

Chapter 1. Rents, Efficiency and Growth

Mushtaq H. Khan.

(in Khan, M.H. and Jomo K.S. ed. *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press 2000).

For the economist, *rents* refer to “excess incomes” which, in simplistic models, should not exist in efficient markets. *More precisely, a person gets a rent if he or she earns an income higher than the minimum that person would have accepted, the minimum being usually defined as the income in his or her next-best opportunity.* A glance at the real world tells us that rents as excess incomes are widespread in all types of economies. Rents may take the form of higher rates of return in monopolies, the extra income from politically organized transfers such as subsidies, or the extra income which comes from owning scarce resources, whether natural resources or specialized knowledge. What does economic theory say about the effects of such excessive incomes or “rents”? This chapter begins with an analysis of rents in conventional neoclassical economics and proceeds to examine how this analysis needs to be extended (and, to some extent, has already been extended in recent years) to analyse the different types of rents which exist in real economies. Drawing on both neoclassical and non-neoclassical economic theories, we see that the efficiency and growth implications of different rents can be very different.

While some rents are indeed inefficient and growth-retarding, other rents play an essential role in growth and development. This variability has important policy implications. The identification of some rents as “efficient” challenges the policy rule-of-thumb of the liberal market model which says that the removal of institutions and rights which protect rents is *always* desirable as a way of moving towards greater efficiency and better economic performance. While this model has the seductive advantage of simplicity, it is often wrong. If some rents are essential for efficiency and growth while others are damaging, more complex institutional and market reforms may be required. Managing development may, in fact, require the continuous discrimination of efficient from inefficient rents by policy-makers and analysts. Consequently, getting the institutional framework right may be more complicated than simply trying to move towards the benchmark of a no-rent competitive market economy. Conversely, the absence of diligence by policy-makers, changes in political and technological conditions or even unplanned institutional evolution may easily make an efficient system of rents inefficient over time. These possibilities clearly have important policy implications for contemporary development debates.

The definition of rent as excess income should not be understood to imply that rents are always wasteful or inefficient. A typical textbook definition of a rent is “the portion of earnings in excess of the minimum amount needed to attract a worker to accept a particular job or a firm to enter a particular industry” (Milgrom and Roberts 1992: 269). But note the precise form of words used by Milgrom and Roberts. The “minimum amount needed to *attract*” suppliers of inputs (such as workers and capitalists) to particular industries should not be confused with the payments which may actually be necessary to induce them to *produce* the good or service. The difference between the two is not always clearly made, but is central to the analysis of the efficiency and growth implications of rents and deserves careful attention.

The economists' notion of the "minimum amount" necessary to attract inputs which go into the production of a good or service is usually based on looking at what the providers could have earned in their next best alternative. Consider the following example of earnings in the steel industry. If capitalists earn a return of five per cent and workers earn 15,000 dollars a year when the next best alternative of the same capitalists would be to earn a return of four per cent in coal production and of the same workers, wages of 14,000 dollars a year elsewhere, then our definition tells us that the steel industry earns rents for both its capitalists and workers. What we do not yet know is whether steel could actually have been *produced* if capitalists were forced to accept four per cent and workers 14,000 dollars a year in the *steel* industry. If indeed steel could actually have been produced for less, then the rents signal inefficiency because overall production in the economy is lower than would have been the case. If, on the other hand, steel of the appropriate quantity and quality would not be produced if capitalists and workers were only paid what they could earn elsewhere, then paying them these rents may *not* be inefficient, even though they would still be rents. Later we will see a number of reasons why such rents may be necessary in many cases.

Thus, while rents are *always* excess incomes in terms of what the recipients would have accepted given their next best alternative, they are *not* always excess payments in terms of what it is *necessary* to pay them to produce the good, provide the service or carry out the activity in question. It follows that rents can sometimes be efficient and in other cases they may be essential for promoting growth and development. This distinction was often glossed over in the older analysis of rents within neoclassical economics. The earlier analysis was dominated by a model of perfectly competitive markets as the benchmark for studying market economies. In this model, there is no difference between the minimum amount which labour or capital would notionally accept and the amount which they would *actually* accept to provide the good or service in question.

This is because the early neoclassical model did not consider any of the reasons for which capital or labour may require *special* rewards in particular sectors. New technology simply appeared from nowhere and did not have to be produced or learned, property rights already existed and did not have to be created, labour could be costlessly managed, information was free and symmetric, so no incentives had to be created for information to be efficiently used, and most important of all, conflicts over property rights did not exist and so transfers to maintain political equilibrium were not necessary. In fact, all the features of society which we would describe as the subject of institutional economics or political economy were deemed to be irrelevant for analysing production and exchange. In this imaginary world, to get any good, it was only necessary to pay the producers what they could earn in their next best alternative. Any payment higher than this (in other words any rent) was an unnecessary waste. It followed that rents were always inefficient in the simple neoclassical model of a competitive economy, and conversely, inefficiency could be identified by looking for rents.

While these policy implications persist even today, they are based on a selective reading of the neoclassical analysis of rents. Even the older neoclassical analysis recognized that there were some types of rents (such as natural resource rents), which could not be removed without reducing the efficiency of resource use. More recent developments within neoclassical economics in the analysis of asymmetric

information (summarized in Stiglitz 1996) and institutions (see Milgrom and Roberts 1992) have shown that the competitive market model may be more fundamentally flawed. These developments suggest that rents may be essential for ensuring that markets work by creating incentives for information generation and monitoring. In fact, the role of super-profits in inducing technical progress in market economies can be traced back at least to Schumpeter (1994, first published 1943), and in fact, to Marx's analysis of innovation in a capitalist economy in *Capital* Volume 1. These arguments had shown long ago why some rents were necessary to ensure that particular types of goods or services are provided.

Our analysis of rents can be substantially extended by introducing some insights from classical political economy. Classical economists were interested in the size and allocation of the *economic surplus* which constitutes the potential investment fund of a society. In particular, they were concerned with the allocation of the surplus since this determined growth. The surplus could be productively invested or "wasted" in luxury consumption, and even when it was invested, its allocation across sectors could determine the rate of growth achieved. While there were differences between classical economists, they defined the surplus not as the *excess* income of any group, but rather as the income accruing to *property owners* after paying the direct costs of production. In a capitalist economy, the principal property owners are capitalists, but landlords and some of the middle classes may also be recipients of parts of the economic surplus. What is interesting about the classical analysis is that distributive conflicts and the associated re-allocations of the "economic surplus" can determine the rate of growth. Thus, like rents, surpluses can be associated with a wide range of economic outcomes, depending on the technological context, and the type of distributive conflict going on over the allocation of the surplus. Since rents too can be the subject of distributive conflicts, the classical analysis is of immediate relevance.

In this chapter we will compare a number of different types of rents and outline their possible efficiency and growth implications. We see that some forms of rent can signal inefficiency or lost growth opportunities while others may signal the reverse. Indeed, some rents may be essential for growing and efficient economies, particularly in the context of development. However, "good" rents are often only effective under well-defined conditions and can become "bad" rents if these conditions change. The existence of rents may also result in a further set of potentially wasteful activities which seek to create, maintain or redistribute these rents. These rent-seeking activities are discussed in our next chapter. The discussion in this chapter is important for the next because the rent-seeking literature has often assumed that rents are *always* socially harmful and that their existence signals adverse effects for efficiency or growth. This is a misleading and restrictive view of rents in general, particularly in developing countries, and has important implications for the analysis of rent-seeking.

The first six sections in this chapter look in turn at a number of different types of rent. In section 1.1 we look at the neoclassical analysis of monopoly rents. The negative efficiency implications of monopoly rents have informed much of the neoclassical analysis of rents. The limitations of this analysis particularly for analysing growth are by now well known and will be briefly reviewed. In section 1.2, we look at natural resource rents which accrue to owners of privately owned natural resources in scarce supply. In contrast to monopoly rents, the existence of natural resource rents often signals efficiency in resource allocation and may be a precondition of growth.

Section 1.3 looks at politically organized transfers which constitute another type of rent. Their efficiency and growth implications can vary widely across countries. In developing countries, the state is involved not only in redistributing incomes (as in advanced countries), but also for creating new property rights, and often entirely new economic classes. This type of “redistribution” was described by Marx as “primitive accumulation”. The same process of seizure or transfer of assets in developing countries is nowadays often described in the language of rent transfers and rent-seeking. Ugly as they are, these processes are closely associated with the emergence of the first few generations of capitalists. But such transfers can also result in tremendous wastage and theft without anything like a productive capitalist class ever emerging. Why the outcomes of primitive accumulation differ across countries is one of the key questions facing political economy. At the same time, political stability in developing countries often requires redistributions of income, often not to the very poor but to emerging middle classes who have organizational and political power. The rent allocations to these classes can have additional negative implications for efficiency and growth.

The last three types of rents are closely related in that each has something to do with information and institutions. They are the subject of the new institutional and information economics. Section 1.4 looks at Schumpeterian rents which reward innovations. These rents can be both efficiency and growth enhancing, but not in all circumstances. Section 1.5 develops the concept of “rents for learning” which are particularly important in developing countries. The main difference with the Schumpeterian rent is that these rents are artificially created by states to accelerate learning in infant industries. While in theory, rents for learning can be growth and efficiency enhancing, compared to Schumpeterian rents, they can more often become counter-productive. Section 1.6 looks at rents which reward good management. This is an area where extensions of the efficiency analysis of neoclassical economics have begun to overlap to some extent with the surplus approach of Marxian economics. In both frameworks, part or all of the surplus which capitalists earn can sometimes be functionally necessary for growth and efficiency. The capitalist surplus is certainly associated with growth in the Marxian analysis even though the surplus is not *justified* by this functional role.

Each of these rents is relevant for understanding the role of rents in economic development, and therefore, the consequences of *rent-seeking* which are examined in the next chapter. In presenting this analysis we will use some simplified diagrams to look at the consequences of different types of rents. Economists may find large parts of the first two sections dealing with monopoly rents and natural resource rents to be well-known territory and may skim through the familiar parts of these sections. The subsequent sections should be of interest to economists as they go beyond the conventional analysis of rents. Some non-economists may find the diagrams difficult though we have tried to keep them as simple as possible. They are not absolutely essential and readers who find them difficult can skim through the paragraphs dealing specifically with diagrams without losing much of the story. Section 1.7 discusses the classical economic surplus and the insights it can provide for the contemporary analysis of rents. Finally, in section 1.8 we compare some of the characteristic features of the types of rents we have discussed and the underlying property rights which sustain them.

1.1 Monopoly Rents

The most commonly used assumptions about rents comes from the analysis of monopoly in contemporary neoclassical economics. Here market restrictions and the resulting monopoly rents are counterposed to competitive rent-free markets. To understand the limitations of this analysis of rents, it is best to remind ourselves of the underlying neoclassical analysis of markets. In this analysis, competition is defined by the absence of barriers to entry and exit. Profit-seeking firms produce more of a product if its price is higher than the cost of producing one more unit (the marginal cost), or they reduce output if the price falls below the cost of producing the last unit. Freedom of entry and exit ensures that no rents are earned because if any producer is earning a rent, others will enter, driving down the price. The analysis then focusses on a narrow definition of efficiency which is achieved when competition wipes out all rents. In the no-rent situation, it must be the case that for *every* product, the cost of producing the last unit is exactly equal to its price. Once this position is reached, if more of any product was to be produced, its price would fall below its marginal cost and society would be producing a product at a higher cost than it was worth. If less of any product was produced, its price would rise above cost, and society would forego the opportunity of producing a product which was worth more than it cost to make. Thus, net social benefit (the difference between the social value of the output and its cost) is maximized at the no-rent position.

This analysis of the benefits of competition ignores the important process through which competition ensures that technologies improve over time. The neoclassical analysis of efficiency is therefore often described as a static analysis. The implications of this analysis for rents can be very misleading, as we will see later. Nevertheless, this static story has played a central role in policy and is summarized in Figure 1.1.

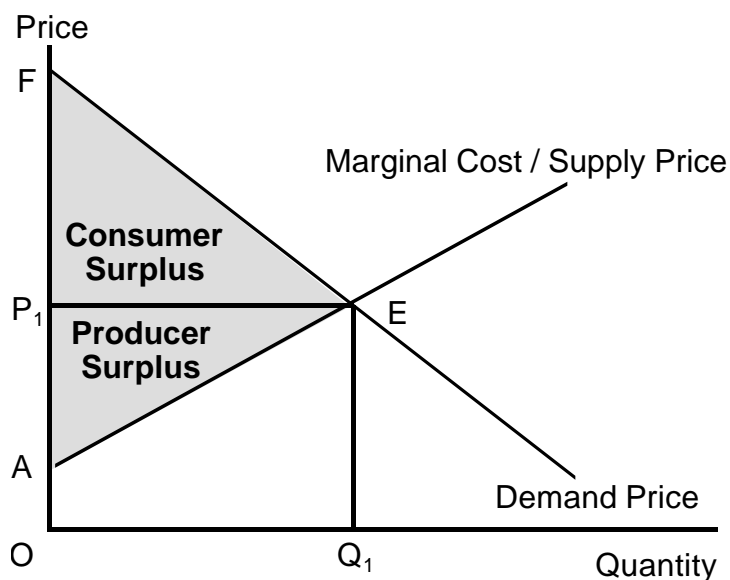


Figure 1.1 The Competitive Market Equilibrium

The demand curve shows the price consumers are willing to pay as the quantity marketed changes. Since the price usually has to fall to attract additional consumers, the demand curve is typically downward sloping. In contrast, the marginal cost curve is typically shown to be upward sloping because it is assumed that the cost of

producing additional units will increase as more is produced. But marginal costs may remain constant or even fall if there are economies of scale. Falling costs can create problems for a competitive market. With falling costs, larger producers have a cost advantage, allowing them to dominate the market and eventually behave like a monopoly. We will return to this problem in a while.

