European Journal of Political Economy 25 (2009) 102–114

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Efficient mercantilism? Revenue-maximizing monopoly policies as Ramsey taxation

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ARTICLE INFO

Article history:
Received 30 November 2007
Received in revised form 3 July 2008
Accepted 3 July 2008
Available online 8 July 2008

JEL classification:
D6
D7
L5

Keywords:
Mercantilism
Rent seeking
Endogenous rent seeking
Rent extraction
Leviathan
Corruption
Anti-trust
Dictatorship
Regulation
Public choice
Innovation
Patents
Interest groups
Encompassing interest
Monopoly
Public finance

ABSTRACT

The economics literature on mercantilism tends to emphasize gold hoarding and external barriers to trade as defining characteristics. Medieval institutions, however, included a host of internal barriers to trade as well as external ones, and monopoly privileges and high offices were often for sale. In this paper, we analyze how a stable unitary government's regulatory policies may be affected by revenues and other services generated by the efforts of rent seekers. Competition for monopoly privilege can be a significant source of government revenue that augments tax revenues, especially in settings in which collecting ordinary tax revenues is problematic. A revenue-maximizing government encourages greater monopolization than is compatible with economic efficiency, but sells monopoly privileges in a manner that promotes innovation and partially accounts for the deadweight losses associated with monopolized markets. Our analysis provides a possible public finance explanation for relatively successful authoritarian states that have relatively little corruption, but many internal and external barriers to trade.

Efficient Mercantilism?

"Control of an entire industry had sometimes been established on the basis of a patent for invention in one part of the process. Courtiers who extorted large sums from petitioners as the price of advancing their claims were roundly condemned. But most offensive of all was the granting of monopoly powers in established industries, as a form of patronage, to courtiers whom the crown could not otherwise afford to reward. This was to the detriment of consumers and established manufacturers alike." Macleod, 1988, *Inventing the Industrial Revolution, The English Patent System 1660–1800*, p. 15.

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0176-2680/$ – see front matter
doi:10.1016/j.ejpoleco.2008.07.001

1. Introduction

One of many puzzles in economic history is the durability of medieval systems of regulation and monopoly privilege. Such long-standing systems of governmental “privilege” are commonplace throughout world history and include many relatively well-run and prosperous national states in the medieval period, such as England, France, China, and Japan, and also many smaller independent city states and principalities. There are also cases of modern societies that prosper in spite of similar formal and informal internal barriers to trade, as in contemporary Singapore and Korea.[1] For the most part, economists regard policy decisions that limit access to local markets, professions, and to political offices to be serious mistakes, and evidence of errors in the economic theories that guide policymakers in those societies. Most economists believe that mercantilist practices are wealth reducing, rather than wealth enhancing.

Our paper demonstrates that secure rulers may construct a variety of rent-seeking games to enhance their revenues and/or support from privileged groups, and may do so in a manner that nearly maximizes national economic income. We do not assume that such rulers are altruistic, but rather demonstrate that their position as residual claimants of national income leads them to approximately maximize income. We also demonstrate that considerable rent-seeking activity may be entirely compatible with this result. A “well-managed mercantilism” tends to increase wealth for the nation as a whole, relative to more corrupt or less well-managed states. Wealth in such prosperous rent-seeking states, however, may not be very broadly distributed.

We combine Olson's (1993) approach to modeling dictatorship with the contemporary rent-seeking literature to demonstrate why this is possible. The literature on rent seeking has carefully examined the extent to which resources tend to be attracted to rent-seeking contests and the extent to which such uses of resources can be regarded as a deadweight loss. The most analyzed cases are those in which the competitive process for allocating monopoly or other privilege resembles a lottery game or an all-pay auction. Successful rent seekers obtain a government-provided privilege of some kind and realize net profits; although, overall, the participants in the contest for privilege earn no profits in the aggregate under the usual Tullock (1967), Krueger (1974), Posner (1975), Hillman and Samet (1987), or Ellingsen (1991) assumptions. Their efforts to secure favor, however, often provide benefits to those who must be influenced to secure the desired rents (Congleton, 1980).

Insofar as government-determined rules of the game largely determine the incentives for resources to be devoted to various political allocation contests, governmental policies may be said to be directly responsible for any deadweight losses that result from those procedures. For the most part, the literature assumes that rent-seeking contests are an accidental consequence of other governmental policies or institutions. And, consequently, an implicit theme of most of the rent-seeking literature is that good governments should attempt to minimize the resources attracted to rent-seeking contests. The formal analysis of rent-seeking contests implies that governments can reduce rent-seeking expenditures in a variety of ways; for example, they may do so by reducing the number and value of grants, by insulating the process of distributing grants from individual rent-seeking efforts, and by encouraging competitive markets rather than monopolies.[2] Consistent with these recommendations, theorists often note that societies in which rent-seeking activities are extensive are relatively poor ones (Krueger, 1974). More informed policies would free scarce resources for uses that are value adding rather than value reducing.

In spite of this advice, most governments at least occasionally create rent-seeking contests. Moreover, in many cases, such contests are deliberately created to increase the level of rent seeking that takes place within a given society. The literature on corruption (Hillman and Katz, 1987; Shleifer and Vishny, 1993) suggests a possible personal income rationale for such allocative procedures. Government officials may profit from rent-seeking contests. However, this hypothesis about the origin of rent-seeking contests still suggests that rent-seeking contests are accidents rather than government policy, because corruption in most countries is officially illegal. We suggest that top government officials – e.g. governments – may also have an interest in promoting competition for government favors.

A relatively small strand of the rent-seeking literature demonstrates that rent-seeking contests can be designed with particular aims in mind (Glazer and Hassin, 1988; Gradstein and Konrad, 1999; Moldovanu and Sela, 2006), but their analyses have not modeled the fiscal context in which rent-seeking contests are designed. This paper suggests that a well-managed, secure, “mercantilist” government may devise rent-seeking contests to enhance public revenues and political support among elites. We demonstrate that the consequences of a well-designed rent-seeking society need not be a grave as previous work suggests. We demonstrate that a government's interest in net revenues tends to cause it to (i) create rent-seeking contests (ii) in a manner that encourages innovation and accounts for deadweight losses, although it (iii) still reduce national output below maximal levels. Olson's insight that even a narrowly self-interested government has good reasons to take into account the effects of its policies on its citizens is clearly evident in our analysis.

Our focus is on what is sometimes called “rent extraction” rather than rent seeking, per se (Appelbaum and Katz, 1987; McChesney, 1997). That is, we take the results of the rent-seeking literature to be essentially correct, and examine the incentives for governments to contrive rent-seeking contests for monopoly and similar privileges. Such contests are certain to attract the efforts of rent-seekers, and the contests may be designed so that the state receives revenues (bid, bribes, or other useful services) from rent seekers in exchange for protection, at least in the short run. The rent extraction of interest here is possible only because of the efforts of rent seekers. We also demonstrate that in some cases the original Tullock rectangle under-states outlays to secure monopoly privilege and potential rent-seeking losses, and also explore several limitations of the “encompassing interest” model of dictatorship developed by Olson (1993). The latter provides a partial explanation for the

[1] Shin (2002), for example, notes that “competitive forces have always been relatively weak in Korea.” Ramirez and Tan (2004) note that the central government plays an important role in economic development in Singapore, which they refer to as “state capitalism.”

[2] Congleton Hillman, and Konrad's (2008) two volume compendium provides an extensive overviews of the rent-seeking literature. Tullock (1980) and many others have demonstrated that the exact dissipation result is a special case, requiring large numbers of participants, although Hillman and Samet (1987) suggest that complete dissipation is more common than might be thought.