}{n^2}R.$$

Total expenses (S) for rent-seeking then sum up to:

$$S = nx = \frac{n-1}{n}R. \tag{2}$$

As more firms (n) enter into the competition monopolistic rents, more resources (S) are devoted to wasteful lobbying. This implies that competition increases waste. If only a single monopolist competes for the rent, that is $n = 1$, no expenses are allocated for rent-seeking purposes, $S = 0$. In the extreme case of perfect competition over monopolistic rents with n approaching infinity, waste equals the rent ($S = R$). This implies that the total welfare loss not only consists of the classical Harberger triangle but also of the total producers' rent. As the invisible hand of competition raises welfare in the case of product market competition, its adverse impact on a market for preferential treatment has been termed "the invisible foot" (Brock and Magee, 1984).

As a result, the establishing of competing rent-seeking lobbies has been identified as being detrimental to welfare. Such an idea has been picked up by Browning (1974), based on the work by Olson (1965). Assume that for a potential state intervention there exists a group of beneficiaries. In order to take advantage of this intervention, a lobby must be formed so as to convince public decision-makers of the necessary intervention. But establishing a lobby brings about organizational problems which are best described by the classical prisoner's dilemma: when from an individual's perspective, non-cooperative behavior is preferable, maximizing individual benefit disregards the utility of others and brings about a suboptimal solution for all actors. This dilemma also exists for a lobby. Engaging in a lobby imposes costs on the individual, but the benefits of the lobbying activity accrue also to those who do not devote time and effort. The preferable strategy is therefore free–riding behavior: not investing any individual costs while still profiting from the efforts devoted by others to the goals of the lobby. With this as the preferable strategy, it is possible that the lobby cannot be formed at all, although its actions are advantageous to the group of beneficiaries. It is commonly assumed that the larger the potential group of beneficiaries the less likely it is that lobbies can be formed. As a consequence, Browning argues that hardly any groups exist which campaign for broad topics such as the progression of income taxes.[4] Lobbies can form most easily when they fight for rather narrow interests and when those who benefit from their actions can be clearly identified. For Browning (1974: 374) this prisoner's dilemma is welfare-enhancing as it impedes the creation of lobbies.

Another application of the traditional rent-seeking theory relates to the role of legislation and the judiciary. According to the rent-seeking approach, "legislation is 'sold' by the legislature and 'bought' by the beneficiaries of the legislation", (Landes and Posner, 1975: 877). The authors investigate the role of an independent judiciary and the Supreme Court in their impact on rent-seeking behavior. These institutions have some discretionary power in interpreting law, in checking the consistency of laws against older legislation and the constitution, and in setting preferences in case of conflict. They may have the power to reject the enforcement of new laws. This restricts the parliament in its potential to "sell" new laws which are in conflict with older laws and introduces continuity in the otherwise unbound and potentially arbitrary laws enacted by parliament. Laws, once passed, assign long-term income sources to those who were able to influence legislation in their favor, because the judiciary helps to enforce the 'deals' made by effective interest groups with earlier legislatures. This raises the rent associated with a certain law and consequently the rent-seeking related to it (Tullock, 1993: 59–60). A similar role is assigned to the veto power of the president by Crain and Tollison (1979).

3. The traditional rent-seeking approach to corruption

From the outset, corruption has been considered as one form of rent-seeking. It was viewed as a special means by which private parties may seek to pursue their interests in the competition for preferential treatment. Just like other forms of rent-seeking, corruption represents a way to escape the invisible hand of the market and influence policies to one's own advantage.[5] But there are diverging viewpoints on how far corruption differs from alternative forms of rent-seeking. Corruption can be distinguished from other forms of rent-seeking by referring to law. While there is certainly a point in applying this idea, it does not clearly contribute to the welfare considerations discussed above. Moreover, as legislation may be endogenous to rent-seeking, such an approach may end up in a vicious circle: the self-enrichment of a ruler could not be termed corrupt because the ruler effectively created legislation to provide legal basis for his actions.

Another approach advanced by Jain (1998: 16–17) is that corruption differs from other forms of rent-seeking with respect to transparency. While corruption is an obscure variant of competition, rent-seeking is carried out in the open with actions observable by competitors and the public. This idea can indeed be helpful. The transparency of an action may be a valuable practical indicator for the public in assessing whether certain actions should be considered legitimate or instead be termed corrupt. But this criterion may again be endogenous to the rent-seeking process: autocratic rulers may not have to fear public disapproval and be under less pressure to obscure their actions. Still more, it is not straightforward to link the transparency of actions to its welfare implications.

A helpful approach to distinguish between corruption and other forms of rent-seeking has been emphasized by the protagonists of traditional rent-seeking theory. First, corruption differs from other types of rent-seeking by the form of transfers involved. Second, corruption differs from other types of rent-seeking by the extent of competition for rents. Both these aspects are explained in the next two subsections. Section 4 continues with a criticism and presents alternative differences that should be drawn between corruption and rent-seeking.

3.1. *Transfer costs of corruption*

Traditional rent-seeking theory commonly differentiates between corruption and lobbying as forms of rent-seeking. One apparent difference between these activities relates to the question of how decision-makers are influenced. If money is given to politicians or public servants, this should represent a clear case of corruption. But if rent-seeking is carried out by starting political campaigns, engaging lawyers and public relation agencies, or by public advertising, most observers would not regard the decision-makers thus influenced as corrupt.

