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Rent-Seeking: A Primer

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Readers of *Ideas on Liberty* often come across references to the term "rent-seeking." Usually from the context it's plain that it refers to something undesirable, but what exactly is it?

The idea of *rent* is an old one in economics. In mainstream economics it refers to a payment to the owner of a fixed factor of production over and above its "opportunity cost," that is, what it could fetch in its next most profitable use. In the case of land, for example, any payment to the owner of a particular parcel beyond the cost of, say, clearing and leveling it or for its "permanent and indestructible qualities" was traditionally considered rent.[1]

There are those, including nineteenth-century social critic Henry George, who believe that such payments are wasteful because (1) they could have been spent to bring other goods into existence, such as houses or food, instead of being used merely to transfer ownership of an already existing commodity from one person to another, and (2) they do nothing to increase the supply of the fixed factor. Does this mean that the pursuit of rent is a bad thing because it's wasteful? No, not in this case.

Let's examine the first argument. A pure rental payment for a fixed factor such as land, whether it's paid in increments over time or all at once in a lump sum, doesn't merely move a product around from one person to another. (In fact, land doesn't even do that because it isn't movable, except near places like the San Andreas fault, where occasionally it is.) But what rent does help to do is encourage the transfer of land ownership from a less-profitable use to a more-profitable use—from, say, a housing development to agriculture, if growing crops will fetch a higher profit than building houses on the land. In this way, the transfer, and thus the rental payment, is part of a process that increases *wealth*.

Here it's important to realize that *production* in economics has nothing necessarily to do with the physical transformation or movement of things, but rather with the *creation of value*, which is subjective in nature. For instance, if John and Mary, without either one using force or fraud, trade ownership of an apple and an orange, both necessarily expect to feel subjectively better off as a result (or else at least one of them wouldn't agree to the trade) because each will be giving up something he or she values less for something he or she values more. The net gain in subjective value that each one feels constitutes newly created wealth. In developed societies this is how most wealth is produced, by free trade.

Likewise, the consumers of food generate for the landowner a greater excess of revenue over cost than do potential consumers of the houses that could have been built on

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the land. Rent is a fixed payment to the owner for using the land in a more valuable way, in terms of willingness to pay.

How does anyone know which use is most valuable in this sense? No one can know for certain, but the entrepreneur-owner of the land has a strong incentive to decide correctly who should have the ultimate use of it, consumers of food or of housing, because he stands to earn a profit for making the right choice and suffer a loss for the wrong choice. *Resources that entrepreneurs spend in seeking rent, insofar as they improve their chances of making wealth-increasing decisions, are not wasteful.*

The second argument against rent is that rents don't increase the supply of land. However, economists think dynamically (or at least they should), and that means taking into account what happens over time as the unknowable future becomes the partially known present. From this perspective it's possible to view the rent that a particular tract earns for its owner as something that could very well induce other profit-seeking entrepreneurs to invest in the clearing or filling in of more land when working space becomes scarce enough. That is, *rent can serve as an incentive to produce more space in which further valuable work can take place.*

So, from the point of view either of efficiently allocating existing working space or of creating new working space, rent aids in the creation of wealth.

Rent-Seeking Defined

Where then does the bad connotation of rent-seeking come from?

Gordon Tullock, one of the pioneers in the theory of rent-seeking, has defined it as "the use of resources for the purpose of obtaining rents for people where the rents themselves come from some activity that has some negative social value."[2]

We've seen how rents generated in the free market have a positive "social value," insofar as we can agree that creating wealth is a good thing.[3] Thus no negative connotation would attach to free-market rent-seeking, that is, spending resources to acquire land rent or any other privately acquired rent. Tullock is referring to those activities that destroy wealth. Nevertheless, people sometimes feel uncomfortable with the free market because they're unable to differentiate profit-seeking from (bad) rent-seeking.

According to the principle of human action that Ludwig von Mises used as the starting point of economics, *man acts in order to improve his situation as he sees it.* One of the important lessons taught by Mises, and later many of the adherents of the Public Choice school of political economy, who follow in the footsteps of Tullock and James Buchanan, is that while the principle of human action is universal, the particular actions chosen, and the consequences that follow from them, depend crucially on the "rules of the game."