With unrestricted entry and exit, if the price consumers are willing to pay (shown on the demand curve) is higher than the marginal cost, the quantity supplied will increase, and vice versa, so that in equilibrium, the quantity produced is OQ_1 , at price OP_1 . The last unit sold now costs OP_1 to produce, and sells exactly at this price. The producer of the last unit can exactly cover all costs and therefore earns no rent. This is the basis of the claim that there are no rents in competitive markets.

The area under the demand curve in Figure 1.1 shows the total value to consumers of different levels of output (the value of output OQ_1 is thus $OFEQ_1$). The area under the cost curve shows the total cost incurred at that level of output ($OAEQ_1$ at output OQ_1). Since the net social benefit is the difference between the social value of the output and the cost of production, the diagram allows us to read off the net social benefit at each level of output as the area between the two curves (as long as there are no external costs or benefits). Thus at output level OQ_1 the net social benefit is $OFEQ_1 - OAEQ_1 = AEF$. By comparing different levels of output, we see that the net social benefit is highest at output OQ_1 . The competitive market achieves this simply through the profit-seeking entry and exit of producers and the free adjustment of prices. The no-rent competitive outcome is thus *efficient* where efficiency means the maximization of net social benefit with given technologies. This is the most important result of the neoclassical analysis of markets.

An important qualification needs to be made here. The claim that there are no rents in a competitive market is actually a shorthand for a much more limited claim which is that there are no rents in the production of the *last* (or marginal) unit. The absence of rents for the marginal producer in a competitive market does not mean that *no-one* earns more than the minimum they would have asked for. In fact, if marginal costs are rising, as in Figure 1.1, it means that all but the last unit could have been produced at a cost lower than the final market price. But why should marginal costs be rising? After all, if existing production facilities can be replicated, it should be possible to produce additional units at the same cost as previous units. Ultimately, rising marginal costs must be due to some resources being in limited supply so that when production increases, the price of these inputs is bid up, increasing the cost of producing additional units.

When the price of an input of a particular kind is bid up, those already supplying it experience a windfall increase in their incomes. These suppliers now earn more than the minimum they would have accepted in the past, though in this case they are not earning more than in their next-best opportunity because the price of what they supply will go up across the board. For instance, if wages rise to attract more of a particular type of labour, workers already in work get a windfall. Graphically, this surplus is shown in Figure 1.1 by the triangle AEP_1 , which is the cumulative surplus which earlier factor providers collect at the output level OQ_1 . This surplus has a rent-like character and is called the *producer surplus*. It measures the difference between what firms actually get paid, OP_1EQ_1 , (the price OP_1 times the quantity OQ_1 sold) and the notional minimum total cost of producing OQ_1 (the area $OAEQ_1$).

The minimum cost $OAEQ_1$ is notional and is not necessarily the cost which the firm is actually able to pay. It would only be the actual cost if each unit could be produced at the cost shown along the marginal cost curve. This could only happen if workers (or owners of other resources) who are *already* employed are prevented from raising their wages when they rise to attract *new* workers. This would be extremely difficult to organize as there would undoubtedly be a strong perception of injustice. Nevertheless, if the firm could pay identical factor suppliers differentially, the producer surplus would accrue to the *firm* and would be a rent for the owners of the firm. More likely, the producer surplus remains a notional rent which is captured by *factor providers* in the form of windfall gains when their resource becomes more expensive.

Consumers too capture an equivalent surplus, known as the consumer surplus, which is shown by FEP_1 in Figure 1.1. The consumer surplus arises because it is not usually possible to charge each consumer a different price, despite the fact that different consumers value the product they purchase differently. All but the last consumer would actually have been willing to pay a higher price for the product they purchase than the price OP_1 which everyone ends up paying. This is the source of the consumer surplus which is a collective welfare gain for consumers, just as the producer surplus is a gain for producers. The consumer surplus is important in welfare economics but will not concern us further. Unlike the producer surplus, the consumer surplus does *not* have a rent-like character given our definition of rent.

The producer surplus is not given much attention in textbooks and is not treated as a rent because it is usually unavoidable given factor scarcities. An unavoidable rent is not inefficient in the sense that net social benefit cannot conceivably be increased. Moreover, as we can see in Figure 1.1, the producer surplus is itself a part of the net social benefit which is maximized by the competitive market. Clearly, the existence of the producer surplus is not in itself a problem. Its existence, like that of any other rent, would only be a problem if it signalled a lower net social benefit.

This competitive market model, static though it is, provides the benchmark for the neoclassical analysis of rents and, in particular, of monopoly rents. This is unfortunate because this model ignores some of the important benefits of competition and markets in the real world, while identifying a number of conditions under which markets achieve efficiency which are not relevant in reality. We will return to these problems in our subsequent discussion. We now turn to how this static approach models the implications of monopolies and monopoly rents. While the existence of the producer surplus appears not to detract from the efficiency of the free market outcome, the existence of monopoly rents does. Monopoly rents for firms emerge as a result of entry barriers which allow firms in protected markets to charge higher prices for their products. Entry barriers can be “natural” when the technology of production involves large economies of scale such that a single large producer can undercut newcomers. More importantly, entry barriers can also be state-created, based on exclusive production rights for particular producers.

Figure 1.2 shows the case of a state-created monopoly, where one producer is given the right to determine the level of output in that market. The monopoly can restrict output and raise prices and other suppliers cannot enter. While it is rarely the case that there is only one producer in any market, monopolistic behaviour only requires *market power*. Market power is the ability of one or more firms to raise prices by

restricting output in a context where new entrants cannot enter, for whatever reason, to reduce prices.

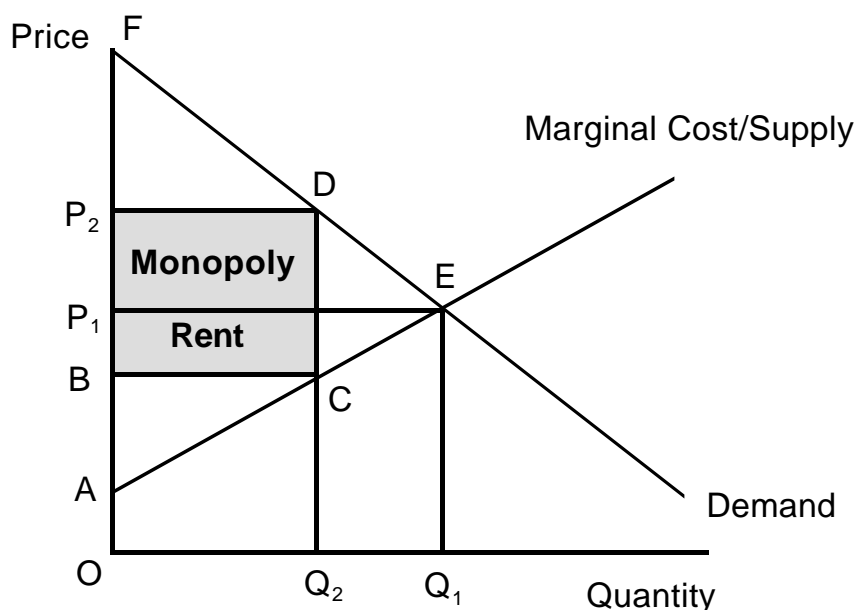


Figure 1.2 Rents Created by Monopolistic Restrictions

The restriction of supply, say to OQ_2 , raises the price which consumers are willing to pay to OP_2 , while the marginal cost of producing the smaller output is OB . As a result, the last unit produced by the firm now costs less to produce than its price. The difference gives the firm an above-normal profit of CD on the last unit, which is technically a rent because the firm earns a return higher than it could have earned in its next best alternative (which is the rate of return in a no-rent market). Since this above-normal profit is earned on each of the OQ_2 units produced, the total rent earned by the firm is shown by the shaded rectangle $BCDP_2$. The level of output OQ_2 is determined by the monopolist to maximize the size of this rent. The monopoly profit is a rent which enriches the firm at the expense of a lower producer surplus and a lower consumer surplus. Technically, the monopoly rent itself (like the producer surplus) is not a problem, because it is part of the net social benefit of producing OQ_2 of output. However, it does *signal* an inefficiency which is attributable to the reduction in production from OQ_1 to OQ_2 .

Consider Figure 1.3, which is similar to Figure 1.2, but which shows, in addition, what happens to the consumer and producer surplus as a result of the monopolistic restriction. The net social benefit (the area between the demand and cost curves) when output is OQ_2 is the area $ACDF$. This can be broken down into the remaining consumer and producer surplus *and* the rent. It is worth repeating that the rent itself is not a loss as far as society is concerned. It is notionally a transfer from consumers and factor suppliers to the owners of the firm since it is composed of what was previously part of the consumer and producer surplus.

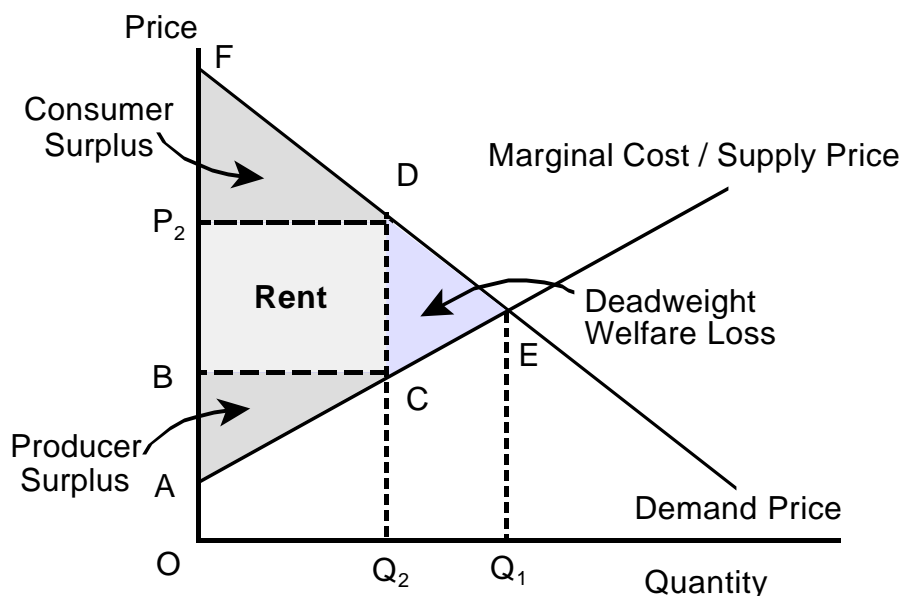


Figure 1.3 Rent, Consumer Surplus and Producer Surplus under a Monopoly

The *social* cost of the monopoly is the net social benefit which is lost as a result of the monopoly. In Figure 1.3 the lost net social benefit (known as the deadweight welfare loss) is measured by the little triangle CDE. The monopoly results in lower output compared to the competitive market, and CDE measures the net social benefit which is lost as a result of this lower production. Thus the rent BCDP₂ does not directly measure the cost of the monopoly. It *signals* an allocative inefficiency (too few resources are devoted to producing this particular product) whose social cost is measured by the little triangle CDE. This is the net social benefit lost to society collectively.

This measure of the social cost of the monopoly is only a first approximation. An implicit assumption in the argument so far is that a competitive structure of industry is possible which could produce OQ₁ of output, in other words, that the monopoly is avoidable. In fact, many monopolies are natural monopolies, which means they are created not by artificial entry barriers but by economies of scale in production, which result in one producer dominating the market because of lower costs. In this case the deadweight welfare loss due to the monopoly has to be compared to the social cost of breaking up the monopoly into smaller units each of which has higher marginal costs. The best policy response in this case may be to allow the monopoly to exist but to regulate its prices, and if necessary, to subsidize it to produce the optimal quantity.

The static welfare analysis, on which the neoclassical critique of monopoly has been based, misses a number of key features of real world competition and monopolies. First, it misses one of the main benefits of competition, which is to create strong incentives for cost reductions. The cost curve in the diagrams we have seen so far appear to be technically determined, but in reality, the level of cost depends on how much effort management takes in keeping costs down. Management is more likely to make an effort if it faces competitive pressures than if it is a monopoly. The inefficiency due to higher costs under monopoly is sometimes described as X-Inefficiency to distinguish it from the allocative inefficiency which the static analysis looks at. If the absence of competition keeps costs high, the actual social cost of a

monopoly may be higher than is suggested by the deadweight welfare loss of CDE in the analysis in Figure 1.3. However, while competition may be important for reducing X-Inefficiency, this does not mean that we need the *perfect* competition of the neoclassical model where all rents are absent. In the real world, a small number of firms, each of which exercises market power (in that they can keep prices above marginal cost), may be engaged in vigorous competition which keeps their cost curves low. Indeed, we will see later in our discussion of monitoring rents that a real-world competitive economy often relies on rents to maintain cost efficiency, a feature which is missed in the standard neoclassical model.

Secondly, the simple neoclassical analysis ignores the incentives necessary for technical progress which reduces costs *over time*. In the long-run, cost reductions depend on a number of factors, and in particular, on investments in new technologies. The growth implications of monopolies in a dynamic analysis are less clear-cut. On the one hand, if monopolies reduce the net social product this can result in lower levels of investment throughout the economy, and thereby in lower growth. On the other hand, the accumulation of large profits by monopolistic firms may induce *more* investment, particularly if deficiencies in capital markets make it difficult for smaller producers to raise capital collectively. As for the incentives for investment, we will see later in our discussion of Schumpeterian rents that investments in new technologies usually require rewards for innovators, and these rewards also have the character of rents. What is more, these rents are often indistinguishable from monopoly rents, as innovators often enjoy a monopolistic position in the market, if only temporarily. Thus monopolies may reduce investment and make investment allocation worse, but if they are not permanent monopolies, they may sometimes result in increased investment and create incentives for technical progress. The overall effects of monopolies can therefore vary from case to case and will depend on the specific technologies, markets and firms involved.

