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Innovation-Induced Rent Seeking As A Free Trade
Treaty Provision: Facilitation Of Regulatory Reform

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Although economists tend to appreciate that trade enables us to specialize, and that by specializing we can produce and thus consume more, trade policy is less informed by economics than it is shaped by matters of political economy.

[Ikenson, D., Lester, S., and Hannan, D. (2019). *The Ideal U.S.-U.K. Free Trade Agreement: A Free Trader's Perspective*. At p. 2, "The Preamble." CATO Institute, Initiative for Free Trade and the CATO Institute.]

Plan of the paper:

Section 1 introduces a Mercantilist Reciprocity model as the setting for the analysis of “positive sum” or “Innovation-Induced” rent seeking.

Section 2 discusses the theoretical foundations of rent seeking, distinguishes between the traditional interpretation as “negative sum” and shows that the theoretical analysis of positive and negative rent seeking would support a role for treaty provisions which encourage positive sum rent seeking through spurring innovation and the dissipation of rent.

Section 3 briefly highlights the types of treaty provisions where “positive sum” rent seeking has the potential to reduce trade barriers and allow resources to flow to their highest valued uses.

Section 4 provides concluding comments.

Major Points of the paper:

“Mercantilist Reciprocity” trade policy is characterized by leveraged threats, personalization, and reliance on personal relationships over political emissaries.

Rent seeking is an inescapable element of Mercantilist Reciprocity and political theater in general.

The goals of interest groups and politicians compete with government’s undertaking of political goals and national aspirations.

Treaties are products of the strategies used and the individual and collective goals pursued to obtain agreements.

Rent seekers seek to create and protect the fruits of special privilege.

Continued.

“Innovation induced” or “positive sum” rent seeking which has the spillover benefit or externality of increased competition and drives both regulatory reform and free trade.

Spillover benefits accrue from the destruction of monopoly rents, the expansion of markets, and creation of new products.

“Counter coalitions” or “incipient regimes” consisting of firms and interest groups that hope to market innovations after the regulatory constraints are lifted. Those firms are motivated by the expectation of earning quasi-rents in the sale of products that embody their innovations.

Introduction:

“Mercantilist Reciprocity,” a modern version of mercantilism, includes a national economic policy aimed at accumulating monetary reserves, economic power, and international stature through a positive balance of trade, especially of finished goods and critical inputs, protective tariffs and domestic subsidies, and the use of tariffs strategically as negotiation instruments.

This paper departs from the standard models of trade negotiations and focuses on the role of rent seeking in the creation of new markets by reducing regulatory barriers that decrease competition and impede the development of new welfare enhancing products.

The model of rent seeking developed in this paper, called “innovation-induced” or “positive sum” argues that the pursuit of special privilege and returns in excess of marginal cost need not lead only to the monopolization of pre-existing competitive markets, but has wider repercussions in “leveling the playing field” objectives which are often cited as the goal for free trade negotiations.

In general, rent seeking behavior has negative connotations. Consequently, one would be slow to suggest it is an important component in trade negotiations and deregulation.

Gordon Tullock's rent seeking insight focuses on the investment of resources by individuals, firms, and organizations to obtain special privilege which enable appropriable benefits in excess of marginal cost. "Rents" may come in the form of monetary gains and power-related assets such as prestige, authority, non-pecuniary benefits, e.g., increased discretionary authority for one group while decreased discretion for others. The appropriation of private gains drives the investment of resources – not all of which will be successful -- prudent or satisfy efficiency criteria.

Unsuccessful investments are viewed as wasted resources, but this need not be the case. Spillover benefits may accrue for the destruction of monopoly rents, the expansion of markets, and creation of new products. This paper focuses on a variant called "innovation induced" or "positive sum" rent seeking which has the spillover benefit or externality of increased competition and drives both regulatory reform and free trade.

This paper describes the trade negotiation strategy of the U.S. and many other countries as a “mercantilist reciprocity” bargaining game involving “tit for tat” in addition to “trade” in physical goods and services. Like other negotiations with political objectives, treaty negotiations involve uncertain impacts, media campaigns, politics, and threats of potential trade barriers including tariffs, quotas, competition rules, domestic taxes, and regulations.