These two alternatives involve different welfare implications. Particularly, the question of whether a bribe represents a form of waste has been the cause of some debate. Krueger (1974: 292–293) suggests that bribes create rents for government officials and that a wasteful competition for public jobs may thus develop. This position is not clearly supported by Posner (1975: 812), who argues that initially bribes represent pure transfers. A lobby may choose between paying bribes or starting a political campaign. It is a straightforward assumption that the first alternative benefits the recipient, while the latter may involve annoying phone calls and influence-peddlers squandering politicians' time and effort. Bhagwati (1982) coined the term "directly-unproductive-profit-seeking (DUP) activities" for such actions. It is therefore only political campaigning that can easily be equated with some form of waste, while bribery is certainly closer to a pure transfer. Corruption therefore appears to be the less wasteful alternative for seeking rents (Wintrobe, 1998: 26). Similarly, Tullock (1980a: 21–23) considers the selling of government positions, which can just be another type of corruption, to be a pure transfer of assets which is not equivalent to waste, since the money increases utility or production elsewhere. This idea is taken up by Wellisz and Findlay (1984: 148–149) and similarly by Appelbaum and Katz (1987: 687). They provide a lobby's expenditure function of the form

$$z = (1 - c)x, \quad 0 \leq c \leq 1,$$

where x is the expenditure for rent-seeking purposes and z the recipient's valuation. The parameter c relates to the transfer costs with $c = 0$ if cash is given and $c = 1$ if those gifts legally permitted (and actually given) are valueless to the recipient. In the latter case, stiff lobbying rules increase transfer costs (c) and increase the extent to which lobbying is wasteful.[6] This leads Wellisz and Findlay (1984: 149) to conclude that:

> "Paradoxically, maximum waste is likely to occur if the licensing system is absolutely 'fair' and if it brings no benefits to the licensor... Graft and corruption reduce economic costs."

3.2. *Corruption vs. competition*

Another suggestion for differentiating between lobbying and corruption has been put forward by Jain (1998: 16). He argues that corruption differs from legitimate lobbying by its level of competition. Corrupt rent-seeking is a parochial form which does not allow potential entrants in the political competition to enter into the bidding process. In contrast, legitimate lobbying is open to everybody and provides clear and transparent rules for becoming a participant. But the analogy between monopolistic rent-seeking and corruption is not perfect. Corrupt bureaucrats and politicians may also prefer some level of competition so as to avoid the strong bargaining power of private monopolies. This may suggest that corruption can also go along with a certain level of competition. But in case of competition it may be difficult for public decision makers to benefit from the awarding of the monopolistic position. There can be large transaction costs to the making of corrupt deals so that bribes can only be taken from well acquainted and trusted business partners, and not their competitors (Lambsdorff, 2001). Likewise, restricted competition can provide the breeding ground for corruption. Since the resulting public decision can less be compared to a competitor's alternative, decision makers are provided with a higher degree of discretion, which they can exploit for themselves. Above that, restricted competition can be regarded as a form of favoritism and nepotism, terms which are apparently close to corruption. This provides sufficient reason to regard monopolistic forms of rent-seeking as being closely related to corruption, suggested by the traditional rent-seeking literature.

While at first glance such competition commonly sounds preferable, from the traditional rent-seeking point of view it is not. Because competition for rents increases the expenses of rent-seeking and subsequently waste, monopolistic forms of political competition are regarded as less wasteful. Viewing corruption as a monopolistic form of seeking preferential treatment suggests that traditional rent-seeking should give preference to this type of rent-seeking over more competitive forms. And indeed, this consequence has been clearly spelled out by advocates of the traditional rent-seeking approach. Krueger (1974: 302) labels less competitive forms of rent-seeking "favoritism" and argues:

> "If [governments] do restrict entry [into competition over rents] they are clearly 'showing favoritism' to one group in society and choosing an unequal distribution of income. If, instead, competition for the rents is allowed (or cannot be prevented), income distribution may be less unequal, and certainly there will be less appearance of favoring special groups, although the economic costs associated with quantitative restriction will be higher."

Similarly, Tullock (1980b: 109–111) suggests introducing some bias into decision-making in the sense of discriminating against certain groups of people and denying them access to competition over rents. Nepotism as a form of corruption has been addressed and advocated by Tullock (1980b: 103–104):

> "It would appear that if one is going to distribute rents, nepotism is a good thing because it reduces the number of players and, therefore, the total investment [into rent-seeking]. This is one of the classical arguments for hereditary monarchies...
> Thus, if [a] mayor ... had confined all of the more lucrative appointments to his close relatives, the social savings might have been considerable ...
> ... it is better if the political appointments of corrupt governments are made quickly and rather arbitrarily, so that not so many resources are invested in rent seeking"

As long as income distribution is "predetermined", that is, remains unchallenged, no wasteful rent-seeking will arise (Buchanan 1980: 12). In this sense, traditional rent-seeking theory does not encourage competition against leading politicians and interest groups, even when their policies go along with an unequal and potentially corrupt distribution of wealth.

4. A criticism

There has been a wide range of criticism of the traditional rent-seeking approach. Magee (1984: 51) criticizes that the traditional rent-seeking theory assumes that first-best solutions develop in situations where no rent-seeking takes place – that is, where there is a total lack of private interference in the political arena. It compares wasteful individual optima with economic situations where no motivation exists for market-distorting actions. The first-best solution is therefore assumed to be given exogenously while only the inefficient outcomes are the result of rent-seeking, (Bhagwati and Srinivasan, 1980: 1086). Bhagwati, Brecher and Srinivasan (1984: 30) point out that in traditional rent-seeking theory the assumption of a first-best solution "descends like manna from heaven". In a similar vein, North (1984: 39) argues that it is troublesome to differentiate between unavoidable transaction costs of the public decision-making process and the wasteful activity propagated by traditional rent-seeking theory.