In developing countries, the discussion of rents often assumes that all rents are monopoly rents, and furthermore, that the effects of these monopoly rents can be adequately analysed in terms of the static neoclassical model. Even in the extreme case of monopoly rents created by government protectionism to favour cronies, their dynamic effects are not always clear cut. There may be genuine economies of scale in these industries, and super-profits may create incentives for greater investment, which can counter to some extent the static inefficiency and Xinefficiency effects of the monopoly. In other cases, monopoly rents may indeed signal lost output and growth opportunities. To examine these possibilities we have to press on with our examination of other types of rents.

1.2 Natural Resource Rents

The role of rents is very different in the case of scarce natural resources, such as fishing waters or pasture lands, which produce a stream of renewable benefits. Here, the existence of rents signals efficiency, and the maximization of rents is socially desirable. If the rate of renewal of the resource is fixed, increasing the rate of extraction will raise marginal costs. For instance, in the case of a fishing lake, increasing the number of fish caught per period may require more and more time in finding fish as the supply of fish is depleted. The efficient allocation of resources requires that in each period, the natural resource is exploited to the point where the marginal cost, in this case of producing fish, is just equal to the marginal benefit.

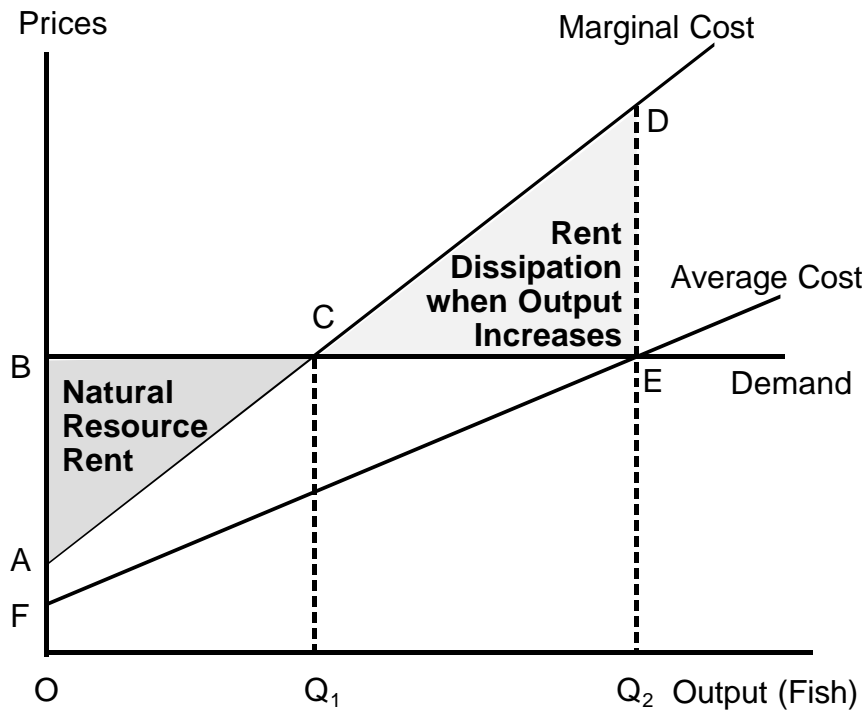


Figure 1.4 Natural Resource Rents

In Figure 1.4, the demand price of fish, (its marginal benefit to consumers), remains constant at OB . This means that producers can sell as much fish as they like at this price, say because the fish from this source are a small part of the total demand for fish. This is a simplifying assumption, introducing a downward sloping demand curve in this case makes the analysis more complicated without changing the essential result. The marginal cost of fishing is shown by the line AD which is rising for the reasons explained. The efficient allocation of resources requires OQ_1 of fish to be harvested in each period. This level of output equates marginal cost to price. The big difference with the competitive output discussed in the last section is that now, at the efficient level of output, the owners of the fishery earn a rent shown by ABC which is similar to the producer surplus in Figure 1.1. Unlike the usual producer surplus, this surplus accrues to the owners of the fishery (the equivalent of the firm). It is a return for the owners which is higher than their income in their next best opportunity *if they did not own the lake*. Thus this rent is clearly predicated on asset ownership in the classical sense. Yet it is a rent which (like the producer surplus in a competitive market) exists despite efficient allocation.

If the fishery did not belong to anyone, and if as a consequence anyone could go and fish in its waters, the rents which accrue to the fishery would be *dissipated* as a result of overfishing. Any output greater than OQ_1 earns a negative rent as cost is higher than value and this reduces the total rent depending on the extent of overfishing. The extent of overfishing will depend on the assumptions made about the number of fishermen, and their expectations about the behaviour of other fishermen (see, for instance, Dasgupta & Heal 1979: 55-73). Each fisherman enjoying free access to the lake will fish as long as the price of the last fish caught covers the cost of fishing. With a large number of fishermen, each catching a large amount of fish, the cost of catching the last fish appears to each fisherman to be the *average* cost of fishing. What this means is that with large numbers fishing, no fisherman is concerned with

the marginal cost of fishing, which may not be known to anyone. Instead, fishermen will fish as long as the selling price covers the average cost of fishing which they each face. With rising marginal costs, the average cost is arithmetically always below marginal cost.

In this case, fishing will continue up to the point OQ_2 , where price equals *average* cost. At this point, the total rent is ABC minus CDE (since CDE is a negative rent). The aggregate rent is therefore much lower, and could in principle be zero. In stark contrast to the monopoly case, rent dissipation here does not lead to efficiency, but rather the reverse. With OQ_2 fish being caught, social resources are being mis-allocated as the marginal cost of fishing exceeds the marginal benefit. Society would be better off with fishing resources allocated elsewhere. This is a simple version of the problem known as the free access problem or the *tragedy of the commons*.

The inefficiency which results from rent dissipation in the tragedy of the commons is widely recognized by economists who point out the efficiency-enhancing role of maintaining scarcity rents through the creation of property rights. The damaging effects of rent dissipation due to inadequate or absent property rights over natural resources is particularly important in developing countries. The *preservation* of rents in this case not only results in allocative efficiency, it may be a precondition for investment in, and the growth of, the natural resource sector. On the other hand, the creation of new property rights is inevitably associated with the creation of substantial rents for beneficiaries. Note that this is not an argument in favour of *private* property rights since communal or collective property rights may in some cases be more efficient in creating the right incentives for monitoring and preventing the over-use of resources. What it does mean is that sometimes it may be efficient to create property rights which generate rents, even though the creation of such useful rents may involve just as much rent-seeking (see Chapter 2) as the creation of wasteful rents.

1.3 Rents Based on Transfers

Rent-like incomes can also be created by transfers organized through the political mechanism. Even in developed countries, income from production is often supplemented or lost as a result of transfers through taxes and subsidies. In developing countries, these transfers are not just the source of additional sources of income, but are often the basis for asset accumulation, and indeed the emergence of new capitalists and emerging middle classes. Clearly, these transfers describe some of the phenomena of greatest interest in a development context. The transfer mechanisms include not just taxes and subsidies, but also transfers (both legal and illegal) which convert public property into private property. These transfers are rents since the income flows being engineered (which are sometimes converted into assets) are greater than any alternative incomes of the recipients.

Not all transfers are necessarily rents. Welfare benefits or subsidies to interest groups are transfers through the fiscal mechanism, but they need not be rents in their entirety. For instance, pensions where the recipient has made a contribution earlier in the form of pension contributions are a form of saving and not a transfer-based rent. Similarly, unemployment benefits are payments to unemployed workers for which, on average, they contribute through taxes during their working periods. In these cases, the transfer is not a pure rent for the recipient because it has a large component based on prior

savings or contributions similar to insurance premiums. However, in other cases, transfers may be pure rents for which no contribution has been made or is likely to be made in the future. Even in these cases, most economists would exclude transfers made largely for welfare reasons from the category of rents though there is clearly an area of ambiguity here. For instance, should we classify subsidies which keep alive declining industries as rents, if they also prevent workers from suffering sharp falls in income and welfare? By definition, these transfers are rents even though they are not usually treated as such.

The economic effect of a transfer has two components. First, the change in welfare depends on the valuation of the transfer by losers and gainers. In theory, if the losers and gainers valued the transfer equally, there would be no welfare effect for society. However, this is usually not the case, since a poor person would normally be considered to value a dollar higher in utility terms than a rich person, if we are willing to make inter-personal comparisons of utility. In other words, a transfer from the poor to the rich should lower social welfare and vice versa. Secondly, the welfare effect of the transfer has a second component, which works through the effect of the transfer on the incentives of those being taxed. This is usually negative.

Prices in Taxed Sector

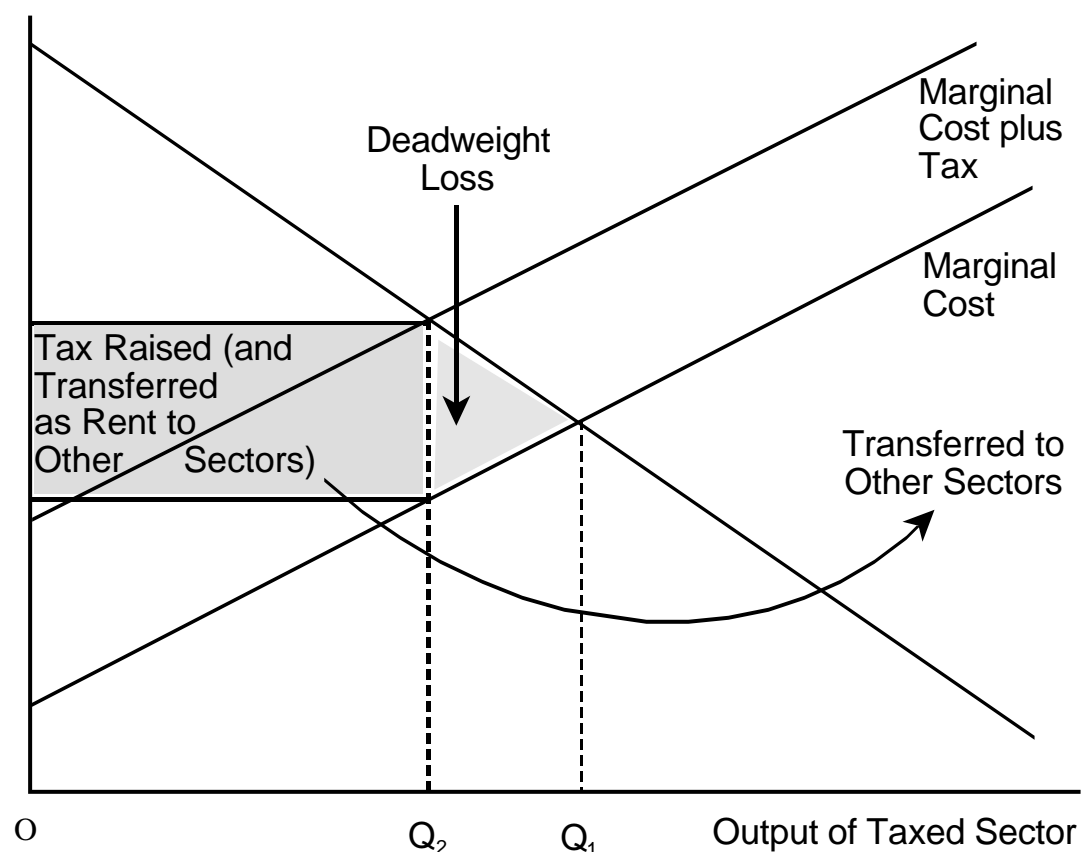


Figure 1.5 Deadweight Losses Due to Transfers in the Neoclassical Model

Figure 1.5 shows how the incentive effects are modelled in neoclassical economics for a single individual or firm being taxed to provide a transfer to some other

individual, firm or sector. Ignoring for the moment any differences in the valuation of the dollars transferred from the loser to the gainer, the figure shows that there will be an incentive effect as a result of the tax on the losers, which will result in reduced effort and output. The fall in output occurs because the tax effectively puts up the marginal cost of production and it is then no longer profitable for the individual or firm to keep producing OQ_1 any more. So even if the transfer itself would have left society as well off as before, raising the funds for the transfer makes society poorer if those who have to pay the tax work less hard and output produced declines from OQ_2 to OQ_1 . The social cost of this fall in output is, as before, equal to the small deadweight welfare loss triangle.

In fact, the monopoly rent discussed earlier was also a transfer from consumers and factor owners to firms. The difference is that there, the transfer was organized by the price mechanism, while here, we are discussing transfers through the political mechanism. However, there is a parallel because in that case too, the welfare loss due to the monopoly came from the deadweight welfare loss, and not the redistribution itself. In both cases, the negative efficiency implications of the transfer are likely to be smaller in magnitude than the transfer itself.

While this is the standard analysis of the effect of transfers in neoclassical economics, it may not be entirely relevant for developing countries. First, it may not be adequate for analysing the implications of a range of transfers in these countries through which new classes, and particularly capitalist classes, are being created. Secondly, the standard analysis also ignores the associated transfers required to make this process politically manageable. During the early stages of development, transfers (usually from the poor to the rich) are often instrumental in creating a future capitalist class. In advanced countries, one would have to go back further in history to find evidence of similar processes, but this is the only difference. Thus transfers in developing countries in the form of soft loans from state-owned banks or allocations of state-controlled land, are often similar in this respect to, say, the enclosures of common lands in England by emerging capitalists with the connivance of the state from Tudor times to the beginning of the Industrial Revolution. The major difference is that in most developing countries these processes are happening at a much more accelerated pace than in the time of the Tudors and with much greater public awareness of the injustices involved.

To the extent that the creation of capitalist property is a necessary precondition for capitalist development, the transfers which underpin the creation of these property rights may be a necessary stage in the development of a capitalist economy. While these processes are taking place, societies are likely to be in political turmoil. Traditional sectors, like the peasant economy or small scale informal manufacturing are likely to suffer from the transfers, with the attendant loss of incentives. On the other hand, in many if not most cases, these transfers do not succeed in creating a productive capitalist class, in which case they do not constitute “necessary” primitive accumulation but rather, primitive accumulation which has gone wrong and has descended into “unnecessary” theft and looting. The efficiency of primitive accumulation is clearly never going to be easy to assess. In some countries, these processes fail entirely and only create an “unproductive” capitalist class. In others, a productive capitalism does emerge, but the theft and corruption associated with primitive accumulation get embedded in the social system and are difficult to stop,

well after their social “usefulness” has become history.

