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POLITICAL INSTITUTIONS, JURISDICTIONAL BOUNDARIES, AND RENT CREATION

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Abstract: Jurisdictional boundaries have retained greater economic significance under autocratic than democratic regimes. The different forms taken by rents under democracy and autocracy underlie willingness to diminish the significance of jurisdictional boundaries as economic barriers to trade and investment. The differences in the forms of rents also underlie incentives for creation of new jurisdictional boundaries.

Key words: Rents; Autocracies, Trade Policy, Globalization, New States, Boundaries.

JEL Classification Number: F13, H11, O24.

1. INTRODUCTION

I am honored to have the opportunity to contribute a paper to this special issue in honor of Professor Michihiro Ohyama. The study of international trade, which has been Professor Ohyama's lifetime field of investigation, rests on the presence of international jurisdictional boundaries. In the absence of the policy discretion that jurisdictional boundaries provide, economic geography (see Fujita, Krugman, and Venables, 1999) replaces the study of international economics. There have been cases where *international* borders have not been required for presence of barriers to trade or factor movements. Historically payments were sometimes required for rights of passage through domains controlled by warlords or local fiefdoms. Tullock (1991a) relates how constitutional provisions preempted protectionist intentions at the state level within the U.S., and Chen (1991) reports instances of provincial protectionism in China. However, in general, it is *international* jurisdictional boundaries that are a requisite for the restrictions on trade and investment.

International jurisdictional boundaries need not necessarily be economic barriers. In the course of "globalization", international boundaries have diminished in economic significance.

Liberalization has, however, not been uniform across countries. In particular, there are differences between high-income democracies and low-income autocracies. My intention here is to consider the source of difference between democratic and autocratic political institutions in amenability and willingness to liberalize. Identifying the sources of the differences provides an indication of consequences to be expected when the institutions of democracy replace those of autocracy.

There are, of course, matters of degree in comparing democracy and autocracy. I shall proceed with a simple dichotomy. My indicators of whether the institutions of a country are democratic or autocratic are whether it is possible to name the leader of the opposition, whether the leader of the opposition is neither in exile nor in jail nor in hiding, and whether the leader of the opposition could in principle replace the incumbent head of government through democratic processes, and sustain office—all conditions are necessary.

The principle of encompassing interest predicts that autocracies will choose efficient policies, including liberal trade, since the autocratic ruler as residual claimant has incentives to seek efficient outcomes (Olson and McGuire, 1996). Also, we expect that rulers in autocracies, if they wish to liberalize trade, will not be inhibited by private-sector political-support considerations, because of absent or diminished need for electoral or voter support.¹

The evidence suggests, nonetheless, that autocracy is associated with less liberal trade policies than democracy. Mansfield, Milner, and Rosendorff (2000) compare trade barriers between pairs of democracies and pairs of countries where one country is a democracy and the other is an autocracy, and find that trade policy is more liberal between democracies than when autocracies are involved. The differences are attributed to the different institutions of decision-making under democratic and autocratic institutions. Milner and Kubota (2005) report empirically based conclusions that democratic institutions are conducive to liberal trade policies. Tavares (2005) similarly finds empirically that higher scores on country measures of democratic institutions are associated with more liberal trade policy. The direction of causality is from democracy to liberal trade policy, although we can observe that a case can also be made for the reverse causation that high incomes due to liberal trade policies evoke demands for democratic accountability.

Autocratic governments have also been less willing to participate in the negotiated liberalizations of international trade (Mansfield, Milner, and Rosendorff, 2002). The more effective liberalizing agreements involve democratic governments (Francois, McQueen, and Wignaraja, 2005).

Nor does WTO membership ensure the liberal trade policies in principle expected from adherence to WTO principles. Rather, many governments sustain protectionist

¹ Autocratic rulers benefit, of course, from a compliant population, which is an analogue of political support in democracy. Wintrobe (1998) presents a classification of types of autocratic rulers according to whether the means used to sustain political incumbency is making the population better off or repression.

policies after WTO admission, and in some cases WTO members have less liberal trade policies than non-members (Rose, 2004).