But in accordance with the propositions of the traditional rent-seeking theory, it has nowadays largely been accepted that the existence of rent-seeking represents a waste of resources. However, the comparison between competitive lobbying and corruption provided by traditional rent-seeking theory is less convincing.[7] Taken to the extreme, traditional rent-seeking theory suggests that corruption is superior to other forms of politics where larger segments of society are enabled to participate in the decision-making process with the help of lobbies (Wintrobe, 1998: 28). This is clearly a provocative conclusion and, as will be shown, it should no longer be maintained.[8]

This section will argue that corruption is indeed a crucial obstacle to economic development and that it lowers welfare. Particular shortcomings of the traditional rent-seeking theory are responsible for its failure to adequately identify the welfare implications of corruption. It will be outlined here to what extent rent-seeking theory must be modified so as to validly contribute to a theory of corruption. Taking these modifications into account, it will be shown that competitive lobbying must clearly be preferred over corruption. The conclusion that a monopolistic form of rent-seeking is preferable to competitive forms must be rejected on theoretical grounds. This will be outlined in Subsection 4.1. The idea that transfer costs of rent-seeking increase waste will be challenged in Subsection 4.2. Furthermore, other distinctions exist between corruption and rent-seeking: corruption implies a more active, self-seeking role of the state than the one assumed by other forms of rent-seeking. This is illustrated in Subsection 4.3. Finally, the interests pursued by corrupt behavior are more narrow than the more broadly defined interests of other rent-seeking activities. The resulting welfare implications are explained in

Subsection 4.4. These aspects clearly support the notion that corruption is the more destructive form of rent-seeking.

4.1. *Endogenous rents*

The first problem with traditional rent-seeking theory arises with the frequent assumption that the size of the rent is exogenous. This shortcoming of the traditional rent-seeking theory, as presented by the formal model in Subsection 2.3, has long been identified and addressed. Models were developed where tariffs and rents are determined endogenously.[9] There exist a variety of factors which may impact on the size of a rent. But it has largely been ignored that competition is one of them. Such an impact becomes plausible if one considers that the size of a rent should be positively dependent on the total rent-seeking expenses:

$$R = R(S), \quad \text{with } R' > 0. \tag{3}$$

When public decision-makers create rents, lowering public welfare, they may suffer from disutilities.[10] Public opinion will commonly be in favor of first-best solutions (Findlay and Wellisz, 1984: 94–95). This will impact on politicians behavior via voting (McChesney, 1997: 136). If a public decision-maker excessively creates rents, third parties may revoke their political support, prospects for the next election may be threatened and the general public may find various forms of expressing dismay. The disutilities associated with creating rents are likely to increase with the size of the rent and the welfare losses imposed on third parties. Inducing politicians to take that burden therefore comes at a price and politicians will choose an optimum between creating rents and avoiding the resulting disutilities. The larger the size of the rent (R) that private parties seek to obtain, the larger the total expenses for rent-seeking (S) required to induce the requested preferential treatment. Equation (3) can be introduced in the formal model in Subsection 2.3. Since $R(S) = R(\sum x_j)$, equation 1 can be rewritten:

$$\frac{d\left(\frac{R(\sum x_j)x_i}{\sum x_j} - x_i\right)}{dx_i} = \frac{R'x_i}{\sum x_j} + \frac{R}{\sum x_j} - \frac{Rx_i}{(\sum x_j)^2} - 1 = 0, \tag{1'}$$

In case of symmetry, $x_i = x_j = x$, the Cournot-Nash-equilibrium is:

$$\frac{R'x}{nx} + \frac{R}{nx} - \frac{Rx}{n^2x^2} = 1 \Leftrightarrow nR - R = nx(n - R') \Leftrightarrow x = \frac{n-1}{n(n-R')}R.$$

Waste as measured by the total rent-seeking expenses is now given by:

$$S = nx = \frac{n-1}{n-R'}R. \qquad (2')$$

A positive impact of the number of competitors (n) on rent-seeking expenses (S) is no longer warranted. If R′ is larger (smaller) than 1, S is larger (smaller) than R and an increase in the number of competitors (n) will decrease (increase) the total expenses for rent-seeking. This shows that the classical assumption of rents dissipating through competition reemerges. In normal product markets, producers' rents dissipate through competition. As rents attract new entry into the market, the increasing production level drives down prices and reduces rents. In the traditional case of rent-seeking for preferential treatment, the rents were assumed to be given exogenously and do not dissipate, (Buchanan, 1980: 6–11) and (Flowers, 1987). But as soon as rents are seen to depend on rent-seeking expenses, the classical advantage of competition reemerges. Economically, this relates to the fact that the positive impact of rent-seeking expenses (S) on the rent (R) will be felt more when few competitors exist. For competing firms, the overall size of the rent is a public good which they will hardly lobby for. They rather seek to increase their share and their individual probability of being successful. In contrast, for a monopolist the total rent is not a public good but his own private good. A monopolist may thus be willing to devote resources to rent-seeking activities. Otherwise the total rent he can capture may turn out to be sub-optimal, since decision-makers are not sufficiently induced to making rents as large as possible. Posner (1974: 349) touches on this aspect when he writes: "…even a naturally monopolistic industry would gain from legislation that increased the demand for its product." As a result, total rent-seeking expenses may increase or decrease with competition. If rent-seeking expenses have a strong impact on the size of the rent, this effect can outweigh the one outlined by the traditional model: monopolists may spend more on rent-seeking than competing firms and monopolies could be more wasteful than competitive firms in a market for preferential treatment.[11]

Apart from the size of existing rents, it is also the creation of new rents which monopolistic firms or lobbies may become devoted to. This is the viewpoint particularly embraced by the economic theory of regulation (Stigler, 1971; Posner, 1974; Peltzman, 1976). Competitive firms do not engage equally in influencing public decision-makers so as to create regulations, tariffs, quotas, subsidies and the like. The reason is that after devoting resources to influencing politicians to enact the desired laws and regulations, a company has no guarantee that revenues thus created will accrue to it. Rent-seekers may be unwilling to invest in lobbying to create rents if they believe that they will have to expend additional resources to compete for these rents once they are created (Mbaku, 1992: 249). While this argument is straightforward, it seems to have been largely overlooked in the traditional rent-seeking literature.

