

I. Rents and Rent-Seeking Defined

Rents – Definition

In economic terms, rent is defined as ‘an income higher than the minimum that the person would have accepted, the minimum being usually defined as the income in his/her next-best opportunity (Khan & Jomo 2000). Under competitive market equilibrium (i.e. free market), no rent should be captured, as the cost of producing a product would be exactly equal to its price.

Rents can be categorized into six general categories: monopoly rent, natural resource rent, transfer-based rent, Schumpeterian rent, learning-based rent, as well as monitoring and management (financial sector) rent (Khan & Jomo 2000).

Monopoly rent requires ‘market power’, i.e. the ability of one or more firm to raise prices by restricting output, or an indivisible right over a lumpy asset, or the legal rights to be the sole supplier in the market. Natural resource rent is obtained from the exclusive right granted to a party over a natural resource. The transfer of a right through political mechanisms (legal or illegal) from public to private property generates a transfer-based rent. Schumpeterian rent is from an intellectual property right, originally introduced as an incentive to encourage investment in research and innovation. Similarly, a learning-based rent is captured due to a policy introduced by a developmental state to induce rapid learning. Good monitoring and management by the financial sector enhances the residual earnings of financial institutions by inducing efficient monitoring of credit portfolios.

Transfer-based rents and learning-based rents can only be created by state policy interventions, as shown in **Table 1**:

Table 1: Characteristics of Rents

Type of Rents	Created by the State?
Monopoly	Maybe
Natural Resource	Maybe
Transfer-based	Yes
Schumpeterian	Maybe
Learning-based	Yes
Monitoring & Management	Maybe

Source: Khan & Jomo 2000

Depending on the nature of the rent, each has efficiency and growth implications, (measurable in terms of net social benefit (NSB), either positive or negative), which also depends on the political, institutional, and technological context.

The presence of a monopoly rent implies market inefficiency, as it presumably involves 'X-inefficiency' (i.e. higher costs due to inefficiency under monopoly), while missing the main benefits of competition (mainly strong incentives for cost reduction). As a result, it may reduce growth, especially when the rent is permanent, as it may ignore the incentives for technological progress (which will substantially reduce costs over time). However, if the monopoly is temporary, it may increase investments and create incentives for technological progress.

The creation of natural resource rents ensures allocative efficiency, as free access would result in higher rent dissipation. Hence, the preservation of this rent ensures enforcement of property rights over the natural resource, which is a precondition for investment, growth or conservation of a particular natural resource sector, yielding a growth-enhancing result.

Transfer-based rents can be viewed as a 'double-edge sword', as they can yield either a positive or a negative outcome, depending on management of the rent.

While this rent is critically necessary for developing a capitalist economy and maintaining the political stability of a developing state, it may possibly result in incentive inefficiencies, with possible rapid efficiency deterioration.

Schumpeterian rents are likely to be efficient and growth enhancing, and hence, socially desirable, as they provide incentives to invest in research and innovation, thus accelerating technological progress. A thin line separates this rent from monopoly and learning-based rents (i.e. the innovation drive).

Learning-based rents have been associated with static inefficiency and low-growth rates. Although the rent has usually been introduced as an investment incentive for 'infant industries', the inability to withdraw the rent from poor performers may result in a 'permanent drain' (whereby the protected industries strive to protect themselves rather than improve their performance so as not to need protection). Hence, the ability of the state to pick the best learners, monitor their performance, and determine the optimal protection period is crucial in ensuring the rent is effective and is not abused.

Lastly, monitoring and management (financial sector) rents may be efficient, depending on the technical and political capacity of financial institutions to regulate both borrowers and banks. The rents earned should provide incentives for the financial institution to monitor portfolios effectively, hence giving the financial institution its 'franchise value'. However, in certain cases, the rent may not be 'earned' and simply encourage rent-seeking (Chin & Jomo 2000). **Table 2** summarizes the net social benefit (NSB, which is the values of the rights and rents produced as the outcome) for each rent discussed above.

Table 2: Growth and Efficiency Implications of Rents

Type of Rent	Efficiency Implications (Static NSB)	Growth Implications (Timeline NSB)	Conditions for Stated Growth Implications
Monopoly	Inefficient	Likely growth-reducing	Permanent execution period
Natural Resource	Efficient	Likely growth-enhancing	Maintenance of a natural resource's property rights
Transfer-based	Neutral (more to inefficient)	Intermediate (more to growth-enhancing)	Quality of bureaucracy
Schumpeterian	Possibly efficient	Likely growth-enhancing	Right coverage period
Learning	Inefficient	Possibly growth-enhancing	Proper management and monitoring of the rent execution by the State
Monitoring & Management	Possibly efficient	Possibly growth-enhancing	Proper monitoring and enforcement by the Monitors

Source: Khan & Jomo 2000

Rent-seeking as a Process

Rent-seeking is the process undertaken by a rent-seeker to obtain the desired rent. In economic terms, it is defined as 'the expenditure of resources and effort in creating, maintaining, or transferring rent'. The net-effect of rent-seeking plays an important factor in measuring the efficiency of a rent, as variations in rent-seeking net-effects are rooted in several factors, namely the state's institutions and structures, political conditions, distribution of bargaining power (in society), and the interdependent effects of technologies.