More generally, and encompassing of these above observations, Graeff and Mehlkop (2003) observe the positive relation between measures of political and economic freedom.

The policies chosen consequent to the creation of new government jurisdictions provide further indicative evidence of differences between democratic and autocratic political institutions. New boundaries have been used as economic barriers in autocracies, when at the same time countries with democratic institutions, including states formerly subjugated by communism, proceeded with policies of greater international economic integration.

A question that can thus be posed is why governments in democracies have been willing to agree to reduce the economic significance of international boundaries when, under autocracy, jurisdictional boundaries are used as market-segmenting barriers. Answers can stress the different accountability of political decision makers to voters or the population at large through democratic and autocratic institutions. Mansfield, Milner, and Rosendorff (2002) point to the credibility to political decision makers imparted through external monitoring of obligations of international trade agreements as underlying how political institutions influence participation in international trade agreements. Autocratic rulers wish to avoid the external monitoring. Milner and Kubota (2005) similarly attribute the increase in liberal trade policies to more democracy.

We can also consider roles of rent creation and the political assignment of rents. Such a perspective draws on the economic analysis of rent seeking behavior and facilitating institutions.

Behavior in a "rent-seeking society" is directed at becoming the beneficiary of rents. Social losses are incurred when resources are used to contest the rents (Buchanan, Tollison and Tullock, 1980; Rowley, Tollison and Tullock, 1988; Hillman and Riley, 1989; Tullock, 1991b). Applebaum and Katz (1987) have aptly described rent creation for the purpose of rent extraction as "seeking rents by setting rents". There can, of course, be no rent seeking for politically created rents in the absence of political opportunities for rent creation. The opportunities derive from facilitating aspects of political institutions that allow rents to be created from various sources. Section 2 introduces a specification of legally and illegally facilitated rents. Sections 3 and 4 describe the differences regarding rent creation and rent assignment between democratic and autocratic institutions. Section 5 establishes the presumption based on rent creation and assignment that, with autocratic institutions, liberal policies will be resisted, as will intrusions of "globalization" into the domestic economy. Section 6 notes the relation between opportunities for rent creation and the creation of new political jurisdictions, and briefly illustrates rent creation with two examples. Conclusions are in the final section.

2. RENTS AND RENT SEEKING

Institutions determine the feasibility of political rent creation, and whether particular rents are legal. Tullock (1967) in his original contribution identifying the social losses due to rent seeking compared rents legally created through tariffs and monopoly with the illegal rents of a successful thief. The legal rents from tariffs and other protectionist policies (Hillman, 1982, 1989; Grossman and Helpman, 1994, 2002) require political discretion to protect, given international obligations. In particular, administrative protection consistent with obligations of the WTO allows anti-dumping policies to be used to provide discretionary protection (Nelson, 2006).

Protectionist policies can be present in democracies and autocracies. Institutions of autocracy are however in particular amenable to rents from corruption, although corruption is illegal (Tanzi, 1998, 2000; Abed and Gupta, 2002; Aidt, 2003). As Tullock (1967) noted, rents are also created through monopolization of domestic markets. If corruption takes the form of bribes that are informal taxes, import restrictions facilitate payment of the tax as a share of protectionist or monopoly rents. There are various other sources of rents, for example, legal rents from financial repression (see for example Hillman, 2003, chapter 7) and illegal rents from privatization (for example, Bjorvatn and Søreide, 2005). Restraints on employment of labor in other jurisdictions provide rents to owners of industry-specific capital (to which we shall presently return in an example).

Against the background of the diverse sources of rents, we can consider a general specification

$$(1) \quad \{R_1, R_2, \dots, R_n; Z_1, Z_2, \dots, Z_s\}$$

where the rents R_i ($i = 1, \dots, n$) can be legally created and the rents Z_j ($j = 1, \dots, s$) are created illegally through corruption (that is, through the use of authority of the state for private benefit). The rents are politically created but can be shared with, or assigned to, private-sector individuals.