Furthermore, Wintrobe (1998: 28–30) suggests another aspect in favor of competition as a means of improving welfare in the market for preferential treatment. The crucial shortcoming of traditional rent-seeking theory is that it makes no difference who wins the contest and consequently no social benefit results from the bidding process. As competitors should be assumed to differ from one another with respect to their product and their rent-seeking skills such considerations become important. Each new competitor introduces the possibility of a better product or service being selected in the resulting bidding process. Benefits are not likely to result if competitors are picked at random, but are much more so if some rationality is guiding the tendering procedure. The heterogeneity of competitors then sets competition at an advantage over monopolies.

Further advantages from competition arise with an information-theoretic point of view. Private firms are commonly best informed about their level of efficiency, making it difficult in public procurement to set the right prices. With the help of a public tender, competitors are forced to reveal some of this information about their degree of efficiency and they are provided with incentives to improve their productivity. In contrast, monopolists are more troublesome to induce to this type of behavior. This failure is likely to introduce further welfare losses in the case of lacking competition.

4.2. *Transfer costs and waste*

Another point in favor of corruption over lobbying has been that bribes increase the utility of the recipient while lobbying does not provide an equal benefit but constitutes a form of waste. This argument alone is certainly not strong enough to tip the balance in favor of corruption, just as any type of punishment is not necessarily in contrast to welfare. The purpose of a penalty is to reduce the benefit to the punished. As long as penalties are not totally at odds with a society's preferences, this is a commonly approved deterrent for the undesired actions. A similar situation arises between lobbying and corruption. Making corruption as costly as possible will provide incentives to allocate rent-seeking expenses for lobbying instead. This reduces the propensity of decision-makers to seek corrupt income by creating rents or increasing existing rents.

This idea can be introduced into the formal model. It appears plausible to assume that it is not rent-seeking expenses per se which are crucial to influencing a politician's behavior but his or her valuation of these expenses. As argued on page 104, this valuation depends on the parameter c, where c obtains a value of 1 if the gifts given by a lobby are valueless to the recipient. A lower value of c indicates bribes instead. If no transfer costs arise for paying bribes one may assume c to approach zero. This suggests a modified rent creation function:

$$R = R((1 - c)S), \text{ with } R' > 0. \qquad (3')$$

Introducing this function into the formal model brings about the following function for a firm's rent-seeking expenses (x):

$$x = \frac{n - 1}{n(n - (1 - c)R')}R.$$

Total waste would no longer be depicted by S because part of the rent-seeking expenses are not wasteful but mere transfers. Waste is rather depicted by cS, that is, total expenses multiplied by the transfer costs which arise for rent-seeking expenses. Total waste is therefore given by:

$$cS = \frac{c(n - 1)}{n - (1 - c)R'}R. \qquad (2'')$$

As can be shown by differentiation, an increase of the transfer cost c raises waste only if $R' < n$ and lowers waste otherwise. In contrast to the conclusion by Wellisz and Findlay, cited on page 104, large transfer costs of rent-seeking expenses do not necessarily go along with higher waste. Lower waste could result in case of large transfer costs. The reason for this is that large transfer costs of rent-seeking reduce the possibilities for inducing politicians to create rents, that is, S decreases with c. This in turn helps to avoid rent-seeking activities and the resulting waste. The conclusions with respect to the total welfare losses are even stronger. These consist not only of waste (cS) but also of the classical Harberger triangle. Since the latter is positively dependent on the rent (R) and this strictly decreases with the transfer costs (c), there exists a negative impact of the transfer costs on the allocative welfare losses. This implies that it becomes even more likely that high transfer costs of rent-seeking are beneficial to the economy. In sum, the welfare loss that occurs as expenses for rent-seeking are wasteful and not beneficial to decision-makers is not a sufficient argument in favor of corruption – just as it is not enough to reject penalties on the grounds that they hurt the criminal.

4.3. *Supplying rents*

> In Nigeria, corruption isn't part of government,
> it's the object of government.
> Anonymous Nigerian political scientist,
> Washington Post, 9.4.1998

Another related criticism of the traditional rent-seeking approach refers to the role of the state and the incentives of decision-makers to supply the rents that are demanded by private interest groups. As argued by Tullock (1967: 228, citation on page 99 of this study) the government itself is not the one seeking rents or motivated to impose restrictions. It is lobbied into these actions by private firms. For Krueger (1990: 10 and 14) corruption emerges as a "by-product" of policy distortions or "inevitably accompanies a set of controls". This leads Tullock (1993: 26) to summarize that "...politicians are modelled as providing a brokering function in the political model for wealth transfers". What is missing in this context is an adequate description of what actually causes policy distortions and creates rents. For Buchanan (1980: 8), some flattery or persuasion may be sufficient to induce a political leader to provide monopoly rights to someone. Such explanations invite criticism. McChesney (1987: 102) noted that traditional rent-seeking theory describes a politician as the "passive broker among competing private rent seekers". According to Tollison (1982: 592) the role of politicians remains that of a "mystery actor". Wintrobe (1998: 25) even considers the role assigned to politicians by traditional rent-seeking theory to be irrational.