If the rules say that the acceptable way to improve your situation is to provide a product or service that consumers would be willing to pay more for than the opportunity cost of the resources used, then that's what you'll tend to do. In that case, if you're correct, and if you can out-compete your rivals in the market for those consumers' dollars, then your actions will have added wealth to society. This is profit-seeking.

On the other hand, if the rules say that it's okay to use *political means*—the government's authority to initiate violent aggression and fraud—to contrive rents by preventing others from competing with you or by forcibly taking the wealth of others, people will naturally tend to spend valuable resources trying to gain access to them. This is rent-seeking.

But unlike profit-seeking, rent-seeking doesn't create wealth, it merely transfers it from one party to another. Whoever wins rents by using political means may be better off, but others, potential competitors, but more importantly consumers, will be made decidedly worse off. The latter will pay higher prices, get poorer quality, or have fewer choices because political means are quite effective in discouraging rival entrepreneurs. The results of rent-seeking also stifle the competitive discovery process, so that consumers are less likely to become aware of more efficient methods or better providers.[4]

Thus the resources that competitive rent-seekers spend in their quest for these politically created rents are indeed wasted because they are used to produce an outcome in which nothing of value is created. Indeed, rent-seeking of this kind destroys wealth.

Rent-Seeking Versus the Rule of Law

So far we've seen that rent-seeking is undesirable because it's wasteful. In addition, however, because it usually takes the form of restrictions on competition or on the use of property rights, the desire to gain rents through political power distorts the operation of the market process. Such distortions, especially as they impinge on interest rates and the prices of goods and services, make it harder for consumers and producers to plan for the uncertain future, increasing their chances of error.

But an even more serious problem at the level of social norms is that rent-seeking tends over time to encourage growing numbers of ordinary people to engage in it, trying to acquire political power either to gain advantages over the less powerful or as redress against the mounting advantages and political power of others. It thereby sets into motion a troubling dynamic that over time progressively erodes respect for the rule of law, limited government, and private property.

The rule of law binds the government by rules that are fixed and announced beforehand, and are not intended to benefit or harm any particular persons or groups. For example, a rule that forbids anyone from engaging in fraudulent advertising is in accord with the rule of law, whereas a rule granting a monopoly privilege to a particular firm or union is not. Like private property, the rule of law serves to protect individuals against arbitrary government interventions, and as such it's one of the pillars of personal liberty, limited government, and the free market.

Rules of the game that beget rent-seeking are clear violations of the rule of law because they arbitrarily privilege some at the expense of others. This in turn gives people an incentive to spend resources either to associate themselves with the winners or distance themselves from the losers. The desire to capture politically generated rents is a fundamental motive for interventionist breaches of the rule of law. At the same time, rent-seeking tends to prevail to the extent that citizens permit government to violate the rule of law. A politico-economic system that strictly observes the rule of law would perforce ban rent-seeking.

The difference between profit-seeking and rent-seeking is akin to that between peaceful trade and armed robbery. Both require time, energy, and skill, but one creates wealth while the other destroys it; one encourages peaceful cooperation, the other undermines it. □

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1. Ludwig von Mises and Murray Rothbard defined rent differently, as simply the payment for the services of any durable commodity. Since this primer is concerned with explaining the meaning not of rent itself but of rent-seeking, which is based on mainstream-economics concepts, it would not be appropriate to address these differences here. On this see Ludwig von Mises, *Human Action*, 4th rev. ed. (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996 [1949]), pp. 635–37, and Murray N. Rothbard, *Man, Economy, and State* (Los Angeles: Nash, 1970 [1962]), p. 249.

2. Gordon Tullock, Gordon Brady, and Arthur Seldon, *Government Failure* (Washington, D.C.: Cato Institute, 2002), p. 43.

3. Tullock uses the term "social" value, but he is simply referring to the new wealth that each individual experiences, viewed as a whole. If economists try to suggest anything more than this by the term, they're probably making a big mistake.

4. Any attempt to compete with those protected by such privilege is a challenge to the power of the state. As a matter of fact, because political rent-seekers rely on the government's authority to initiate aggression and fraud their gains essentially come from robbery at gunpoint.