We denote by a_i ($i = 1, \dots, n$) ($0 \leq a_i \leq 1$) the share of a legal economic rent obtained by government officials, with the remaining share $(1 - a_i)$ accruing to the private sector. The share an illegal rent retained government officials is b_j ($j = 1, \dots, s$). Officials therefore obtain the legal or illegal transfers

$$(1a) \quad \{a_1 R_1, a_2 R_2, \dots, a_n R_n; b_1 Z_1, b_2 Z_2, \dots, b_s Z_s\}.$$

The greater is a_i or b_j , the greater is the political incentive to create the rent for personal benefit. The rents

$$(1b) \quad \{(1 - a_1)R_1, \dots, (1 - a_n)R_n; (1 - b_1)Z_1, \dots, (1 - b_s)Z_s\}$$

are the objects of rent seeking by the private sector and are the sources of efficiency losses through rent dissipation. Under conditions of complete rent dissipation, the shares of the rents in (1b) are precise social losses, although rent dissipation may be incomplete (see Hillman 2003, chapter 6). If the rents to political decision makers in

(1a) are contestable, these transfers also attract rent seeking and represent further social losses (Hillman and Katz, 1987).

3. RENTS IN DEMOCRACIES

In a democracy, for non-corrupt politicians, $a_i = 0$ for all i and $Z_j = 0$ for all j . A politician or candidate for political office can be corrupt but social and political norms in a democratic society will tend to make the corruption non-sustainable. With corruption absent or known to be non-sustainable, the economic rents in (1) do not primarily motivate personal quests for political office. The benefits from political office can then be described as subjective ego-rents

$$(2) \quad \{E_1, E_2, \dots, E_m\}$$

sought by m political contenders participating in political competition in a democracy.

There are also political benefits for the m political contenders

$$(3) \quad \{P_1, P_2, \dots, P_m\}.$$

A political benefit P_k ($k = 1, \dots, m$) consists of political support through campaign contributions and voter support sought in order to achieve or maintain political office. The resources used to achieve political office reflect the positive values of the ego-rents. If we regard P_k as the probability of electoral success,

$$(4) \quad \sum_{k=1}^m P_k = 1.$$

Political optimization entails politician k choosing policies that maximize the probability of electoral success P_k through private-sector rents that the politician offers relative to other rents offered by other politicians. A candidate k chooses rents to create and assign through economic policies,

$$(5) \quad \{R_{1k}, R_{2k}, \dots, R_{nk}\}, \quad k = 1, \dots, m$$

where

$$(6) \quad P_k = f^k[(R_{1k}, R_{2k}, \dots, R_{nk}, W(R_{1k}, R_{2k}, \dots, R_{nk}), \Omega], \quad k = 1, \dots, m.$$

The policy announcements or offers of all other candidates are expressed in Ω . The function $W[\cdot]$ is a measure of welfare of the broad population or of broad voter support given the rent-creating efficiency-detracting policies that political candidate (or party) k has chosen. A private-sector rent provides political benefit but the policies that create the rent reduce broad consumer welfare:

$$(7) \quad \frac{\partial f^k}{\partial R_{ik}} > 0, \quad \frac{\partial f^k}{\partial W} \frac{\partial W}{\partial R_{ik}} < 0 \quad i = 1, \dots, n, \quad k = 1, \dots, m.$$

We can envisage Nash equilibria of outcomes of political competition among candidates (Hillman and Ursprung, 1988) where candidates choose policies that create rents as in (5) to trade off narrow special-interest private-sector benefit and broad voter dissatisfaction. Alternatively, incumbents can receive offers of political support (Hillman,

1982; Grossman and Helpman, 1994) and political competition is implicit the welfare loss that the incumbent can impose on the general population and hope to retain office.

