TRANSACTION COST POLITICS, RENT SEEKING, INSTITUTIONS FOR COMMITMENT & REGULATION

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The importance of institutions

- To economic growth
- To efficient regulation
- To economic development
- Institutions: governance
- deep versus shallow interventions
- good policies will fail unless the institutional superstructure is right

Institutional functioning

- Credible commitment to good policies
- reputation
- commitment technologies
- power sharing

- Rent seeking
- acquisition of a monopoly
- wasteful
- regulatory failure
- growth failure

Commitment to good policies

$$U^G = -(1/2)c_1 w^2 + \theta c_2 (w - w^e)$$

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The first term on the right-hand side is the direct cost of rent-seeking activities by the government, drawn from a vector of policies or activities, w, in quadratic form, and c_1 is the parameter measuring this direct cost. The second term indicates the gains to the government from reneging on an announced set of policies, or the benefit from a policy "surprise", where the level of the actual policy vector (w) exceeds the level *expected* in advance

$$w = \theta c_2 / c_1$$

This is the equilibrium choice of w and is greater the higher the element of avarice, c_2, the greater the availability of rents from rent-seeking activities, θ, and the smaller the direct cost of reneging, c_1

Solution: tie the government to good policies, commitment technologies

$$U^G = -(1/2)c_1 w^2 + \theta c_2(A)(w - w^e) - c_3(S)(w - w^e)$$

Additional term represents a commitment technology: a deep intervention, which results in a smaller incentive to engage in rent seeking.

$$w = (\theta c_2 - c_3) / c_1$$

Rent seeking contests. The object is to capture a winner take all prize.

The prize, P could represent a monopoly right or franchise to a privatised utility say.

$$E_i = \gamma_i P - c_i$$

E is expected utility, gamma is the probability of winning, depending on one agent's outlays compared to the whole outlay of c which represents lobbying costs *(bribes).*

There can be increasing returns to scale to bribes, making it a very profitable activity.

Increasing returns to rent-seeking outlays will be more likely to emerge in the context of soft laws and regulation that are honoured more in the breach than in the keeping. Hence the institutional framework matters.

Costs of the above

- Misallocation of talent
- Unproductive activities
- Regulatory failure
- Growth failure
- Better institutions of governance may make rent-seeking less attractive.
- But requires deep interventions to alter the rules of the game, not just the operation of the game.

Good Policies will not work unless we have Good Institutions

- Good governance
- Democracy?
- Reduction of inequality?
- Pro-poor economic strategies?