A second and equally important set of transfers in developing countries are transfers to maintain political *stability* while primitive accumulation is going on. The magnitude and allocation of these transfers varies widely because developing countries differ in their social structures and the traditions of legitimacy which they have inherited. Nevertheless, in many developing countries classes of political intermediaries play an important role in managing the political system and appropriating and allocating substantial transfers to maintain a minimum degree of political stability. Given the inherent unfairness involved in processes of primitive accumulation, it has been relatively easy for political intermediaries from the urban petty-bourgeoisie, the rich peasantry and other emerging middle classes to organise popular opposition to the more brazen aspects of early capitalist transition. Since this opposition has typically been led and organised by members of emerging middle class groups left behind in the development process, it is more intense in societies where these groups are better organised and entrenched.

States in developing countries thus face intensely conflicting demands while allocating public resources through transfers. On the one hand, there are economic imperatives to develop a capitalist class and to make sure that in this process the transfers are not in turn transferred to Swiss banks, but actually help to generate growth. On the other hand, there are political imperatives which mean that transfers have to be organized to benefit those with the greatest ability to create political problems, often members of the emerging middle classes or multi-class factional coalitions.

The growth implications of the overall structure of transfers can be positive or negative. The outcome depends on how much of the transfers goes to individuals or groups who have the incentive and opportunity to make the transition to productive capitalism. It would also depend on the configuration of political forces which determines the structure of the transfers to political intermediaries and their factions, since these transfers can also have effects on incentives and opportunities. In some countries, transfers were associated with rapid accumulation and capitalist growth. In others, the result has been large-scale theft and the onward transfer of resources to foreign banks. The problem is that transfer-based rents were ubiquitous in *all* developing countries, not just in the stagnating ones. Thus it is misleading to argue that economic success required the *absence* of rents based on transfers. To make matters more complicated, the patterns of economic and political transfers which have resulted in successful transitions have varied quite a lot. What works depends not only on the strategy of accumulation but also on the underlying balance of political forces. This makes it difficult to analyse in a general way the efficiency and growth implications of transfer-based rents. Recent events in South-East Asia underline how easily processes of capitalist accumulation which are well advanced can suddenly get unstuck and face serious crises of legitimacy. In other countries, the structure of political payoffs which ensures legitimacy may be such that the accumulation process is much slower to start with. The Indian subcontinent provides an example of this more typical story of intensely contested and inefficiently allocated transfers (Khan 1996a; 1996b).

While we do not yet have general analytical models with which to assess the economic implications of these types of transfers, we have to include them in our

analysis of rents. Since the *pattern* of economic and political transfers matters much more than the fact that transfers take place, and since the pattern depends on how competing groups are organized, we will look at these processes in greater detail in Chapter 2 when we consider the process of rent-seeking. There we will compare differences in the patterns of redistributive transfers within patron-client networks in the Indian subcontinent, South Korea, Malaysia and Thailand at critical points in their development history. For now we only need to note that these transfers have the character of other rents, in that they are incomes higher than the recipient would otherwise have had. Secondly, the implications of these transfers are much more complex than the incentive analysis of neoclassical economics suggests, once we understand that transfers underpin both early capitalist accumulation and the political processes of maintaining legitimacy.

1.4 Schumpeterian Rents

The rents we discuss in this and the next three sections are closely related in that information costs or information failures are at least partially implicated in each case. In this section, we will define Schumpeterian rents as rents which emerge due to innovation and information generation. The generation of new information, in the form of innovations involving new technology, new institutional arrangements or even the use of information which notionally already exists, is not costless. The innovation or discovery process costs effort and may involve substantial risk. In such contexts, a type of rent which we will call Schumpeterian rent, plays a key role in ensuring that efficiency and growth are sustained. Like natural resource rents, Schumpeterian rents create incentives for the efficient use of a scarce resource, in this case the *ability* to find and use existing information or generate entirely new information. We first look at the role of Schumpeterian rents in the case of new innovations. We then see that a similar set of rents is implicated in the everyday generation of information in all markets, which traditional neoclassical economics had ignored.

Schumpeterian Rents for Innovators. Suppose an entrepreneur has innovated a better product, or a way of making an existing product more cheaply, which other entrepreneurs cannot instantly copy. The innovating firm then has an advantage over its competitors and is able to earn a rent. The rent is generated because the firm has either a cost or a quality advantage over its competitors, which allows it to earn a higher return for some factor owners compared to their next best alternatives. These rents, which we will call Schumpeterian rents (following the analysis of innovation by Schumpeter 1994: 72-106), are very similar to the excess returns or super-profits which Marx identified as the driving force behind technical progress in capitalism (Marx 1979: esp. 429-438). Although Schumpeter is widely credited for having made the link between the search for excess profits and innovation, in fact Marx made this point well before Schumpeter. Marx's analysis is richer in a number of respects, including the way in which innovation in his analysis can be both technical and institutional. A reorganization of work in the factory which uses existing capital and labour *differently* could be partly a technological and partly an institutional innovation. What is important is that the innovating entrepreneur earns a return higher than the next-best (or average) entrepreneur.

The source of the rent in this case is that the entrepreneur has a resource (knowledge, often embodied in a machine) which is non-reproducible in the short run. Like the

owners of factors of superior quality or in scarce supply who are earning a producer surplus in Figure 1.1, firms which “own” the innovation are able to earn a rent which is very much like a producer surplus. In Schumpeter’s story, or in Marx’s description of capitalist innovation in *Capital*, the scarcity of the innovation is “natural” and is based on the fact that other entrepreneurs cannot imitate the innovation very rapidly. In other cases, particularly where innovations can be easily copied, the scarcity may have to be “artificially” protected through patents. This is because in many cases, an invention or innovation, once it has been made, has the nature of a public good. It could potentially be rapidly copied in which case patent laws may be necessary to prevent this from happening. Thus, the Schumpeterian rent, like the monopoly rent, may be natural in some cases or protected by the state in others. What distinguishes the Schumpeterian rent from monopoly rents is that the above average profit the firm earns is due to innovation.

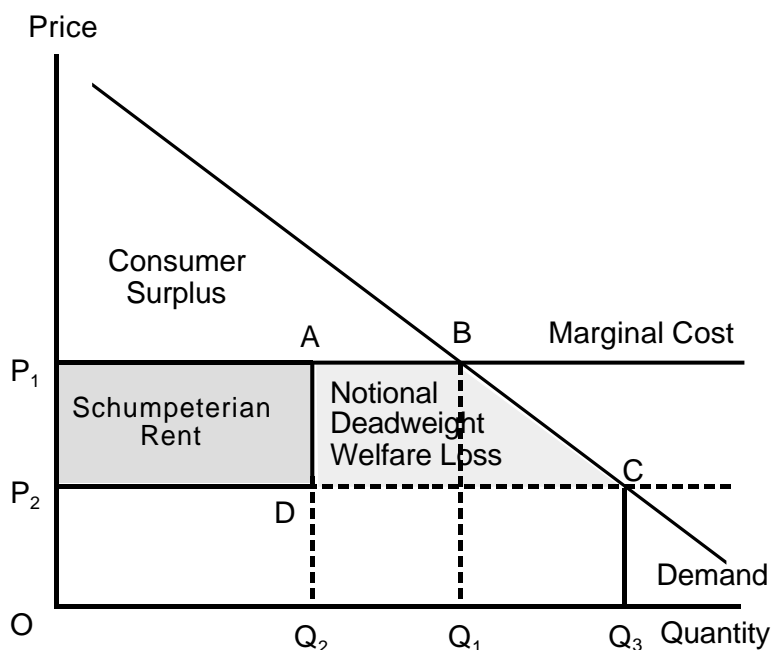


Figure 1.6 Schumpeterian Rents

Figure 1.6 shows the simplest case of innovation, where the innovating firm is able to produce an identical product at a lower cost. In reality the innovator usually produces a product of higher quality as well, which complicates the analysis, but the simpler story captures the essentials. The marginal cost in the industry now has a discontinuity which is easiest to see if the marginal cost simply has two levels, a lower one for the innovator and a higher one for the older producers. The innovating firm has a production capacity, so it can produce an output of OQ_2 at most, at the lower marginal cost of OP_2 . The rest of the market demand up to OQ_1 has to be met by higher cost producers and this results in the price of the product being set at OP_1 . This is simply a special case of an upwardly sloping marginal cost curve. Since the price for the good is higher than the marginal cost of the innovating firm, the latter earns a producer surplus shown by the area P_1ADP_2 which is the Schumpeterian rent in Figure 1.6.

Marx’s analysis is somewhat more complicated. Instead of the industry price being determined by the marginal or high-cost firm, it is set by the *average* cost of production. The post-innovation price is thus lower than OP_1 but higher than OP_2 .

This is more realistic in many contexts because we often observe innovating firms engaging in price-cutting and non-innovating firms making losses. In reality, particularly in oligopolistic markets, all firms have *some* spare capacity and can increase sales by cutting price. The innovating firm may have an incentive to cut price if it can increase sales and make even bigger profits after a small price cut. With price-cutting innovators, the story becomes too complicated for our simple diagram but the essential story is unchanged. The innovator still earns a super-profit of the same order of magnitude as P_1ADP_2 . It would only be much larger in the exceptional case where the innovator had significant spare capacity and could capture a very large market share after a price cut. In the more usual case, price cutting by the innovator will not materially change the simpler analysis except in one important respect. With price cutting, the pressure to catch up is much more intense. Older firms have to innovate rapidly or perish because when there are price cuts, they will be making reduced profits or even losses instead of just normal profits.

The more rapidly other firms can imitate the innovation, the greater the benefit for consumers. Once all firms have imitated, the price drops to OP_2 and the quantity purchased increases to OQ_3 . Not only would consumers gain the Schumpeterian rent as part of the consumer surplus, there would be an additional net social benefit in the form of an additional gain to the consumer surplus shown by the hatched area ABCD which we have called the “notional deadweight welfare loss” which exists prior to the imitation of the innovation. This is the loss of net social benefit attributable to the absence of imitation by competitors. The term “notional” indicates that this is a loss for consumers but only to the extent that other firms could actually have imitated the innovator. In some cases they may be unable to imitate even if they had tried because learning takes time. In this case, the Schumpeterian rent is not actually reducing net social benefit below any attainable level, and is therefore not associated with inefficiency. In other cases, imitation may be prevented by law. In these cases, the net social benefit in a static sense *is* lower due to the Schumpeterian rent, by the amount ABCD, and strictly speaking the rent is associated with *static* inefficiency.

Whether or not Schumpeterian rents are associated with static inefficiency, the dynamic implications for net social benefits, or in other words the implications for growth, are quite different. While both Marx and Schumpeter point out the spur which excess returns gives innovation, Schumpeter is more explicit in pointing out that it may not be desirable to try and get rid of these rents too rapidly. This may seem paradoxical given the potential gain to society from the dissemination of the new innovation. The paradox is resolved if we see the process of innovation as one which is happening over time, is risky, and requires effort and investment. Many would-be innovators actually find that their investments fail. As a result, the rewards for the successful have to be above average to keep attracting risk-takers. In the extreme case, if any innovation can be instantly copied and the excess profit wiped out, what would be the incentive to innovate? Admittedly, there are very few sectors where such rapid imitation can take place, so in most cases, sufficient incentives will remain for potential innovators. But there may be plenty of sectors where, even though imitation is not instantaneous, it is rapid enough to significantly dampen innovation. In these cases institutional and policy protection of rents may be socially desirable if they sustain the incentives for technical progress.

The policy question is whether the length of time over which Schumpeterian rents are observed to exist (due to say natural delays in imitation) is too long or too short. It is

too long if the persistence of the notional welfare loss for consumers due to slow imitation outweighs the benefit from the additional innovation which the protection calls forth. It is too short if rents disappear so rapidly that the loss of future innovations outweighs the immediate gains to consumer welfare. All government policies which affect the profits of innovators can increase or decrease Schumpeterian rents. Thus, tax rules which give tax breaks to innovators, competition policies which prohibit or allow restrictive practices by innovators to maintain their profits, or patent laws which directly restrict imitation for a certain number of periods are all effectively determining the length of time for which innovators can earn extra profits. Figure 1.7 shows the outline of the policy problem.

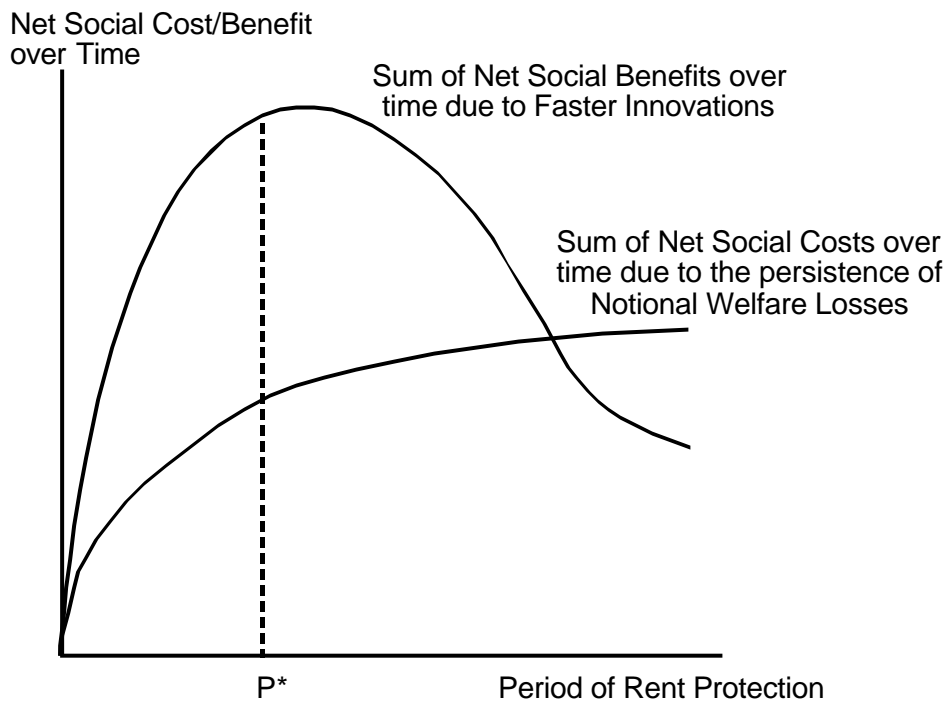


Figure 1.7 Dynamic Net Social Benefits with Schumpeterian (and Learning) Rents

In Figure 1.7, the overall net social benefit over time from the protection of Schumpeterian rents is broken down into the sum of net social benefits over time due to faster innovation and the sum of net social costs over time due to the persistence of notional deadweight welfare losses for consumers. The sum of net social costs over time (the lower of the two curves in Figure 1.7) increases with the period of protection. To see why, recall that the area ABCD in Figure 1.6 is the welfare loss in one sector and in one period as a result of rent protection for innovators. As the period of protection increases, this welfare loss lasts for longer and the net social cost increases. However, costs in the distant future count for less, as they are discounted using society's time preference, so costs aggregated over time do not rise at the same rate as the period of protection. The shape of this curve will depend on the magnitude of the notional welfare loss in each sector and society's rate of time discount.