Identification of beneficiaries of the economic rents R_i in democracies establishes the prima-facie motives for the private interest in influencing public policy (Hillman, 2003, chapter 6), or more particularly identifies the private motives for seeking to influence international trade policy (Hillman, 1989; Grossman and Helpman, 2002). That is, with institutions of democracy to provide accountability of politicians to voters, a political exchange nonetheless takes place to the disadvantage of overall voter welfare (or efficiency), through rents politically created and assigned to private beneficiaries for the purpose of electoral support.²

The principal point is that, in political competition in democracies, political candidates and incumbents are motivated to seek or retain office by ego rents. Successful candidates have no personal claims to the economic rents that policies (or promised policies) create, other than through the indirect political benefit of increased likelihood of political success, and thereby an increased likelihood of benefiting from the ego-rent of political office.

Since the ego-rents are the only motivating influence, incumbents and candidates engaged in political competition can be led to choose economic policies that diminish the economic significance of national boundaries. Beneficiaries of incomes from factors specific to export industries as well as consumers at large in general wish to have liberal trade policies (Hillman and Moser, 1996). Risk spreading facilitated by asset markets diminishes the extent of links between individual incomes and wealth and sector-specific rents, and perfect risk spreading through asset market diversification would lead voters to want free trade (Feeney and Hillman, 2004). At the same time, the MFN clause makes any bilateral liberalization a multilateral liberalization (Ethier, 2001, 2002).

4. RENTS IN AUTOCRACIES

In autocracies there are not only ego-rents but also the full range of rents in (1) can be available for creation and assignment. Some of the legal economic rents denoted R_i in (1) take the same forms in democracies and autocracies (rents from monopolization and protection and through the government budget in the form of subsidies and other public spending). The extensive corruption in autocracies (see Tanzi, 2000; Easterly, 2001; Abed and Gupta, 2002; Paldam, 2002; Hellman, Jones, and Kaufmann, 2003; and many others) introduces the rents Z_j in (1). The domain of rents available for creation and assignment is thereby expanded. Sources of rents include appropriated budgetary funds including foreign aid,³ bribes in the course of designating suppliers for government

² There are also median-voter representations, where trade policies are determined directly without intervening politicians (Mayer, 1984).

³ Foreign aid provided to governments in low-income countries has been overall ineffective in improving living standards of the poor. See the meta-study by Doucouliagos and Paldam (2005).

procurement and for facilitating or allowing investment given restrictions set by regulations and investment priorities of development programs, and personal appropriation of proceeds of sales of natural resources that are in principle owned by the state. With no requirement for political support through transferring or creating rents for the private sector, the proportion of a rent a_i retained for personal benefit by political decision makers can be positive. Being a member of the ruling elite is not an impediment to being in private business, or the family being in private business. Indeed, a member of the family may be sent into the bureaucracy of government precisely to further the economic interests of the family. Sharing of rents may take place with outside parties in the private sector, with government officials as “silent partners”.

We are of course describing here a different political culture than that of democratic accountable regimes. The domain of human relations is more that described by Nietzsche (Hillman, 2004). Ethical or legal restraint is absent from personal behavior. The strong are in control only because they are strong, and do as they wish to the weak (see the example of the extreme circumstances described by Verwimp, 2003, who associates the quest for rents in Rwanda with the price of coffee).

Since the control over others exercised by an autocratic ruler exceeds the self-importance that can generally be provided through political success subject to the institutions of democracy, we expect ego-rents in autocratic domains to exceed the ego rents that a successful politician might achieve in a democracy. Ego rents also decline with the number of persons with whom political power is shared, and hence, for any domain of power over others, ego-rents are maximal when an authoritarian ruler controls the authority of the state.

5. A COMPARISON

The utility of an authoritarian ruler includes the heightened ego-rents and the expanded personal economic rents. If we set $a_i = 1$ to represent the political culture when there is no impediment to use of political office for personal financial benefit, we have:

$$(8) \quad U^A = f^A[(R_1^A, R_2^A, \dots, R_n^A, Z_1^A, Z_2^A, \dots, Z_s^A, E^A)]$$

where the superscript A indicates institutions of autocracy. An honest successful politician in a democracy will have utility only from ego-rents of political office, which we portray contingent on political success as

$$(9) \quad U^D = f^D[E^D].$$

With $E^D < E^A$ and all R_i^A 's and all Z_j^A 's positive, the comparison between utility under institutions of democracy and autocracy is unambiguous with no scope for trade-offs:

$$(10) \quad U^A = f^A[(R_1^A, R_2^A, \dots, R_n^A, Z_1^A, Z_2^A, \dots, Z_s^A, E^A)] > U^D = f^D[E^D].$$