“Tit for tat” bargaining models refer to a response in kind, retaliation, and counterattack which is played out in the media. The term is derived from the Middle English term “tip for tap,” which means “blow for blow” which is consistent with the exchange of threats, insults, and public statements. In game-theory, it is a strategy in which each participant mimics the action of their opponent after cooperating in the first round. It is often used in games with repeated moves or in a series of similar games.

Mercantilist Reciprocity games dissipate into rent seeking in addition to the undertaking of political goals and national aspirations. Competitive rent seeking leads to the breakup of monopolies which reduces prices. The increased spending from lower prices stimulates individual consumption and investment in newly opened markets. Treaty provisions which encourage rent seeking of this special kind – “positive sum” or “innovation-induced rent seeking” should be recognized and used to the national and international advantage of the parties – including consumers.

Section 1: “Mercantilist reciprocity” as a bargaining game.

International trade negotiations may be described as a “mercantilist reciprocity” bargaining game involving “tit for tat” in addition to “trade” in physical goods and services. Negotiations are motivated by the pursuit of personal, professional, and political objectives. Trade negotiations may include tariffs, quotas, competition rules, and domestic taxes and regulations. Key components of treaty negotiations include strategy, bargaining, bluffing, and the use of various forms of diplomacy to accomplish national economic goals and strategic objectives. In turn these may be combined with such tools as media campaigns, political pressures, and efforts to create narratives of visions (or fears) of alternative futures and treaty provisions as the institutional routes for obtaining them.

“Tit for tat” bargaining features a response in kind, retaliation, and counterattack which is coordinated with media campaigns. The term is derived from the Middle English term “tip for tap,” which means “blow for blow” which is consistent with the exchange of threats, insults, and public statements. In game-theory, it is a strategy in in games with repeated moves or in a series of similar games in which each participant mimics the action of their opponent after cooperating in the first round. The bargaining space for “mercantilist reciprocity” provides many opportunities for rent seeking, an important and inescapable feature in understanding the political economy.

Section 2. Theoretical Foundations of the Rent-Seeking Insight Inescapable rent seeking – deadweight costs, monopoly rents, and the potential for “positive sum” effects.

Rent seeking is an inescapable element of Mercantilist Reciprocity and political theater in general. The goals of interest groups and politicians may dominate, displace, or coordinate with the government’s undertaking of political goals and national aspirations. Treaties are products of the institutional structures and strategies used coupled with the individual and collective goals pursued to obtain and implement agreements. The outcome of treaties includes economic effects such as price changes and the distribution of goods and services, the political consequences of such changes, and the “unintended” consequences of the implementation of agreements.

Treaty structure and language may permit “loosely structured discretion” and “interpretative license” which encourages rent seeking in both the formative and implementation phase of treaties. The creation of monopoly power through rent seeking or market dominance is associated with reductions in the welfare of individuals and the citizens of countries. The modern literature has stressed the deadweight costs (Harberger 1954) and the rent-seeking costs of monopoly that arise from competition for monopoly returns (Tullock 1967). Assuming perfect competition for monopoly rents, the total cost of monopoly power is a trapezoid, composed of the triangle of lost consumer surplus (“Harberger costs”) plus the rectangle of monopoly profits devoted to rent-seeking activities (“Tullock costs”) (Posner 1975). To this we may add a third dimension – the net reduction in rents due to competitive rent seekers which leads to the breakup of monopolies which reduces prices.

Section 2. Theoretical Foundations of the Rent-Seeking Insight. Inescapable rent seeking – deadweight costs, monopoly rents, and the potential for “positive sum” effects.

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The increased spending from lower prices stimulates individual consumption and investment in newly opened markets. This paper speculates that treaty provisions which encourage rent seeking of this special kind – “positive sum” or “innovation-induced rent seeking” in international trade treaties should be recognized and used to the national and international advantage of the parties.