The higher curve in Figure 1.7 shows how the additional net social benefit over time due to faster innovation changes with the period of protection of rents. In the single sector shown in Figure 1.6, this benefit is initially the rent P_1ADP_2 for the innovator over a few periods, followed by the additional consumer surplus of P_1BCP_2 for consumers thereafter. The discounted present value of this flow of benefits is a

measure of the value of the innovation in one sector. For each period of protection, we sum these flows of benefits across all sectors to plot the curve. The shape of the curve depends on how the rate of innovation changes with the period of protection. If rents last for a negligible period, there may be no innovations which are attributable to the incentives created by these (non-existent) rents. As the period over which rents last increases, there may be a faster and faster rate of innovation due to increased incentives and the net present value of the innovations due to the rents will rise. However, after a certain level of protection, these rents may become like monopoly rents and the rate of innovation may actually decline because existing rent-recipients lose incentives for further innovations. The curve can therefore start declining after a point. The optimal period of protection for society is P^* , where the net social benefit over time, measured by the gap between the benefit and cost curves, is maximized. This ensures that the growth rate is optimal. However, if the period of protection is wrong, Schumpeterian rents may be associated with both static inefficiency and sub-optimal growth rates.

The problem is that there is no precise way to determine the period of protection which will ensure the optimal growth rate. Estimating the optimal period of protection can, at best, be very approximate, particularly since the shape of the benefit from innovation curve in Figure 1.7 is a matter of speculation. The shape of this curve depends on how the rate of innovation changes with the period of protection for rents. Among other things, this relationship will depend on i) the riskiness of innovation given particular technologies and ii) the “animal spirits” and degree of risk-taking of entrepreneurs in the sector. These may vary across countries and sectors, and as a result, the optimal period of protection can vary. For instance, if innovation in some sectors is more risky, or if entrepreneurs are more risk averse, longer periods of protection may be optimal.

As the characteristics of technologies or the risk-aversion of investors change, the period of protection for Schumpeterian rents offered by patent laws and other mechanisms have to be periodically reviewed. Moreover, patent laws can easily be misused to maintain profits without innovation, in which case they effectively support monopoly profits rather than Schumpeterian rents. For instance, Dasgupta and Stiglitz discuss the case where R&D involves sunk costs (costs which once incurred cannot be recovered). Sunk costs increase entry barriers and as a result, the rate of innovation can actually *drop* with patent protection. Insiders in a sector who have a slight advantage in research over their rivals can threaten to speed up research and win the patent race if newcomers try to enter. Since the newcomers stand to lose their R&D investments as sunk costs if they lose the race, and since they know that insiders have a slight advantage, they may well not enter the innovation race in that sector, allowing the insiders to enjoy their existing rents for much longer than was intended. These rents then have the character of monopoly rents rather than Schumpeterian rents (Stiglitz 1996: 139-152; Dasgupta & Stiglitz 1988). For this reason, Stiglitz argues that policy should err on the side of promoting competition, although in theory, too much competition can often be as bad as too little. The optimality of patent laws is less significant in developing countries where learning (see next section) rather than new innovation is more important.

Information Rents as a Variant of Schumpeterian Rents. While Schumpeterian rents have usually been examined in the context of incentives for *innovation*, in fact, the logic applies equally to the incentives required to generate and use all types of

information. Real world markets can only work if someone has the incentive to generate information about opportunities. No-one could possibly have the incentive to spend time and effort digging up this information if, as a result, they could not make something extra. In reality, those who possess information, say about price differences across markets, *do* make money. They earn a higher return by using that information than in their next best employment and so, by definition, they earn rents. Yet, far from signalling inefficiency, these rents are critical for making markets work efficiently.

The role of information rents may seem to offer a qualifier rather than a knockout blow to the no-rent neoclassical model which informs much of policy-making in market economies. But many information economists think otherwise. Thus, Greenwald and Stiglitz (1986) argue that the presence of asymmetric information effectively destroys the usefulness of the general equilibrium (zero-rent) benchmark. Their claim is that with information costs, even if there were no innovations, the economy would require a wide range of rents. These rents are inefficient only in terms of the irrelevant benchmark of general equilibrium, but in the real world such rents are efficient because they are necessary to make markets work and there is no feasible alternative.

In developing countries, asymmetric information is pervasive, and so are information rents. Weak institutions for information dissemination together with weak regulation (which allows information to be monopolised) often results in information rents much higher than in advanced countries. Some of these rents may be still be “efficient” given high information costs, but if better information dissemination can be developed, these rents may signal inefficiency. The question for policy is whether it is feasible to construct better institutions for reducing information costs in the short run. If yes, high information rents may be inefficient, but otherwise some of them may not be.

As with the more conventional Schumpeterian rents for innovations, information rents may or may not be efficiency-enhancing over time. If information is monopolised and does not eventually diffuse, information rents can be very damaging. As with Schumpeterian rents for innovations, the condition for dynamic efficiency is that there has to be eventual freedom of access to the information, but not instantaneous access. If access is instant, the result will be an immediate competing away of the rents, and generators of information will not be able to make additional money for their effort. As with innovation rents, the judgement about the optimal period of protection beyond which information rents become inefficient is not a precise science.

1.5 Rents for Learning

In developing countries productivity growth is usually led not by innovation but by *learning*. Firms and entrepreneurs can dramatically increase net social benefit by adopting and adapting technologies which may be well known in more advanced countries. In this case too, rents may have an important role to play in facilitating the process of learning (Amsden 1989). In fact, it is often difficult to distinguish between innovation and learning. Learning involves not just the copying of existing technologies, but also significant amounts of adaptation to local conditions, available capital stock, institutions and so on. In other words, learning can involve substantial amounts of innovation. Like innovators, the entrepreneurs or firms who learn faster will be able to reduce their marginal costs and/or improve quality. But like

innovation, learning takes effort and can be risky. In theory, the risk-aversion of entrepreneurs need not stop investments in risky sectors if there are good capital and insurance markets. But capital markets are typically weak in developing countries and insurance markets which can take the risk out of investing in new sectors are a theoretical fiction even in advanced countries. Left to their own devices, developing country entrepreneurs may prefer low productivity but safer locally known technologies to high productivity but risky new ones. The latter may eventually be socially beneficial but may be financially ruinous for the entrepreneurs involved if things go wrong. The divergence between the social and private benefit from learning thus provides a justification for subsidizing learning.

To accelerate technological learning, rents in the form of policy-induced *conditional subsidies* may be created by a developmental state, as Amsden outlined in the case of South Korea. The analytical similarity between innovation (both technological and institutional) and learning is that in each case, rents can provide incentives for cost-reduction over time. In the case of learning, the rents in question are usually conditional policy-induced subsidies which we will call “rents for learning”. Unlike Schumpeterian rents, rents for learning are created *ex ante* by a policy decision rather than *ex post* as a result of an innovation. Schumpeterian rents reward investments which have already been made, so their incentive effect is to create expectations of rewards for *future* innovators. In contrast, rents for learning allow producers in the learning sectors *time* to catch up. Rents for learning have been referred to by a number of other names including *contingent rents* by Aoki, Murdock & Okuno-Fujiwara (1997: 14-18) and somewhat less elegantly, as *performance-indexed rewards* by the World Bank (1993). The key difference between subsidies which are rents for learning and those which are simply transfers is that the former are conditional on the achievement of learning over a specified time-frame, while the latter may have any of a number of other motivations.

Figure 1.8 shows an industry in a developing country where the domestic marginal cost curve DCE is higher than the foreign marginal cost curve ABQ, due to backward domestic technology. In other words, productivity in the developing country is so low in this sector that its costs are higher despite its lower wages. The world market price of the product is shown by PP'. With this configuration, the domestic industry will not produce any of the product and the country will import any domestic requirement. In many cases, high costs in the developing country are not due to any intrinsic inability to handle high technology, but reflect the fact that learning to use technology takes time. In theory, capitalists should be willing to finance this short-term loss. After all, given lower wages, if productivity could be raised even partially, they would be able to undercut the advanced countries. The private sector may, nevertheless, be unwilling to invest because of imperfections in the capital market which make it costly to raise funds for such investments. Investors generally do not like the combination of risk and illiquidity which infant industry investment represents. The grounds for intervention are strengthened if there are positive externalities for this sector. These externalities could take the form of labour being trained or international reputation being established for the country by the learner which then benefits learners in other sectors.

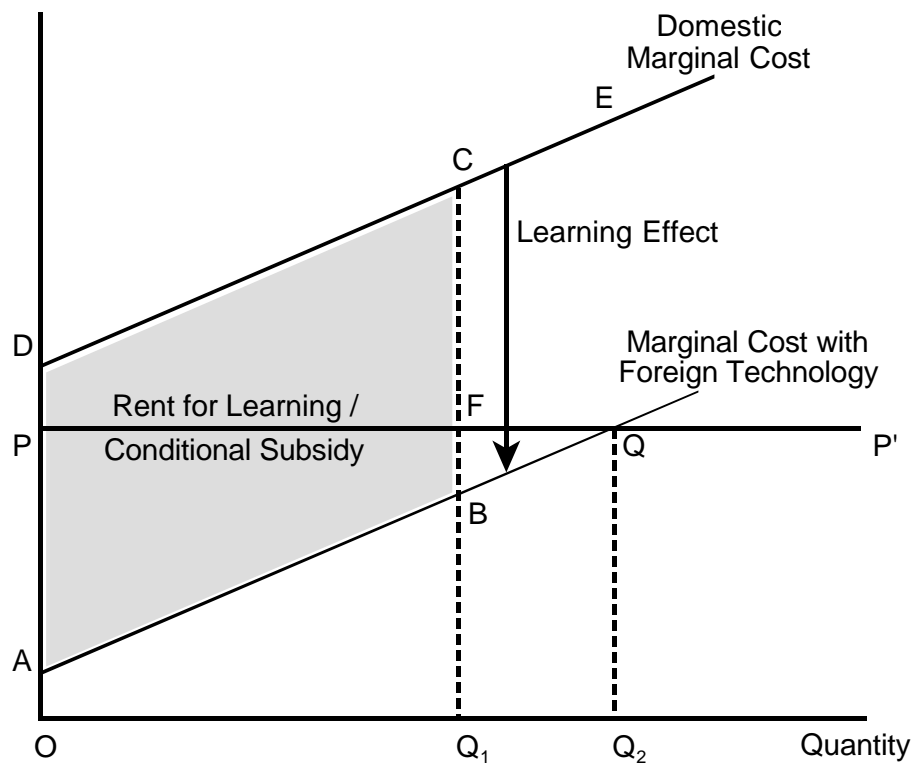


Figure 1.8 Conditional Subsidies as Rents for Learning

In the simplest case, suppose the government offers the industry a subsidy of AD per unit of output, with a cap on the total subsidy offered set at $ABCD$. This is effectively a rent for the firms in the industry since it is an income higher than their next-best income, which would involve selling their product in world markets. Note that factors of production like labour need not be earning rents, provided they could have earned the same elsewhere. In this case the subsidy simply compensates for the lower productivity of the firm. In other cases, say where labour would otherwise have been unemployed or where workers earn more in subsidized enterprises, labour may be earning rents as well. For our purposes, it is the rent directly earned by the firm which is relevant. The subsidy lowers the marginal cost of domestic production over part of the range, giving an effective domestic cost curve along $ABCE$. This allows domestic production of OQ_1 of the product. On the face of it, such a subsidy is inefficient because it allows production in a sector where the actual cost of production is higher than the price of the output, involving a social cost of $PFCD$. In addition, the subsidy for this sector involves an explicit or implicit tax for some other sector, which implies deadweight welfare losses due to incentive effects in the other sector, as shown in Figure 1.5. The subsidy therefore implies immediate negative net social benefits and is therefore inefficient in a static calculation.

Over time, the subsidy *may be* justified if it is conditional on learning (for instance restricted to a specified time frame or conditional on export growth), and if the conditionality is credible. If so, the subsidy may create incentives for accelerated learning-by-doing. If successful, learning would lower the domestic marginal cost to at least the international level or lower. It is possible that domestic costs fall below the international level because the developing country most probably has lower wages and could produce at lower cost if it could attain international standards of productivity. Once this happens the subsidy $ABCD$ is no longer required, domestic production can increase to OQ_2 , and the industry can, on its own, capture the producer surplus of APQ thereafter.

The social *benefit* of learning is the discounted value of the stream of future producer surpluses APQ plus any positive externalities (spillover effects) for other sectors. The social *cost* over time is the discounted value of the stream of temporary social costs of PFCB plus the social cost of transferring ABCD to this sector in the form of temporary disincentive effects elsewhere in the economy. Provided that the costs do not have to be sustained for too long, and provided that the learning gains are large, the net social benefit *over time* may be positive, implying that the learning subsidy is dynamically efficient.