Choice between the institutions of democracy and those of autocracy thus affects utility of the political class. The decisions regarding how to create and assign economic

rents, including personal benefits from corruption, are predicated on the political institutions in place. We expect that, where traditions of democracy have not taken hold, elected rulers may seek to overturn term limits and to change institutions to increase personal power or reduce contestability of political office.

Autocratic regimes will view “globalization” with disfavor, since competitive markets compromise rent creation made possible through control of the state. We expect the rhetoric to criticize “globalization” because of the good that the state can *in principle* do but is impeded from doing because markets constrain the role of government.

The preference in (8) can be reversed when democratic institutions are part of personal utility. The case of Singapore has also demonstrated that autocracy can be consistent with a ruler for whom corruption is unethical and for whom ego-rents are maximized by seeking the best outcome for the population at large.⁴

6. ECONOMIC BARRIERS AND NEW POLITICAL JURISDICTIONS

The choice between institutions of democracy and autocracy expressed in (8) presupposes jurisdictional boundaries that designate the domain of authority of the state and allow different levels of economic barriers. We have observed that in democracies where ego-rents are the primary (or indeed only) motive for seeking political office, political processes can give rise to protectionist policies or high economic barriers or just as well to liberal economic policies. The welfare of the population at large appears in the political objective function (6) and finds expression in (7) as the source of a trade-off against political benefits of rent creation and rent assignment. The beneficiaries of the economic rents available under institutions of autocracy face more limited need for political support from the population. In the Nietzschean limit, the power of the state is used exclusively for the benefit of the strong in control of the state. There are also incentives to form new jurisdictions that provide the means of formalizing latent autocratic institutions.

Two instances of formation of new jurisdictions can attract our interest as brief case studies. The first example is that of the new states created following the end of communism in Europe and central Asia; the second is the construction of a physical barrier between areas of the state of Israel and areas of jurisdiction of the Palestinian Authority.

6.1. *Post-communist countries*

The republics of the former Soviet Union became independent regimes when at the same time high-income democracies were proceeding with greater economic integration. Post-communist states with democratic institutions pursued policies of economic integration with Europe but, where regimes were more autocratic, the new jurisdictional boundaries became economic barriers that allowed rents to be created.

Although some trade was sustained through barter that replicated or used previous input-output production relations (Marin and Schnitzer, 2002), the new jurisdictional

⁴ We are also led into the more complex account of the role of Gorbachov in the end of authoritarian communist rule, including the relation between the intention and the outcome.

boundaries disrupted the vertical supply relationships of the previous planned production system. In many cases, the new international trade all but collapsed (Schoors, 2003). The end of planning and the beginning of transition to a market took place without extensive trade barriers in place.⁵ However, although official visible trade-policy instruments suggested liberal trade policies, selective trade taxes and non-tariff barriers restricted trade, and capital controls encumbered investment and foreign payments (Bodenstein, Pülmper, and Schneider, 2003).

Corruption was also extensive. Levin and Satarov (2000) report that a majority could not be found in the Russian parliament (or duma) for a law that would prevent members of parliament from benefiting personally through business connections from their own legislation. Gaddy and Ickes (2002) propose that only natural resource extraction has had positive value-added, and that all other economic activity is based on rent transfers.

6.2. *The Palestinian Authority*

Another instance where a new jurisdictional boundary disrupted prior economic integration is the demarcation between areas of jurisdiction of the Palestinian authority and parts of the Israeli economy.⁶ In this case also a jurisdictional boundary that could in principle have been but a political demarcation became an economic barrier. The barrier also separated different institutions, the democracy of Israel and the authoritarian regime of the Palestinian authority. As with jurisdictional and economic segmentation in the former Soviet Union, the separating barrier was counter to tendencies of market-integration elsewhere.