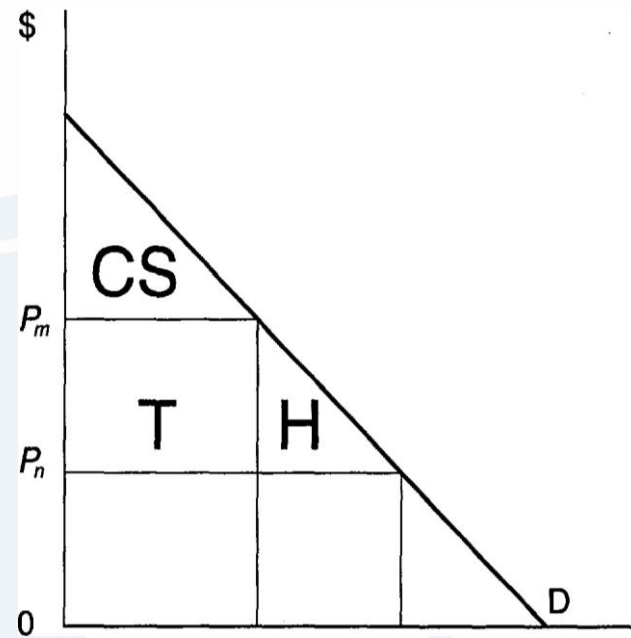
Rent Seeking to Promote Regulatory Reform through incipient regimes

Consider treaty negotiations (bargaining) in the Mercantilist Reciprocity model involving two countries one of which precludes some firms from employing particular cost-reducing innovations in the production process. This may occur due to monopolization, cartels, or patents and trademarks. We assume that inefficient restriction was established and has remained in place because benefits a dominant coalition composed of:

- (1) bureaucrats who wish to maintain strict regulatory controls over industry;
- (2) firms and workers with political capital in the existing system (entrenched existing firms and unions that seek to minimize competition from potential entrants and cost-reducing competitors; and
- 3) third-party public interest groups that advocate intrusive regulation.

Now let us assume an incipient regime representing an alternative view is formed to lobby for the removal of the restriction on innovations. The incipient regime consists of firms and interest groups that hope to market innovations after the regulatory constraints are lifted. Those firms are motivated by the expectation of earning quasi-rents in the sale of products that embody their innovations.

Figure I shows the innovative products industry that comes into being as a result of the counter-coalition's success. Compared with the competitive ideal of Q_n sales at a price of P_n per unit Q_m units are now sold at a price of P_m per unit. Rent seeking by “incipient regimes” or counter-coalitions absorb resources represented by rectangle T, Tullock costs, and creates Harberger costs represented by triangle H. Those costs are associated with a net increase in, rather than a diminution of, social welfare, since the innovative products market would not have come into being in the absence of the rent seeking by the incipient regime or counter-coalition. Therefore, rectangle T merely offsets the gain in producer surplus attributable to the creation of the new market—it does not constitute a waste of pre-existing surplus.



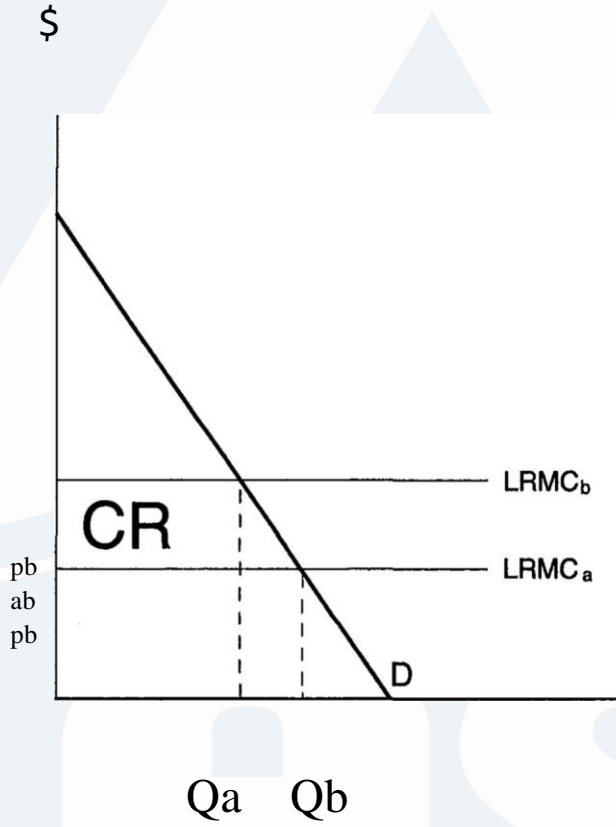
Triangle H should not be included in welfare calculations at all. Triangle H merely represents forgone gains in consumer welfare that could have been realized through the supply of additional units of innovative products—not the destruction of pre-existing surplus through a post-monopolization production cutback in an existing market. However, triangle CS represents an unambiguous gain in consumer surplus accruing to purchasers of innovative products in the form of cost reductions that could not have been achieved without rent seeking by innovative products suppliers. In short, rent seeking to lift regulatory barriers to innovation yields unambiguous net welfare gains equal to triangle CS.