Learning rents may be delivered to the firm through a number of policy mechanisms. These include the provision of subsidized credit, or protection which allows it to charge higher prices in the domestic market and, of course, the straightforward subsidy which we have looked at. The latter is easiest to analyse but similar issues are raised in the other cases. The critical question is, once again, the time frame over which the subsidy or protection is offered to the learning sector. The issues are very similar to Schumpeterian rents, and so Figure 1.7 can be used with some re-labelling. The overall net social benefit from the learning rent can similarly be broken down into the sum of net social costs due to the persistence of inefficiencies and the sum of net social benefits due to accelerated learning. As the period of protection increases, the sum of net social costs due to the subsidy is likely to increase in the same way as the cost curve for Schumpeterian rents in Figure 1.7. The sum of net social benefits due to accelerated learning due to learning rents is also likely to have a shape similar to the benefit curve in Figure 1.7. Too short a period of protection would result in very low benefits in terms of future producer surpluses, as domestic entrepreneurs would have insufficient time to learn. But too long a period can also result in waste, as infants know they will never have to grow up and learning can actually slow down. Thus, as before, there is an intermediate period of protection which is optimal for each sector. But in this case, enforcing this period is more difficult. The state has to be clear about the kind of performance it expects from learners, and it has to be able to withdraw rents if performance is poor. Otherwise the subsidy can become a permanent drain which is frequently observed in many developing countries in the form of “infant industries” which refuse to grow up. In such cases, rents for learning will be associated with both static inefficiency *and* low growth rates.

The state has to make decisions about *specific* firms and sectors *ex ante*, and has to be able to correct decisions rapidly if they turn out to be mistaken *ex post*, or if the recipients fail to perform. Compared to Schumpeterian rents, there is a greater likelihood that learning rents will fail to generate growth. Not only must the period of protection be right, the sectors and firms selected for support must also be more or less right. This requires not only a high degree of competence amongst state bureaucrats, more importantly, the state has to be able to *correct* mistakes once they have been identified.

The *quality of the bureaucracy* is clearly an important variable but not the only important one. The state's ability to pick potential winners can become more difficult as *technology* becomes more complex. In general, learning rents are easier to administer during the earlier stages of development, when the next steps up the technology ladder are relatively obvious and performance criteria can be set by looking at the next tier of countries. Here, exposing domestic firms to international competition over a pre-set time frame may be sufficient to monitor performance. As

technology becomes more sophisticated and products more differentiated from those of competitors, it becomes more difficult to specify the performance expected under all future contingencies. This brings us to the most important variable: the state's ability to enforce the allocation and withdrawal of subsidies, which depends on the *political context* in which industrial policy is conducted. For all but the simplest technologies, the successful operation of the system depends on the ability of the state to make pragmatic judgements about when performance is unacceptable and to take action without the losers being able to contest the decision indefinitely. The recipient of the learning rent has to accept that the state will have to use its judgement if things go wrong to decide whether to keep subsidizing, to restructure or even to terminate the project. This implicit contract between the state and the firm is difficult to convert into a formal contract since the latter would have to cover all contingencies which may arise and the course of action to be followed in each contingency. It follows that any industrial policy system has to be based on trust, to some extent, and good networks of communication between the state and the recipient capitalists can help. But critically, it is dependent on the political power of the state to enforce the decisions it takes. Industrial policy is unlikely ever to be entirely based on formal contracts simply because the transaction costs of formally specifying all contingencies in the learning game and resolving future disputes through third-party arbitration in courts would probably be prohibitive.

Countries differ very significantly in the power which their states have to enforce decisions about subsidy withdrawals. This *political ability* to discipline can also decline in successful industrial policy countries such as South Korea when business and civil society become more assertive of their legal rights. The growing demand that the rule of law should be adhered to, paradoxically, have made the pragmatic re-allocations of subsidies and property rights which characterized early South Korean industrial policy increasingly more difficult. In the late eighties and nineties, there was growing evidence that South Korean business was increasingly unwilling to submit to what it saw as the arbitrary power of the state. Revelations about the misuse of political power by the state in its conduct of industrial policy became more frequent. Business houses like Hyundai began to play a more assertive role in politics, arguing for greater transparency and the formalization of state-business relationships. While it is clear that the power of the state to make pragmatic decisions about subsidies (and resource allocation in general) can be misused, and *was* misused to some extent in South Korea, it is also clear that a transition to a more transparent and formal set of contracts for allocating learning rents would be much more expensive in terms of transaction costs. Whether such a system can be developed remains one of the key questions for the next tier of developing countries.

Since the social desirability of rents for learning depends crucially on the “efficiency” of the state in managing these rents, the optimal *technology trajectory* of a country is not independent of the type of state it has. If the state is unable to efficiently grant and withdraw subsidies for learning, it may be better for economic performance if the state limits learning rents to very few sectors and thereby avoids the inefficiency of building up an inefficient, but subsidised, industrial sector. The economy would undoubtedly move up the technology ladder much more slowly, but this may be better than getting stuck with the third-best, which is an attempted catching-up strategy which fails.

While all developing countries had substantial transfers supporting primitive

accumulation, they differed a lot in their learning strategies and technology trajectories. South Korea in the sixties and seventies extensively used state-managed subsidies for learning *and* it had a state which could effectively manage these rents, at least in the early years (Amsden 1989; Aoki, Murdock & Okuno-Fujiwara 1997). Its performance was dramatic. In contrast, Thailand in the eighties (Doner & Ramsay; Rock this volume) relied *less* on state-led learning, even though primitive accumulation was rife. Thailand's loss was less serious than it may seem, as it is unlikely that the Thai state could have effectively disciplined industry in the same way, given its internal politics. Given the constraints facing the Thai state, a lower reliance on learning rents for industry and a more decentralized set of transfers supporting primitive accumulation kept the Thai rent system relatively dynamic. On the other hand, compared to South Korea, its progress up the technology ladder was slower. In contrast, India and Pakistan did attempt to manage substantial learning rents for infant industries in the sixties and seventies, but lacked states which could effectively manage these rents. In these countries not only was technical progress slower than in South Korea, performance was also worse than in Thailand. In effect, the Indian and Pakistani states ended up creating vast rents for “infant” industries which were difficult to remove for reasons of domestic politics. Thus the type of state (and the feasible ways in which it can be changed) will determine whether learning rents can be effectively managed, and therefore the most appropriate technology trajectory for a particular country (see also Khan 1995).

1.6 Monitoring and Management Rents

The analysis of rents has also progressed to explore the role of rents in creating incentives for management. This analysis is based on the view that part or all of profit is a surplus, much like a rent. This view of profit is itself a radical departure from conventional economics since the surplus view of profit is associated with Marx and the classical economists. The latter explained profit as a surplus, or residual, left over after other factors, in particular labour, had been paid. Profits therefore depended critically on the degree to which the capitalist could control the labour process in the factory. In contrast, in the neoclassical model, the rate of profit was determined by the value of the marginal product of capital (the value of output produced by the last unit of capital). Here the capitalist plays no role in determining profits since the value of the marginal product of capital depends only on technology, the number of workers working the capital stock and the price at which the product can be sold. The first serious criticism of this analysis by neoclassical economists came from Alchian and Demsetz (1972). They recognized that the profit rate is not determined in this way because the marginal product of capital is impossible to measure independently of how well the production team as a whole is working. Instead, they argued that profits must be a residual after workers and suppliers have been paid. Profits can therefore vary greatly depending on the competence of managers and the discipline of workers.

If profits are a residual, do they have any function, and can they be justified? Alchian and Demsetz argued that profit as a residual played a critical function as a reward for good management. Organizing teamwork in the workplace is a difficult job. For Alchian and Demsetz, the management problem is entirely due to asymmetric information. It is costly to find out how much effort each individual worker has put in. Even other workers would not know whether someone in their team was free-riding unless they spent time observing their colleagues. The role of management is to do this observation (*monitoring* is the North American term) and the profit which owners

and managers earn as a residual after paying all direct costs is their reward for monitoring. Much earlier, Marx, too, had pointed out that the capitalists' search for profit played a function. It created incentives for managing the labour process, but more importantly, in driving technical innovation which was later picked up, as we have seen, by Schumpeter. An important difference with Alchian and Demsetz is that Marx added that capitalist profits were not *always* functional in generating economic dynamism. In any case, he was willing to make a political critique of the capitalist's claim to be exclusively entitled to manage and make decisions about what to do with the subsequent surplus.

A more important difference is that for Alchian and Demsetz, the role of management is entirely defined by the problem of asymmetric information. Workers can hide information about the effort they have put in, and uncovering this information requires effort by management. In contrast, Marx's analysis suggested that the labour process involved more serious conflicts, in particular, distributive conflicts over wages, and worker resistance to technologies which dehumanized work (Marx 1979: 975-1038). Thus, in both these traditions, management plays a role in disciplining the labour-process. In both, management has an incentive to manage because its rewards are based on the surplus which depends on how well they manage. But in the neoclassical tradition to which Alchian and Demsetz belong, the overcoming of information failure through better monitoring by capitalists increases efficiency in the sense that both capitalists and workers are better off. Even workers are better off because if all workers "shirk", they suffer collectively. For Marx, the capitalist drive for profit is a double-edged sword because on the one hand it increases production, but it also sacrifices workers' autonomy and their right to participate. Nevertheless, particularly in the early stages of development, the rapid growth in production under capitalism was welcomed by Marx.

Alchian and Demsetz's analysis of profit has implications for our discussion of rents. If profits were determined by technological conditions alone, variations in profit rates across sectors would be rapidly corrected by the entry and exit of physical capital. In the Alchian and Demsetz story, a somewhat greater variation in profit rates is allowed because management matters, and better managers cannot physically take over everyone else. Thus, there will be a range of returns to capital around some *average* rate, and only those managers who are so bad that their profits fall below a *minimum* will actually go out of business. Capitalists who are (or can hire) better managers will earn higher than the minimum return in each sector. Since the minimum return would be sufficient to keep capital in that sector, good management ensures rents for owners and managers. It is precisely the search for these rents that keeps management on its toes.

Clearly, there are close analytical links between the role of rents in creating incentives for managing the work process, and the role of rents in generating information or innovations which we discussed earlier. In all these cases, rents create incentives for certain types of actions which are efficient given the costliness of information. Having said that, we should also say that the rents to management are based on more than overcoming asymmetric information problems (as suggested by Alchian and Demsetz). The success of management can also be based on its "political" role in disciplining labour and suppressing contestation in the workplace (which Marx pointed out). Nevertheless in all these cases, rents which appear to signal inefficiency according to the no-rent benchmark of competitive markets may be growth and

efficiency-enhancing when we look at the incentives they create for particular types of actions.

It is worth pointing out the degree to which the neoclassical analysis of profits has taken on board the insights of the classical, and in particular, the Marxist analysis. If we combine the separate points made by the neoclassical analysis of natural resource rents, Schumpeterian rents, and now monitoring and management rents, we see a range of arguments linking the incomes of property owners to static and dynamic efficiency. However, this has only been achieved by recognizing that the incomes of these property owners have the nature of rents, that is, they are surpluses even using the narrow benchmark of the alternative opportunities of the recipients. The property rights system which underwrites these incomes can, *under certain conditions*, generate efficient outcomes, but only at the cost of creating classes of surplus income earners.

Monitoring Rents and Financial Institutions. The analysis of monitoring rents has provided new tools for investigating the role of financial institutions in developing countries. It has been argued that rents for financial institutions may be *efficient* if they induce efficient monitoring of credit portfolios (Hellman, Murdock & Stiglitz 1997; Stiglitz & Weiss 1981). Financial sector rents were widespread in East Asia when many of these countries were achieving rapid industrialization. On the other hand, their financial sectors were also at the centre of the crisis which hit many of them in 1997. The management incentive models are a starting point for the analysis of financial sector rents, though they do not identify important aspects of the role of these rents in the growth phase of the Asian countries, or their role in the subsequent crash.

The monitoring perspective is certainly a useful break from the older neoclassical approach which argued that developing country financial sector rents were always inefficient. Developing country governments often held down interest rates for savers with the intention of giving industrial borrowers windfall incomes to encourage them to borrow and invest. This was called *financial repression*, and the strategy was criticised for creating a deadweight welfare loss by creating a gap between the supply and demand price of credit (in the same way that a monopolist creates a gap between price and marginal cost). The important point was that in the financial repression models, the rents created played no useful function and simply signalled allocative inefficiency (see Hellman, Murdock & Stiglitz 1997 for a critique of these models).

The new approach based on monitoring costs suggested that financial sector rents may, under some conditions, be useful. Financial markets are particularly subject to problems of asymmetric information, which in turn can lead to a market breakdown (Stiglitz and Weiss 1981). Bad borrowers can drive out good borrowers because bad borrowers are often willing to pay higher interest rates since they have no intention of actually repaying. Unless financial institutions are good at monitoring to distinguish between good and bad borrowers, they are likely to eventually become bankrupt.