Again, to be fair here, protagonists of the traditional rent-seeking theory have elaborated on the causes of rents, the process of rent-creation, for example Krueger (1990: 19) and the various contributions by Tullock cited in this study. It should not be overlooked that rent-seeking theory was much inspired by public choice theory (Downs 1957; Buchanan and Tullock, 1962; Niskanen, 1971), and the economic theory of regulation (Stigler, 1971; Posner, 1974; Peltzman, 1976), which put clear emphasis on the motivation of politicians, characterizing actions by politicians and public servants as the result of maximizing behavior. However, it is predominantly assumed that this relates to the maximization of an agency's budget or the number of votes a politician can obtain. This viewpoint has been criticized by Hirshleifer (1976), Peltzman (1989: 7) and elaborated in McChesney (1997: 17–18 and 133–155), who point out that public servants and politicians should be treated as wealth maximizers instead.

Particularly, what has been disregarded by traditional rent-seeking theory is how far corruption, as opposed to lobbying, may impact on the process of rent-creation. Corrupt politicians and public servants need not be pushed by private businessmen to take regulatory action but have a motivation of their own. Corruption motivates politicians and public servants to impose (or threaten to impose) market restrictions so as to maximize the resulting rents and the bribes paid in connection with them.

The chief shortcoming of traditional rent-seeking theory can be illustrated with the help of an example by Buchanan (1980: 12–13). He describes a taxi market where the municipal government limited access for taxi drivers, for “whatever reason”. He continues to describe how the resulting rents may later be captured by political entrepreneurs. While this is a possible sequence of actions, there is no convincing reason why the causality should not just work the other way round: very good reasons existed for limiting entry into the taxi market; politicians and administrators may have limited the access for taxi drivers so as to sell the valuable licenses and to pocket parts of the rents they were creating. This type of causality appears less logical for the case of lobbying, where public decision-makers are exposed to troublesome interest-seekers and have few prospects of extracting some profit for themselves. Lacking these prospects for self-enrichment, this type of rent-seeking is not actively pursued by public decision-makers. In contrast to lobbying, corruption reverses the causality. It is a force motivating the creation of rents.

That corruption can motivate the creation of monopolies and regulations so as to obtain bribes can be illustrated with the help of some recent case studies. The dramatic downturn of the economy in Georgia has been blamed on mismanagement and corruption. International investors have complained of capricious tax officials and a bewildering system of licensing businesses, which some of them say is designed to squeeze cash out of entrepreneurs for personal gain.[12] Quite striking is an example from Pakistan. The gold trade was formerly unregulated and smuggling was common. Shortly after Ms Bhutto returned as Prime Minister in 1993, a Pakistani bullion trader in Dubai proposed a deal: in return for the exclusive right to import gold, he would help the government regularize trade – and make some further private payments. In 1994 the payment of US $ 10 million on behalf of Ms Bhutto’s husband was arranged. In November 1994, Pakistan’s Commerce Ministry wrote to the bullion trader, informing him that he had been granted a license to be the country’s sole authorized gold importer – a profitable monopoly position.[13] Another illustrating example comes from Nigeria. The Abacha family was behind the operations of the firm Delta Prospectors Ltd., which mines barite, a mineral that is an essential material for oil production. In spring 1998, shortly after Delta’s operations had reached full production, General Abacha banned the import of barite. This turned the company into a monopoly provider for the large Nigerian oil industry.[14] Rose-Ackerman (1999: 37) provides further examples where market concentration has been increased as a result of corruption, even when the respective firms have been privatized.

Policy distortions may be the result of corruption and not the other way round. This idea has also been spelled out explicitly by Bardhan (1997: 1323):

> “The distortions are not exogenous to the system and are instead often part of the built-in corrupt practices of a patron-client political system.”

As an example in this respect, Myrdal (1968) cites the 1964 Santhanam Committee on the Prevention of Corruption appointed by the Government of India. He argues that corrupt officials may, instead of speeding up, actually cause administrative delays in order to attract more bribes. A similar proposition is put forward by Rose-Ackerman (1978: 90), citing Gardiner and Olson (1974: 196):

> "... bureaucratic personnel may deliberately slow down service after the initial payoff and create more red tape in order to establish additional inducements for others to make payments or to raise the ante."

Similar to bureaucrats, politicians can also engage in such tactics, for example, by imposing or threatening troublesome regulation so as to extort donations from the private sector, (McChesney, 1997: 3). Also Tullock (1989: 659) in his more recent work argues on behalf of this type of causality:

> "... once corruption becomes established in a government, laws may be enacted for the specific purpose of maximizing the bribes available for permitting people to avoid them."

Coolidge and Rose-Ackerman (1997: 4) point to the fact that, particularly in the case of rent-seeking among the top of a country's hierarchy, "the search for personal gain can itself importantly influence the level and type of government intervention in the economy". Opportunities for rent-seeking emerge as a result of officials' desire for personal financial gain. Imperfections in government in this case are the result of optimizing behavior and not of laziness or incompetence. Bribes then paid do not help to circumvent bothersome regulation but are a source of inefficiency on their own. The authors provide case studies to support their argument. Also the investigation of excessive bureaucratic regulation in De Soto (1989) leads the author to conclude that they were largely motivated by the desire to generate corrupt revenues. It has therefore been suggested that corruption might be distinguished from lobbying by focusing on the endogeneity of legislation and regulation. Corruption differs from lobbying in so far as artificially created rents by public decision-makers are the result of rent-seeking and not its cause, (Pritzl, 1995).