In empirical terms, the rent-seeking 'net effect' can be summarized as the sum of the rent-outcome associated with the NSB, less the rent-seeking cost (i.e. the cost of inputs used in the rent-seeking process). **Table 3** outlines the composition of each

variable.

Rent-seeking 'Net Effect' = Rent-outcome – Rent-seeking Cost

Table 3: Composition of Variables in Rent-Seeking 'Net Effect'

Variable	Elements
Rent-outcome	Value of the rights and rents produced in the outcome and associated with the NSB: Net gains for gainers (x) – Net losses for losers (y) (e.g. creation of rights, allocation of licenses, subsidies granted, etc.) <i>* Socially desirable rights are only created if $(x - y > 0)$</i>
Rent-seeking cost	Cost of inputs used in the process (of rent-seeking): Rent-seeking Expenditure + Social cost* (of expenditure) + Sunk costs* (i.e. investment made which, alternatively, has little current value) + Distribution of power* (i.e. competition to 'contest, bargain and hold out' to obtain desired rent) <i>* Inclusion of element shall depend on availability of related data</i>

Source: Khan & Jomo 2000

Variations in the rent-seeking 'net effect' can be categorized into three different types of rent-seeking processes, i.e. effort through private negotiation (no involvement by the State), effort of influencing the State, and effort led by the State (Khan & Jomo 2000).

Rent-seeking Through Private Negotiation

In this type, the rent-seeker privately negotiates with another party to obtain the desired rents. Subsequently, the gainers compensate the losers, and hence, the rights will only be proposed if the net outcome is positive. There is no involvement from the state in a private negotiation. This type may materialize when two companies collude or merge, e.g. to secure a monopoly position. Compensation to losers is difficult to determine and may not be accepted even if offered.

Rent-seeking by Influencing the State

In this type, the rent-seeker influences the state to establish rights or policies that allow the rent-seeker to capture the desired rents. There are three scenarios, as summarized in **Table 4**:

Table 4: Three Scenarios of Rent-Seeking by Influencing the State

Scenario	Description
Spending power of rent-seekers is proportional to their gain/loss	Who can spend more on lobbying/bribing shall win/obtain rents. May fail should there be: <ul style="list-style-type: none">- 'Collective action' problems (e.g. presence of free-riders benefiting from others' efforts)- Inter-temporal problems (e.g. when gains and losses happen in different periods)
Political power of rent-seekers is proportional to their gain/loss	Who can ensure a value-enhancing right shall win/obtain rents, whereby for a positive rent-outcome (where $x - y > 0$), gainers (who gain x) will have greater political power than losers (who lose y). Condition holds only if: <ul style="list-style-type: none">- Political power is ultimately based on the ability to mobilize economic resources
Political demands for transfers can be met with a stable set of redistributions	Transfer of rents to non-productive groups, usually to intermediate classes, with possible effects of: <ul style="list-style-type: none">- Higher negative incentive effects on other groups (should transfers grow excessively)- More subtle effects (particularly development of alliances with dissatisfied groups)

Source: Khan & Jomo 2000

Rent-seeking Led by the State

In this type, the state creates the rights or initiates the policies for rent-seekers to capture the desired rents. There are four scenarios of this type, as summarized in **Table 5** below:

Table 5: Four Scenarios of Rent-Seeking Led by the State

Scenario	Description
State officials are value-maximizers (who learn rapidly from their mistakes)	In order to ensure a value-enhancing rent, state-leaders must have these qualities: <ul style="list-style-type: none">- be value-maximizers- able to learn quickly from their mistakes However, the economic performance of the state cannot be attributed solely to the quality of state leaders.
Cost of collecting bribes/taxes does not differ across groups	Should there be no differences in transaction costs, value-reducing and inefficient rents should be a blocked, even if states are selfish
State's institutional structure allows all costs and benefits to be internalized	All costs/benefits are internalized due to institutional structure, which does not have any externalities. In ensuring value-enhancing rents: <ul style="list-style-type: none">- centralized state, if technologies are large-scale or complementary with many externalities- fragmented state (with less agency coordination) if technologies have few externalities with little benefit to be gained from coordinating
Losers do not have power to politically resist the State	If the clients are weak: <ul style="list-style-type: none">- the state is able to dictate terms with clients- clients do not generally provide strong political resistance to the State

Source: Khan & Jomo 2000

While some rent-seeking processes yield unproductive and inefficient results, some also involve transaction costs that indirectly led to productivity gains, thus supporting the development of economies (in which rents are created efficiently). This argument is the starting point for studying the significance of rent and rent-seeking processes in the Malaysian economy.