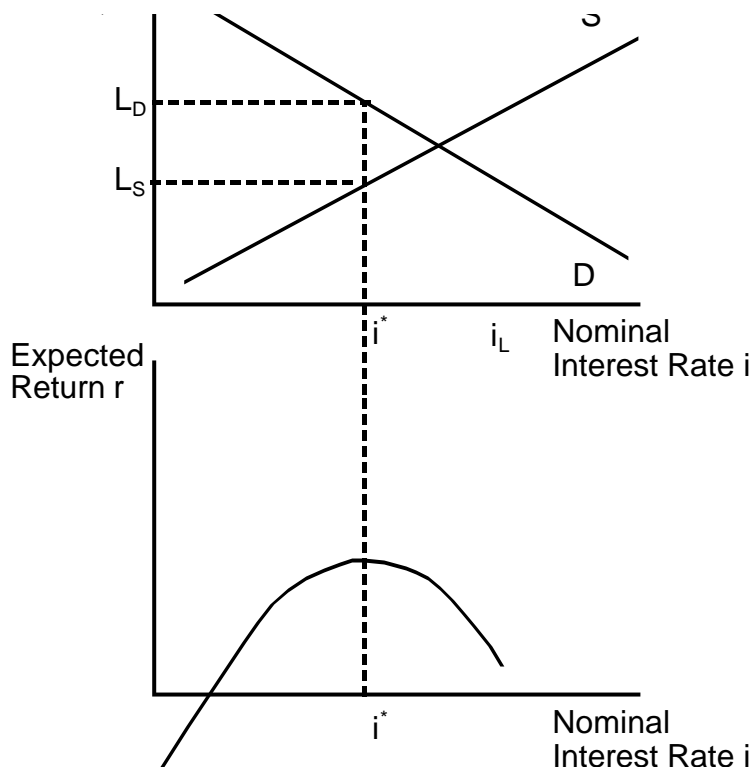


Figure 1.9 Disequilibrium with Efficient Monitoring: The Stiglitz and Weiss Model

As interest rates for borrowers become higher, it becomes more and more likely that only risk-loving borrowers or borrowers with no intention of repaying will keep borrowing. The *expected* return to the bank will then be lower than the *nominal* rate of interest because of default, and the expected return may actually start falling at high rates of interest. It follows that if the market clearing interest rate is high, banks may not actually want to lend at that rate. To maximize expected returns, banks may then lend below the market clearing interest rate to keep out risky borrowers. When this happens, the financial market can appear to be superficially similar to the financial repression case. However, here, the interest rate ceiling is set not by the government but by the banks who decide to ration credit.

The lower diagram in Figure 1.9 shows that the expected return to the bank, r , is not the same as the nominal interest rate, i , charged to borrowers. After a critical interest rate of i^* , the expected return, r , starts dropping because too many bad risks are attracted at higher rates of interest. This is the *adverse selection* problem. In addition, there is a *moral hazard* problem as even good borrowers may be forced to act in riskier ways than the bank would like at high rates of interest, and find, as a result, that they go bankrupt. There is thus an interest rate i^* which maximizes returns for the bank, the problem is that this need not be the market clearing rate.

This possibility is shown in the upper diagram, which shows the standard demand and supply for loanable funds, but with the interest rate along the horizontal axis. As it is drawn, i^* is below the market-clearing rate, and at this lending rate, there is an excess demand for funds. At the interest rate i^* , banks are only willing to lend L_S while the demand is for L_D of loans. The excess demand is dealt with by “non-price” rationing of credit by banks, in other words by bank monitoring which aims to separate good from bad borrowers to allocate credit to the good borrowers alone. This model shows that efficient financial markets will not necessarily be in equilibrium in the standard fashion.

The Stiglitz and Weiss model shows how information problems in financial markets can lead to credit rationing by banks. Hellman, Murdock & Stiglitz (1997) extend this argument to developing countries by arguing that where the banking sector is weak, *government* regulations which create rents for banks can strengthen their incentives to monitor their portfolios better. The availability of these rents makes banks more valuable for their owners by giving the bank what these authors call *franchise value*. If the protection of this value requires good portfolio management in the future, the rents sustaining franchise value may create incentives for better monitoring.

Their argument is that a government-created ceiling on the interest rate paid on savers' deposits which is below the market-clearing rate can create rents, and so franchise value for banks, and therefore stronger incentives for portfolio management (Hellman, Murdock and Stiglitz 1997). In Figure 1.10, the gap between the regulated deposit rate, r_d , and the market lending rate, r_L , is the source of the rent for banks. The only way that these rents will continue to be available for the owners of the bank is through the bank's survival, which in turn is only assured if its managers manage its portfolio well.

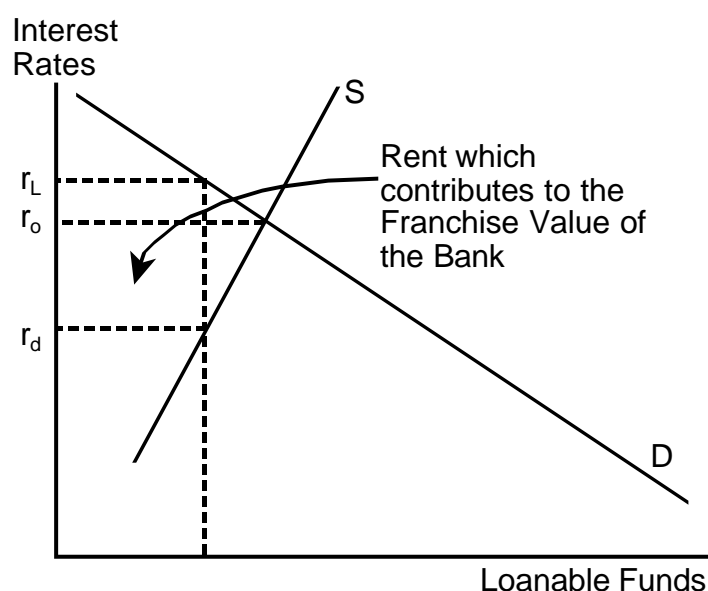


Figure 1.10 Financial Sector Rents as Incentives for Monitoring

Banks have played an important role in East Asia, both in the high growth phase as well as in the runup to the financial crisis of the late nineties. But to what extent does the Hellman, Murdock and Stiglitz *financial restraint* model contribute to our understanding of the role of financial rents in the growth and eventual crisis in East Asia? The financial restraint model is important because it challenges the assumption that a no-rent competitive equilibrium in the financial market is possible and efficient. On the other hand, the model does not identify important institutional and political features of East Asian financial markets and therefore is not adequate on its own.

First, the monitoring-efficiency model assumes that the banks' *ownership structures* were such that the rents earned provided an incentive to monitor their portfolios

effectively. The institutional structure which would best achieve this would be one where banks were owner-managed and the owners appropriated the rents. A second-best structure would be one where banks were not owner-managed, but the owners could coordinate their actions to hire and fire managers to maximize their rents. Neither of these ownership structures characterized the bulk of the banking sector in East Asia. In some countries like South Korea, banks were owned by the state throughout much of their high growth period. Even after the partial privatizations of the eighties, South Korean banks remained under state guidance and control till the early nineties. The existence of rents in public sector banks will not provide incentives for managers unless we believe that public sector bank managers are able to appropriate a large part of these rents. In other Asian countries, when banks were privately owned, they often had ownership links with industrial conglomerates. This type of ownership structure would also dilute the incentives of bank managers to monitor since a significant part of the bank's lending could be to the owners of the bank themselves.

Secondly, a related problem is that the incentive to monitor can be significantly diluted if the bank does not face a credible threat of bankruptcy, which is how franchise value can be lost. It is more likely that banks will face bankruptcy if they are small banks whose collapse will not affect the financial market as a whole. The social cost of bankruptcies increases if banks are very large, as they typically are in both developed and developing countries. In terms of the information argument, this can result in a moral hazard problem since managers and owners know that their bank will not normally be allowed to go bust without an attempt at a bailout by the government. If this is the case, rents may not provide a sufficient incentive for the good management of banks.

Thirdly, even if bank managers did have the *incentive* to monitor to maintain their rents, the information-centred models assume that banks also had an *effective* (as opposed to simply a legal) power to monitor borrowers. In fact, the effective power to monitor varied widely and did not correlate with the existence of incentives to monitor. The difference between efficient and inefficient bank-based lending often had more to do with the effective power of banks to monitor and discipline borrowers rather than the incentives they had. Once again, South Korea provides a useful case. Here, although banks were publicly owned during much of the high growth period (and therefore could be expected to have weak incentives to monitor), they did have the *effective* power to monitor and discipline borrowers and seem to have used this power effectively. South Korean banks were used by the state to direct credit to priority sectors and to monitor performance, and they could do this during the sixties and seventies because they had the power of the state behind them to discipline poorly performing loan recipients. We have already suggested that the politics of South Korean industrial policy was changing over the eighties as business became more assertive and less willing to accept the high-handed interventions of the state. This must be part of the story behind the declining efficiency of its banking system in the nineties. Paradoxically, at the same time, financial liberalization and privatization of the banks was transferring bank rents to private owners, which according to the franchise value theory, should have strengthened the incentives for good management by the new owners of the banks. Instead, we see declining financial sector performance and eventually a crisis, which suggests that monitoring theories of financial sector rents must be inadequate on their own.

In most Asian countries, banks never enjoyed the same degree of effective power to monitor and punish as their South Korean counterparts. The inability of banks to discipline borrowers in most developing countries is most often due to the political and social power of borrowers to protect themselves, usually by mobilizing rival political constituencies. Thus, in addition to the *incentive* which lenders must have to monitor, perhaps a more important variable is likely to be the *effective power* of the lender to discipline recipients.

Finally, and closely related to the previous points, the financial restraint model understates the role of the *state* in regulating firms (and banks). It focusses only on the role of the state in creating rents for banks, with the rents creating sufficient incentives for *banks* to monitor. This is considered to be desirable since banks are assumed to have better information than the state and are therefore likely to do better monitoring. However, this representation is misleading because the government is typically very closely involved in the operation of the financial sector. It has to regulate the size and ownership structure of banks and these determine the effectiveness of rents as incentives for management. The effective power of the banking system to monitor, which we have already seen is critical, depends on the state's ability to enforce contracts and implement policy decisions. Thus the *technical* capacity of the state to regulate, and its *political* ability to overcome resistance and enforce decisions on both borrowers and banks are critical variables. The state may also have other political objectives in allocating finance which can also significantly reduce the efficiency of financial allocation as Jomo and Chin (this volume) discuss in the case of Malaysia.

If the role of rents in providing incentives for good monitoring are subject to such important qualifications, how can we account for the simultaneous existence of high financial sector rents and good economic performance in East Asia over a period of over two decades in some cases? We would argue that financial sector rents did play an important role in these countries, but not primarily through the mechanism of creating monitoring incentives. First, in many cases, financial sector rents were being created for onward transfer to emerging classes in ways which are more accurately described as primitive accumulation. The success or failure associated with such 'financial sector rents' has to be assessed by looking at the viability of these broader processes of accumulation, and not just at the incentives for portfolio management.

Thus, financial institutions were used in all these countries to manage transfers to emerging capitalists engaged in primitive accumulation as well as to political clients of the state from the intermediate classes to maintain political stability. The latter sometimes acquired significant proportions in countries like Malaysia (Jomo and Chin, this volume). In the East Asian countries, this process of capitalist transformation was for a long time tremendously successful. While the process was vulnerable and based on fragile political compromises, the performance of the East Asian countries over a period of several decades means that capital could not have been allocated that badly over such a long period.

Secondly, in addition to primitive accumulation and political transfers, state controls over interest rates were often used to simultaneously create learning rents for infant industries by keeping borrowing rates low. This possibility is recognized by Hellman Murdock and Stiglitz (1997). Thus the role of the financial sector in many East Asian countries, and in particular in South Korea, was not just to monitor portfolios, but also

to create learning rents for industry. The associated economic performance may have had more to do with the success with which these rents for learning were being administered by the state than with any monitoring incentives simultaneously created for banks. The success or failure of learning rents over time depends, as we have seen, on the administrative ability of the state to identify strategic sectors and monitor performance, and on its political ability to grant and withdraw rents as necessary.

The increasing technical complexity of industry, which was partly a direct result of the success of some Asian countries, and the growing political constraints facing “arbitrary” state actions, eventually made effective policing by the state more and more difficult. This may explain why rents for learning eventually failed to be associated with rapid growth in many of these countries. In other words, in many of the high-growth Asian countries, a growing proportion of the rents transferred through the financial sector were, by the mid-nineties, becoming monopoly rents or inefficient and growth-retarding political transfers, rather than remaining efficient rents for learning. This more complex story, which looks at the role of the financial sector in managing political transfers, learning rents *and* monitoring rents, can capture more accurately the initial association of financial sector rents in East Asia with good economic performance, and the subsequent weakening of this link to varying extents by the mid-nineties.

The decline in the efficiency of bank allocation of credit should not be solely blamed for the declining efficiency of capital allocation in the late nineties. A further complicating part of the story in many of these countries was the growth of the stock market during the nineties. Stock markets can also generate variants of information rents for those who own particular stocks, or invest in particular countries, if their judgement in choosing stocks and countries has been good. One of the features of the early nineties in many developing countries was the growth of stock market information rents relative to long-term state-created bank-based rents in the financial sector which we have been discussing so far. In principle, the search of stock owners for information rents should drive capital towards more efficient firms because they would offer higher returns in the long-run. If this was true, stock market information rents could indirectly perform a useful function in capital allocation. However, while financial liberalization proceeded rapidly in many Asian countries in the nineties, there are reasons to doubt whether the growth of the stock market contributed to performance.

The relative weakness of stock-market information rents in inducing efficient investment allocation has been extensively discussed in the literature on financial markets. Stiglitz (1996: 92-96) follows Keynes in questioning whether stock market returns can generate impartial information about investment prospects and the credit-worthiness of competing groups of borrowers. Stock prices tell investors what the stock market *thinks* a company’s prospects are and not what its prospects *actually* are. This distinction was behind Keynes’ famous analogy between a stock market and a beauty contest. To predict who will win a beauty contest, one does not have to judge the absolute beauty of any individual, but one does have to guess who the judges will *think* is beautiful. The stock market is similar in that making money requires a good *sociological understanding* of what the market thinks is important, and not always, or necessarily, a good analysis of fundamentals.

As a result, whatever affects sentiment in stock markets can affect capital allocation

regardless of changes in fundamentals. Thus in advanced countries, market sentiment has often forced managers of firms to pay high dividends, even when that was not in the long-run interest of the company. Such behaviour was often a response to the prevailing perception in their stock markets that dividends were a good indicator of management performance. This perception led to the allocation of stock market capital towards high-dividend companies, and managers paid low dividends at their peril. More recently, the focus on dividends has become less as sentiment has swung towards 'technology' stocks, with similar questions being raised about their fundamentals in many cases. In developing countries, information on which to base stock market valuations may be much more limited and easily manipulated by insiders. As a result, capital allocation is less rational and fluctuations in value more severe. The rapid move towards the deepening of stock-markets in East Asia in the nineties was no doubt partly driven by the global move towards financial liberalization, but in addition, it often had strong domestic political support from groups which sought to capture stock-market rents.