Additional benefits may also flow from such rent seeking. Given the imperfect appropriability of research and development (Jaffe 1986; Mansfield, Schwartz, and Wagner 1981; Levin, Klevorick, Nelson, and Winter 1986), some of the knowledge derived in connection with the introduction of new products may spill over to firms other than new product suppliers. That allows such third-party firms to reduce their costs.

Consider Figure 2, which shows cost reductions accruing to third-party firms in the widget industry (which is independent from the innovative products industry). Those cost savings shift the widget industry's supply curve (long-run marginal cost) from $LRMC_b$ to $LRMC_a$, yielding net gains in consumer surplus equal to trapezoid CR.

In sum, rent seeking that eliminates inefficient regulatory restrictions and, thereby, allows the introduction of new markets, raises rather than lowers welfare. In this case, Tullock costs are more than offset by additional surplus created in the new markets, and Harberger costs merely represent additional potential welfare gains that cannot be realized, rather than the destruction of existing surplus. Further accretions to surplus result from spillover benefits of innovation (cost-reducing advances in knowledge) to third parties.

FIGURE 2; THIRD-PARTY EFFECTS



The failure to see the possible counterbalancing rent creation is a flaw in the received doctrine on rent seeking. It has been argued that because rent-seeking costs are largely sunk costs that cannot be recouped under most conditions, the monetary returns from deregulation may be smaller than previously thought (McCormick, Shughart, and Tollison 1984).

The limitation of this argument is the failure to consider the positive effects of rent seeking to break down monopoly rents which may result from competitors seeking to obtain the rents themselves. Therefore a payoff from rent seeking in this context is that rent producing sinecures and special privileges may eroded by competition for existing rents which may be undertaken by parties in either country to the treaty negotiation.

In Mercantilist Reciprocity bargaining, the motivation lies in the net accretion of economic surplus resulting from the competition for rents which is driven by the potential new rents, and destruction of existing rents (“Schumpeter’s creative destruction”). While the Mercantilist Reciprocity model focuses on the net accretion to participants, international trade institutions offer opportunities to encourage domestic regulatory reform by exposing such countervailing rent. These may be motivated by centralized political authorities as a reflection of the broader goals of their constituencies or changes in political leadership. Nevertheless, treaty negotiations will also reflect the competition for rents among affected parties and incipient regimes speculating on joining these coalitions.

The incentive of free trade advocates to dissipate rents through treaties has the effect of expanding existing and opening new markets. The essence (net accretion of surplus) of the “innovation induced rent seeking” is both in stimulating institutional change which open markets and expand trade. The prize to consumers is the improvement of the life styles of consumers and not the individual losses in specific markets. Opposition by the *status quo*, however, is the stumbling block to this analysis because the dominant coalitions of existing firms stands to incur economic losses --- and hence has the incentive to block change.