The active role of creating rents is sometimes ascribed only to public servants and politicians, for example by McChesney (1997). But business people can also be central players. This has already been illustrated by the case study from Pakistan on page 112. Another illustrative case stems from Saudi Arabia. Via the internet, allegations were made concerning a son of the minister of the interior in Saudi Arabia. It was suggested that he had established a chain of body shops for car repairs. Afterwards he engaged his father to obtain a decree by the king, imposing a requirement for the annual inspection of all 5 million cars registered in Saudi Arabia in a licensed car repair shop. His chain was the first to obtain the license. To the best of my knowledge, no evidence has been produced to substantiate the claims. But the existing rumors are helpful in illustrating the point being raised here. While the creation of rents commonly involves public and private actors, responsibility for the resulting inefficiencies cannot be assigned ex ante to either side. Some cases exist where private parties are clearly the cause of rent-creation, for example, when politicians are lobbied into regulation that hampers competing companies or bribes are paid to the police to harass a rival, (Rose-Ackerman, 1999: 24–25). An extreme example are organized criminal groups who obtain preferential treatment from public servants through extortion.

This is certainly not to say that rents created by public decision-makers are always caused by corruption. A multitude of other reasons may be thought of for political interference in the market. But even when market restrictions occur for "whatever reason", corruption often acts as a motivating force: to ensure market restrictions in the future. For example, South Africa had a twin currency system for a while. This was aimed at providing foreign currency to investors for most-needed investments at below market rates while impeding purchase of less-needed import goods which had to be purchased for the higher exchange rate. But the parliamentary commission entitled to distribute the cheaper currencies was said to request favors in exchange. As a result, currencies were awarded to those providing favors rather than to the most important investments. Abolishing this system was long impeded by the commission's influence on parliament.[15] In Nigeria in the early 1980s free trade reforms were favored by the International Monetary Fund (IMF) but were not carried out because the import licensing system was a major source of payoffs. When the system was finally abolished in the late 1980s the state quickly introduced other new rent-seeking opportunities (Rose-Ackerman, 1999: 11). Corruption can motivate the extortion of bribes when inefficient rules provide bureaucrats with a high level of discretion. According to a survey of business people in Karnataka, India, an out-moded regulatory mechanism was used by the middle and lower level bureaucrats to harass investors and extort bribes.[16] Reforming regulation is in this case commonly impeded by those who intend to preserve their level of discretion.

The fact that the active, self-seeking role of governments has often not been clearly addressed may relate less to lack of sophistication and rather more to political caution. Obfuscating the actual causes for rents may present a less controversial way to criticize: in 1993 the World Bank noted the emergence of conglomerates in Indonesia that seek "to capture rents created by policy-created market distortions." In reality, this description meant that Suharto-crony businesses were given government-issued licenses to control various parts of the economy, i.e. corruption motivated the creation of monopoly positions for Suharto relatives.[17]

For many years, multilateral donor agencies were reluctant to openly address the problem of corruption. They spoke of "market distortions", but their causes, that is, the corrupt incomes they were intended to generate, were not addressed publicly, a situation that has changed since, (Rose-Ackerman, 1999: xi–xii). Cautious wording in such contexts should not mislead the reader as to the corrupt motivation that often lies behind the initiating and supporting of market distortions.

4.4. *Narrow-minded interests*

Seeking preferential treatment by public decision-makers includes a wide range of different actions. Imagine that a manager of a construction company considers engaging in rent-seeking. This may include such diverse activities as first, bribery in order to obtain a contract in public procurement, second, organizing a lobby aimed at increased spending for public construction, or third, campaigning jointly with other interest groups to increase public spending.

While all these activities are commonly regarded as forms of seeking rents, traditional rent-seeking theory does not differentiate enough between them. All of these activities are potentially beneficial to the construction company and may bring about competition for the rents as other companies or lobbies also try to capture them. Thus rent-seeking theory should be a helpful tool for analysis. But more interesting is in how far these actions *differ* from each other with respect to their welfare implications. There is a general notion that the last activity is more or less legal and legitimate while the first one is basically illegal and illegitimate. These aspects are important to political scientists but are difficult to apply to welfare considerations.

For this purpose it is crucial to identify the *interaction* with other rent-seekers. It is the interests involved and the type of good being exchanged which distinguishes one rent-seeking activity from another. This may have been Samuels' (1975: 908) concern when he raised the question: "How can we differentiate between special and general interest legislation, a distinction which is very important to the heuristic and probative value of" the analysis by Landes and Posner (1975), as mentioned on page 102.

One such approach has been suggested by Olson (1982), see also MacGuire and Olson (1996) and Pryor (1984). The idea elaborated there is that interest groups which embrace larger segments of the economy will take the macroeconomic impact of their actions into account when trying to maximize the income of their members. This considerably reduces the ill effects of rent-seeking as the larger lobbies have an "encompassing interest" in creating welfare-enhancing policies. As a result, large interest groups are less detrimental to economic development than smaller ones. In the utopian case of a lobby consisting of everybody in the society the interests pursued are public interests, (Posner, 1974: 350). An organized political campaign for higher public spending is unlikely to disregard the broader economic effects and more complicated repercussions of its actions. It is therefore closer to promoting a first-best solution. In contrast to this, lobbies which campaign for larger expenses in public construction may not care about other sectors' performance and promote policies which are more harmful to the economy.