East Asian stock market rents in the early nineties were very largely based on insider information and changes in international sentiment about emerging markets, and played little if any role in improving performance. The severity of the market crash of 1997 was to a large extent also driven by rapid changes in sentiment which far outweighed underlying changes in fundamentals (Stiglitz 1998; Jomo 1998; Palma 1998). The market crash of 1997 coincided both with the rapid growth and decline of inefficient stock market information rents (and other speculative rents) as well as with a much more gradual and systemic decline in the efficiency of learning rents channelled through banks. The policy response to the first involves better regulation of stock markets and of international capital flows such that valuations do not move greatly out of line with underlying fundamentals. The policy response to the gradual decline in the efficiency of learning rents is much more challenging. In some countries, the decline was due to technological progress making investments more complex, in others, it was the growth of political constraints preventing the allocation of rents according to efficiency criteria. Constructing new institutions which can manage learning rents in these changed circumstances presents an important challenge for developing countries.

1.7 Rents, Rights and the Surplus

Our discussion of rents has already drawn on the surplus approach of Marxian economics and it may be useful to compare the neoclassical and classical approaches explicitly at this stage. The economic surplus was the primary focus of classical economics which saw the surplus as the key variable explaining long run dynamics. Marxian economics, drawing on Ricardo, defines the economic surplus as the *income accruing to asset-owning classes after paying for the direct costs of production (wages, raw materials and the depreciation costs of machinery)*. Thus, the surplus is defined so as to identify what a society could potentially invest. The surplus is essential for growth, but does not guarantee that growth will be achieved. Marx, in particular, observed the role played by the search for super-profits in generating innovation and technical progress, but he also pointed out how the search for profits can lead to crises.

Looking first at the similarities, the classical surplus and the broadly defined notion of rent clearly describe an overlapping set of income flows. The main difference is that

the classical surplus is a broader category than rent since it includes the *normal* returns to land and capital, which are typically not considered to be rents. However, we have seen that some neoclassical institutional economists have begun to treat even normal profit as a surplus captured by managers, which can give much of profit the character of a rent. At the same time, most rents are part of the classical surplus as they usually accrue to capitalists and landlords. The exceptions would be the relatively small rents accruing to some types of specialized labour. Therefore, if we envisage the set of incomes comprising the classical surplus as a big circle, the neoclassical rent would be a slightly smaller circle located almost entirely within the bigger one.

TYPE OF RENT OR SURPLUS	STRUCTURE OF RIGHTS SUSTAINING IT
Classical Economic Surplus	Property Rights of Capitalists over Capital Equipment and of Landlords over Land
Monopoly Rent	Indivisible Rights over Lumpy Assets or Legal Right to be Sole Supplier in Market
Natural Resource Rent	Exclusive Rights over Natural Resource
Rents Based on Transfers	Transfers of Rights through the Political Mechanism
Schumpeterian Rents	Rights over Intellectual Property
Rents for Learning	Transfers conditional on learning
Rents for Monitoring	Rights over Residual Earnings

Figure 1.11 Rents and the Rights Sustaining Them

Secondly, both rents and surpluses are sustained by an underlying structure of economic rights. The basis of the surplus in rights is explicit in the Marxian analysis, but rights also underpin neoclassical rents. Making this explicit will help us in our analysis of rent-seeking in the next chapter since changing the structure of rents almost always involves some form of institutional change or re-allocations of economic rights. In the Marxian analysis, the appropriation of the economic surplus by capitalist or landlord is explicitly based on their ownership of capital and land respectively. In fact, Marx would argue that without these specific property rights, even *normal* profits and rents would not exist. Thus *all* of the economic surplus in the Marxian model is underpinned by the property rights structure which describes capitalism. This is shown in the first row in Figure 1.11.

The parallel association of specific neoclassical rents with some set of associated property rights is shown in the following rows. Monopolies are either “natural” monopolies based on economies of scale, or they are artificial monopolies created by legal restrictions on entry into markets. In the case of natural monopolies, economies of scale exist because some assets are “lumpy” and cannot be divided. Lumpy assets have to be bought for a fixed cost which means that larger outputs can be produced at a lower average cost. Ultimately, the indivisibility of an asset is due to the difficulty of creating shared property rights over it. Artificial monopolies on the other hand are

more obviously based on the restrictive right of a single producer to supply a particular market.

Natural resource rents require exclusive property rights which allow the owners to monitor usage and to collect the surplus. The rents implicit in subsidies are based on transfers of property rights through the political mechanism. Schumpeterian rents are based on rights over intellectual property, which may be “artificial” rights created through patents or “natural” rights which innovators possess over their innovation before others imitate them. Rents for learning are based on transfers of rights through subsidies to induce learning. Finally, rents for monitoring are rights over residuals which may induce more efficient monitoring. Thus each type of rent or surplus has an underlying structure of economic rights which sustains it.

Thirdly, while neoclassical analysis has traditionally been interested in efficiency and classical analysis in growth, the extension of the neoclassical analysis to look at innovation and the labour process has brought the two traditions closer together in the questions they address. In the Marxian analysis, the economic surplus is not only not damaging for growth, it is essential. What is damaging is its mis-allocation in unproductive expenditures or its excessive consumption by parasitic capitalists or landlords (Baran 1973). Similarly, modern neoclassical analysis now recognizes that while some rents are damaging for growth, others are essential (see, in particular, Stiglitz 1996: 89, 139-152). This convergence in areas of interest is particularly interesting given the differences in the methods of analysis and in the political conclusions.

However, fundamental differences remain between the two approaches. In the neoclassical tradition, the role of rents is primarily to provide *incentives* for innovation, learning, information generation or efficient monitoring rather than directly to provide investment funds. In contrast, in the classical approach, the role of the surplus is primarily to provide the *resources* for accumulation, though the incentives created by the underlying rights for investment of different types is also very important. We believe that an eclectic approach which borrows insights from both traditions can be richer than one which is exclusively based on a single approach.

Another fundamental difference between the two approaches is in the role of politics and power in determining the size of the surplus and its allocation. The Marxian approach was keenly interested in the ways in which class conflicts might determine the overall magnitude of the surplus and its allocation. In contrast, the neoclassical approach does not look at rents as having a political determinant. We have argued that the distribution of power can determine the magnitude and allocation of rents and also their efficiency implications (for instance in the case of learning rents). In this sense, we draw heavily on the classical tradition. Undoubtedly there are fundamental differences between classical and neoclassical approaches to surplus and rent, but at this stage there is more to gain by pragmatically drawing on both traditions.

1.8 Characteristics of Rents: A Summary

Since rents differ widely in their efficiency and growth implications, the characteristics of one rent should not be extrapolated to other types. While this is often recognized, some of the features distinguishing good from bad rents in the literature are positively misleading. In Figure 1.12 rents are compared according to

whether the rent is due to an artificial (government-created) scarcity or a natural one and whether the rent is associated with prices higher than marginal costs. But these frequently referred-to distinctions do not, in fact, serve to separate good from bad rents.

	Created By Government	Price More than Marginal Cost
Monopoly Rent	Maybe	Yes
Natural Resource Rent	Maybe	No
Rent-Like Transfers	Yes	Irrelevant
Schumpeterian Rent	Maybe	No
Rents for Learning	Yes	Maybe
Rents for Monitoring	Maybe	Maybe

Figure 1.12 Misleading "Differences" between Rents

The distinction between “artificial” and “natural” rents, is based on the claim that the first type of rent is inefficient while the second is not (Buchanan 1980). This position, not surprisingly, is common amongst market-supporting economists who accept the importance of some types of rents. However, a look at Figure 1.12 shows that this distinction does not necessarily separate efficient from inefficient rents. Schumpeterian rents may be “artificial”, but they may sometimes be efficiency and growth-enhancing. This is even more true for rents for learning, or some types of rents for monitoring, which may be created by the state and yet be efficient and growth-enhancing.

Secondly, rents are often loosely interpreted as signalling a deviation from competitive markets where price is equated to marginal cost in every market. Since a deviation from this condition signals inefficiency in the simple neoclassical model, all rents are sometimes associated with inefficiently operating markets. A look at the third column in Figure 1.12 tells us that the existence of a rent does not always signal a divergence between price and marginal cost. The price-marginal cost divergence is always true only in the case of monopoly rents. Moreover, once information asymmetries and monitoring problems are admitted, the equalization of price and marginal cost may not even be required for efficiency. We have seen that some rents created by market disequilibrium may be *efficient* in generating useful information or in providing incentives for efficient monitoring. Thus rents do not always signal a divergence between price and marginal cost, and even when they do, this may not always be inefficient!

Figure 1.13 summarizes the efficiency and growth effects of different rents based on the discussion in this chapter. Clearly, no simple efficiency or growth implications can be read off from the observation that rents exist. The presence of rents can sometimes signal a dynamic and efficient economy, just as the absence of rents can

sometimes signal inefficiency and stagnation. To remind ourselves, the efficiency associated with a rent is assessed by looking at the immediate, or static, net social benefit (NSB) associated with the rent and comparing it with the net social benefit achieved in its absence. The growth implications are assessed by looking at the growth of output (or of net social benefits) in the presence of the rent, compared to the growth achieved in its absence. The last column of Figure 1.13 tells us that the efficiency and growth implications of many rents depend on more detailed conditions. We have seen that the fulfilment of these conditions depends on the political, institutional and technological contexts in which particular rents are located. These differences between types of rents are the starting point for our analysis of rent-seeking in the next chapter.

Figure 1.13 Relevant Growth and Efficiency Implications of Different Rents

TYPE OF RENT	EFFICIENCY IMPLICATIONS (Static NSB)	GROWTH IMPLICATIONS (NSB Over Time)	OBSERVATIONS
Monopoly Rent	Inefficient	Likely to Be Growth-Reducing	Sometimes Difficult to Distinguish from Schumpeterian or Learning Rents
Natural Resource Rent	Efficient	Likely to Be Growth-Enhancing	
Rent-Like Transfers	Neutral with Possible Incentive Inefficiencies	Indeterminate: May Be Growth-Enhancing	May Be Essential for Primitive Accumulation and to Maintain Political Stability but may also become Inefficient very rapidly
Schumpeterian Rent	May Be Efficient	Likely to Be Growth-Enhancing	May Become Monopoly Rent if it persists for too long
Rents for Learning	Inefficient	May Be Growth-Enhancing	Efficiency May Depend on Monitoring and Enforcement Ability of the State
Rents for Monitoring	May Be Efficient	May Be Growth-Enhancing	Efficiency May Depend on Monitoring and Enforcement Ability of Monitors

REFERENCES

- Alchian, A. & Demsetz, H. 1972. Production, Information Costs and Economic Organization, *American Economic Review* 62.
- Amsden, A. 1989. *Asia's Next Giant: South Korea and Late Industrialization*. Oxford: Oxford University Press.
- Aoki, M., Murdock, K. & Okuno-Fujiwara, M. 1997. Beyond *The East Asian Miracle*: Introducing the Market-Enhancing View, in Aoki, M., Kim, H-K and Okuno-Fujiwara, M. *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.
- Baran, P. 1973. *The Political Economy of Growth*. Harmondsworth: Penguin.
- Buchanan, J.M. 1980. Rent-Seeking and Profit-Seeking in J. Buchanan, R.D. Tollison and G. Tullock (eds.), *Towards a Theory of the Rent-Seeking Society*. College Station: Texas A&M University Press.
- Dasgupta, P.S. & Heal, G.M. 1979. *Economic Theory and Exhaustible Resources*. Cambridge: Cambridge University Press.
- Dasgupta, P.S. & Stiglitz, J. 1988. Potential Competition, Actual Competition and Economic Welfare, *European Economic Review* 32.
- Greenwald, B. & Stiglitz, J. 1986. Externalities in Economies with Imperfect Information and Incomplete Markets, *Quarterly Journal of Economics* 101.
- Hellman, T., Murdock, K. & Stiglitz, J. 1997. Financial Restraint: Towards a New Paradigm, in Aoki, M., Kim, H-K and Okuno-Fujiwara, M. *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.
- Jomo, K.S. ed. 1998. *Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia*. Hong Kong: Hong Kong University Press and London: Zed Press.
- Khan, M.H. 1995. State Failure in Weak States: A Critique of New Institutional Explanations, in Harriss, J., Hunter, J. and Lewis, C. eds. *The New Institutional Economics and Third World Development*. London: Routledge.
- Khan, M.H. 1996a. A Typology of Corrupt Transactions in Developing Countries, *IDS Bulletin* 27 (2).
- Khan, M.H. 1996b. The Efficiency Implications of Corruption, *Journal of International Development* 8 (5).
- Marx, K. 1979. *Capital Volume 1*. Harmondsworth: Penguin.
- Milgrom, P. & Roberts, J. 1992. *Economics, Organization and Management*. New Jersey: Prentice Hall.

Palma, G. 1998. Three and a Half Cycles of “Mania, Panic and (Asymmetric) Crash”: East Asia and Latin America Compared, *Cambridge Journal of Economics* 22 (6).

Schumpeter, J.A. 1994. *Capitalism, Socialism and Democracy*. London: Routledge.

Stiglitz, J. 1996. *Wither Socialism?* Cambridge Massachusetts: MIT Press.

Stiglitz, J. 1998. *Towards a New Paradigm for Development: Strategies, Policies and Processes*. 1998 Prebisch Lecture at UNCTAD Geneva, October 19 1998. Unpublished.

Stiglitz, J. & Weiss, A. 1981. Credit Rationing in Markets with Imperfect Information, *American Economic Review* 71.

World Bank 1993. *The East Asian Miracle: Economic Growth and Public Policy*. Oxford: Oxford University Press.