Rent seeking by “Counter Coalitions” -- “Incipient regimes”

Institutional entrepreneurs speculate on the payoffs from institutional change (and how they may appropriate it). Support for institutions which allow/encourage innovation-induced rent seeking will come from several sources. The most obvious source is those firms and interest groups which stand to obtain near term and obvious benefits. One can expect the formation of latent coalitions of interest groups (“incipient regimes”) which speculate on their appropriable benefits from expanded markets and “rents” from constructing institutional barriers – or removing them.

Mercantilist Reciprocity is motivated by potential appropriable benefits and rents for dominant coalitions of participants. The size of the payoffs may be large to countries, interest groups, and individual firms. Consequently, countries, firms, politicians, bureaucracies, and interest groups are motivated to invest in media campaigns and engage in political activities involving threats to impose costs through potential trade barriers including tariffs, quotas, competition rules, domestic taxes, and cumbersome regulations.

My argument is that “positive sum” rent seeking should be recognized in free trade treaty negotiations. It is, of course, true that “economic rents” are sought in articulating the provisions of trade treaties – the UK and EU, the United States–Mexico–Canada Agreement (USMCA) which replaced the North American Free Trade Agreement (NAFTA).

The next section briefly addresses the question of free trade oriented treaty provisions which might be amenable to free trade advocates and “leveling the regulatory playing field.”

Reducing tariffs and other border barriers to enable goods and services to cross frontiers is the traditional way to expand the size of the market. These kinds of barriers remain formidable in some manufacturing and agricultural sectors of rich countries. However, integration and market expansion will remain hindered if the laws and regulations governing commerce differ between or among the countries that reduced their border barriers.

Section 4: Concluding comments and future research.

The objective of trade is to expand the size of the market to enable greater and more refined levels of specialization, economies of scale, and resources going to their highest valued users.

Ideally, the language would be short, sweet, and unequivocal: “There shall be free trade among the Parties.” Ideally key concerns should be focused on treaty provisions which provide opportunities for free trade advocates to the important benefits of “innovation-induced” rent seeking? A brief summary of five trade related areas is examined --- there many more, but due to time, these represent general areas of concern.

A major concern in “levelling the playing field” is regulatory coherence among the parties. Frequently, there is a divergence in regulatory scope and enforcement practices which can serve to increase costs and frustrate market integration. Further relevant to this rent seeking and free trade treaties is the likelihood that regulatory divergence masks protectionism or is simply a “back door” to restrict imports.

Regulatory coherence efforts should not simply require parity of regulations -- a practice which leads to the efforts to “harmonize” by setting the highest prices found among all countries.

Maximizing labor mobility in response to opportunities should be an objective pursued by free trade advocates. “Levelling the playing field” should enhance the opportunity for workers to “vote with their feet” and move to other countries where their unique skill set is more highly valued and in short supply. The free flow of capital through investment provisions should also focus the debate on such obstacles as “most favored nation treatment” and rights to compensation for government expropriation of an investment.

E-Commerce is a critical area for free trade advocates to address. Simply stated there are many opportunities to insure data security while protecting the free flow of data --- as well as preventing forced localization of data servers and technologies.

Obviously, competition should be encouraged by parties to promote the security of the internet and protecting the privacy of individuals and businesses as they use and create content. Free trade advocates should target such restrictions as customs duties on electronic transmissions, requirements that foreign companies provide software source code as a condition of doing business, restrictions on cross-border transfer of information by electronic means, and requirements that foreign entities use of local computing facilities as a condition of doing business in the territory.

Government procurement is a closely related issue to data quality and security. Treaty provisions should seek to provide nondiscriminatory consideration of bids from producers and service providers regardless of the country in which they reside.

Concluding comments:

Reducing tariffs and other border barriers to enable goods and services to cross frontiers is the traditional way to expand the size of the market. These barriers remain formidable in some manufacturing and agricultural sectors in rich countries.

However, integration and market expansion will remain hindered if the laws and regulations governing commerce differ between or among the countries that reduced their border barriers. “Innovation-Induced” and “Positive Sum” rent seeking can play a positive role in identifying and removing obstacles to free trade. The negative sum variant of rent seeking will always be a problem.

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