With respect to smaller interest groups, Olson (1982) argues that the thicket of special interest groups in any society chokes off innovation and dampens economic growth. This argument is plausible when comparing smaller interest groups with those who have a broad encompassing interest. But it may not be valid when comparing smaller interest groups to individuals who separately engage in rent-seeking. Individuals would strive to maximize a very narrow range of self-interest, while smaller groups may be the first step to broadening the interests involved. This idea was advanced by Putnam (1993), who defends the contribution of smaller groups in building society and helping democracy at the same time. Smaller groups are shown to form horizontal networks of civic engagement, improving the effectiveness and responsiveness of regional governments, (Putnam 1993: 176 and 229).

The argument that lobbies which embrace larger segments of society are less detrimental to welfare can be proven with the help of the formal model. Lobbies may be able to internalize the negative externalities that rent-seeking by one party imposes on other parties. For example, those participating in a public tender impose a negative externality on their competitors by paying bribes, but a joint lobby would take this effect into account. Another example of negative externalities relates to industrial groups which lobby for restrictions on market entry on behalf of their members, inducing higher prices for their products. These impose negative externalities on those who buy their product. In case a larger lobby is formed which also includes industrial sectors who purchase the product, the negative externality will partly be taken into account. Let us assume that the total losses imposed on others as a result of a rent is proportional to the size of the rent: qR. These losses consist of welfare losses and transfers, for example from consumers' to producers' rent or from one producer who pays increased prices for input factors to those who artificially increased prices with the help of rent-seeking. Due to the welfare losses, q should be assumed to be greater than 1. Let t be the extent to which the externality is internalized by a lobby. The fraction $(1 - t)$ of the negative externality is carried by parties not represented by the lobby. While the expected gain from rent-seeking for the individual firm has been determined on page 100 to be $E(p_iR - x_i)$, that for the organized lobby turns out to be $E(p_i R(1 - qt) - x_i)$. Introducing this modification into the basic model as determined in Subsection 2.3, the Cournot-Nash-equilibrium can be shown to yield the following optimal level of rent-seeking:

$$x = \frac{n-1}{n^2} R(1 - qt).$$

Total expenses (S) for rent-seeking then sum up to:

$$S = nx = \frac{n-1}{n} R(1 - qt). \qquad (2''')$$

The more lobbies are able to internalize the negative externality, that is the larger t, the lower the resulting total expenses for rent-seeking. Assuming that the rent is positively dependent on total expenses for rent-seeking, like in equation (3) on page 107, a lower rent will equally result.

Firms can be better off if they unite their rent-seeking activity by forming a lobby. Jointly and publicly, firms may favor the establishment of rules for decent competition, contracts to be awarded to the best qualified, and adequate tendering procedures that are set up to guarantee such an outcome. But individually, they would strive to undermine this by paying bribes and increasing total rent-seeking expenses. It is still not the macroeconomy which such a lobby becomes concerned about but the well-being of a whole sector. As the interests involved are broadened the welfare losses diminish.[18]

This differentiation between narrow and broad interests is also tackled by Stiglitz (1998: 16), when he argues that a distinction between rent-seeking interest groups and voice-conveying citizens must be drawn, even if this may be difficult in practice. He argues that

> "increasing the numbers of participants and degree of competition would ensure more balanced signals of societal preferences."

To sum up, the crucial difference between the three actions mentioned above is the *type of interest involved* and the *type of good* being exchanged. The first transaction includes the payment of a bribe by a single company to a single public servant to obtain a single contract. As this is equal to a very narrow interest, it does not take into account the negative externality this imposes on other construction companies. The narrow interest of the actors corresponds to a product which provides a special privilege to its recipient. Such a type of rent-seeking is particularly harmful because the expenses for rent-seeking are large and incentives for creating market distortions are strong. In the second transaction the scope of interest is broadened to include other companies. The goods being exchanged do not include special treatment to individuals but larger groups. This may go along with a less ad hoc and arbitrary administrative or political decision. Such a type of rent-seeking is less harmful. As negative externalities are partly internalized, total expenses for rent-seeking diminish and the incentives for creating rents are lower. Still, the interests involved remain limited, as negative externalities to other sectors are not taken into account. As the encompassing interest is further broadened in the third transaction, the resultant rent-seeking gets closer to yielding a first-best solution. The larger lobby will internalize most of the externalities and will rather avoid large rent-seeking expenses and large rents to be created by public decision-makers via imposing market restrictions.

This leads one to reject Browning's (1974) conclusion, which was mentioned on pages 101–102. He argued that the free-riding problem in the forming of lobbies is welfare enhancing. But lobbies are a first step away from narrow interests, balancing the various interests of its members to form a broader interest. This can be helpful as bribery by its individual members, for example firms within a certain sector, is abandoned in favor of maximizing a common goal. Therefore, the difficulties lobbies encounter in formation impede a potentially helpful aggregation of interests.

Likewise, as argued on page 101, traditional rent-seeking theory implies that an independent judiciary increases the total rent of a law being passed by the parliament. The same effect has been attributed to a president's veto power. But to derive adverse welfare implications from this would be misleading. Such institutional devices are likely to change the product that is being exchanged through rent-seeking and the interests that are involved. Laws apply to a large and anonymous group of private parties while ad hoc decisions give preferential treatment to individuals or small groups. Therefore, laws that are valid over a longer period will be fought for by larger lobbies which promote broader interests. Quickly changing laws and ad hoc decisions are lobbied for by those striving for narrow interests. This can easily result in outright bribery. Restricting legislation to durable laws will therefore help countries move closer to an open debate where public opinion has a chance to enter.