Since the barrier segmented prior integrated labor markets, Palestinian workers who, because of short commuting distances, had previously had access to the labor market in Israel were in particular disadvantaged. The high-cost high-technology barrier was a response to electoral pressures for a means of defense against Palestinian terror.⁷ The terror emanated from an autocracy that could control personal activity within its jurisdiction. Terror was predicted to decline or cease after construction of the separating barrier. Of two outcomes without terror, that without the barrier is more efficient, because of the benefits of market integration rather than market segmentation (also resources spent on construction of the barrier could have been more productively used). Survey evidence indicates that, among the population living under the jurisdiction of the Palestinian authority, workers expressed greatest opposition to the terror to which the separating barrier was a response (Krueger, 2004).⁸ Workers thus took a position consistent with their economic self-interest. For higher-income parts of the Palestinian

⁵ Market protectionist instruments were not required under communism since international trade, like domestic production, was planned.

⁶ In most places, the boundary is a fence, but in some places the barrier is a wall for security purposes.

⁷ It is not the intention here to consider the reasons for the ongoing Arab-Israeli conflict: for perspectives on the conflict, see for example Cowen (2004) and Plaut (2004). Eldor and Melnik (2004) describe the effects of the terror through financial markets. There was an ethical dilemma in construction of the barrier, since the barrier could not be used selectively against terrorists: see Franck, Hillman, and Krausz (2005).

⁸ Thus, support for terror was not associated with low incomes. For more extensive evidence that poverty or low-income is not the cause of terror, see Kruger and Maleckova (2003) and Berrebi (2003).

population supportive of the terror, economic self-interest was expressed in the rents from labor-market segmentation for owners of sector-specific capital. The jurisdiction of the Palestinian authority also facilitated rents from corruption, including appropriation of aid (see Abu Nimah and Abunimah, 2004, and EU Funding.org, 2005). Rents were thus created. Continuing terror required the government of Israel to respond to pressures from the Israeli electorate to continue with construction of the separating barrier, when construction of the barrier would have ceased, had the terror ceased. The terror created the barrier, which remained to create and sustain rents.

7. CONCLUSIONS

An investigation of the role of the boundaries of the state encompasses various dimensions of analysis.⁹ Economic theories of international economic integration focus on efficiency aspects of the policy domain of states, through preferential trading arrangements (Viner, 1950; Kemp, 1969), and on the monetary dimension through designation of characteristics of optimum currency areas (Mundell, 1961). Political motives suggest alternative perspectives on integration. European integration, for example, might be viewed as primarily politically motivated and based originally on anticipation of a reunited Germany, with market integration as a means rather an end. With regard to currency areas, Goodhart (1998) observes that political motivations and seignorage rents associated with control of the money supply within jurisdictional boundaries have historically determined the currencies that people use and not optimum-currency area principles. I have here considered jurisdictional boundaries from the comparative perspective of institutions of democracy and autocracy. Democratic institutions are in principle designed with socially beneficial intentions of facilitating collective decisions about public finance while providing accountability of political representatives to voters (Hillman, 2003; Mueller, 2003).¹⁰ We have observed that politically created rents in democracy are principally a means to the end of securing ego-rents through success in political competition. The predominance of ego-rents and absence of personal direct political benefit from economic rents can lead political candidates and incumbents in democracies to choose liberal policies, and change can be observed under democracy through trade liberalization and other liberalizing policies. The *purpose* of the autocratic state is however rent creation, and rent protection.¹¹

Regime change from autocracy to democracy is broadly expressed in institutions that determine political accountability and political discretion.¹² Changes in the scope for rent creation and political self-assignment of economic rents are particular means whereby such regime change diminishes the economic significance of jurisdictional boundaries.

⁹ Allesina and Spolaore (2003) provide a broadly based analysis explaining or predicting domains of the state.

¹⁰ The benign intentions do not prevent involuntary rent transfers through voting (Tullock, 1959).

¹¹ An exception would emulate Singapore.

¹² On internal political calculations and preconditions for regime change, see Rosendorff (2001).

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