5. Conclusions

In accordance with the traditional rent-seeking approach, this study argues that corruption can be understood as a form of preferential treatment by public decision-makers. Such treatment invites private parties to try to benefit from the resulting economic rents and compete against each other by paying bribes. In comparison to lobbying, corruption is commonly described as the more monopolistic form of rent-seeking. Rent-seeking is called corruption when competition for preferential treatment is restricted to a few insiders and when rent-seeking expenses are valuable to the recipient.

But traditional rent-seeking theory largely failed to correctly identify the resulting welfare effects of corruption. It failed to understand that corruption motivates the creation of inefficient rules that generate rents. It failed to notice that the size of the rent a public decision-maker controls will commonly increase with the extent of corruption, and that corruption involves interests which are narrower than those of competitive lobbying. In contrast to the traditional rent-seeking theory, it was argued that corruption has worse welfare implications than alternative rent-seeking activities. Since corruption impedes the organizing of broad interests it goes hand in hand with larger expenses for rent-seeking and higher inducements for public decision-makers to create market distortions.

Notes

1. See for example Kofman and Lawaree, 1996; Laffont and Tirole, 1993; Olsen and Torsvik, 1998; Strausz, 1995; and Pechlivanos, 1997.
2. See Bangkok Post, 17.9.1998, "Killing what is its to protect".
3. See for example Tullock, 1967; Krueger, 1974; Posner, 1974 and 1975; Tullock, 1980b; Bhagwati and Srinivasan, 1980; Congleton, 1980; Hillman and Katz, 1984; Appelbaum and Katz, 1987; and Bartsch and Thomas, 1995.
4. Posner (1974) and Stigler (1971) have alerted that this relationship may be countered by another aspect: seeking to build a cartel, large lobbies consisting of many producers may have a larger demand for state intervention as compared to groups of few producers who may be able to overcome free-riding behavior privately.
5. While Mbaku (1998: 197) largely supports the argument that corruption is a form of rent-seeking, he points out that some forms of corruption may not be rent-seeking. He mentions the embezzlement by public servants as an example. But also this type of behavior should be regarded as a form of rent-seeking. Public servants must lobby for administrative positions which provide opportunities for embezzlement – giving rise to competitive rent-seeking. And even if no competition for such opportunities takes place, this simply represents a monopolistic form of rent-seeking.
6. One may assume that transfer costs arise for two reasons. First, a valuation of a gift by the recipient which falls short of its costs and, second, the transaction costs which are required to make the payment. The idea that cash payments can be made without transaction costs is a strong assumption. Recent contributions by Husted (1994), Lambsdorff (2001) and Rose-Ackerman (1999: 91–110) have emphasized that corruption can go along with considerable transaction costs. One may therefore assume that $c>0$ in case of bribery. But the assumption of c being larger in case of lobbying can still be defended, because in addition to the transaction costs the lower recipient's valuation of the gift increases c.
7. Some academics fail to differentiate between lobbying and corruption and assume that the welfare conclusions as derived by traditional rent-seeking theory are equally applicable to corruption, see for example Mauro, 1997; and Klitgaard, 1988: 45. This study shows their viewpoint to be misleading.
8. To be fair here, most protagonists of the traditional rent-seeking theory admit that corruption has further adverse effects, for example by undermining the legitimacy of government, (Krueger, 1990: 18). But when it comes to utilizing economic tools, the verdict

of traditional rent-seeking theory, as described by the multitude of citations presented in this study, is clearly unambiguous.

9. See for example Brock and Magee, 1978; Findlay and Wellisz, 1984; Magee, 1984; and Bhagwati, Brecher and Srinivasan, 1984.
10. This is a common assumption made in public choice theory. Appelbaum and Katz (1987) and McChesney (1987) introduced such public choice elements into formal models similar to the one provided in Subsection 2.3. However, they failed to observe that this results in competition having an impact on the size of the rent.
11. This argument must be modified when considering that monopolies may have further means to influence public decision makers. As compared to competitive lobbies they might be in a stronger bargaining position. Also, inside information from past deals could provide them with the possibility of extorting favors from public decision makers. This results in monopolists having recourse to further cost-effective means of influencing public decision makers. Monopolists can in this case better influence the creation of rents but may not have to increase the overall rent-seeking expenses to reach this goal. The resulting total welfare loss then consists of a large Harberger triangle due to an increased creation of rents, along with less waste in the form of rent-seeking expenses. The overall welfare effects of an increased bargaining power appears to be ambiguous.
12. See Reuters, 27.7.1998, “Georgian leader forces government to quit”.
13. See The Straits Times, Singapore, 1.2.1998, “Paper trails points to illicit Bhutto hoard”, and 2.6.1998, “The Scandals”.
14. See Washington Post, 9.6.1998; “Corruption Flourished In Abacha’s Regime. Leader Linked To Broad Plunder”.
15. See Financial Times, 14.3.1995, “Strong Debut for Unified Rand” and Rose-Ackerman, 1999: 11.
16. See The Hindu, 10.1.2000, “Investors see Red in Karnataka”.
17. See The Wall Street Journal, 14.7.1998, “Speak No Evil: Why the World Bank Failed to Anticipate Indonesia’s Deep Crisis”.
18. Forming lobbies does not only aim at broadening the interests involved but also at obtaining a better bargaining position. Vis-a-vis a corrupt bureaucrat or political leader, individuals may come to realize that paying bribes is too costly. Uniting their interests by forming a cartel, they may attempt to redistribute rents on their behalf. In public procurement they can form a cartel which hands out small bribes to a public servant for awarding contracts and then determines the actual contractor according to some prespecified rules. Something similar may happen to lobbies which cooperate only with the intention of increasing their rents at the expense of a corrupt public sector.

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