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Rent seeking opportunities and economic growth in transitional economies

Nasir Iqbal [a], Vince Daly [b,*]

[a] Pakistan Institute of Development Economics, Islamabad, Pakistan
[b] Department of Economics, Kingston University, London KT1 2EE, UK

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ABSTRACT

This study empirically explores the growth effects of rent seeking activity (RSA) for a group of 52 developing/transitional countries, using a dynamic panel data approach. The modeling framework is a Mankiw–Romer–Weil (MRW) conditional convergence model with path dependence and augmented by measures of the opportunities for RSA, namely indices for the extent of democracy and corruption control. The empirical analysis suggests that, for this group of countries, RSA retards economic growth, in that (i) democratic institutions — which are inimical to RSA, are growth enhancing and (ii) reduction in the extent of corruption is growth-enhancing if supported by well-developed democratic institutions. We find also that health is more relevant than educational participation as a measure of human capital development, that path dependence is absent where democracy is weak, and that the MRW model characterizes the growth process more successfully in the stronger democracies.

1. Introduction

It is well-known that the neo-classical growth model predicts economic "convergence" — a process in which the passage of time allows poorer countries to catch up with the rich. It is equally common knowledge that such catching up is not yet evidently complete and, for some countries, may seem to have not yet started. One response to this apparent disconnect between the neoclassical growth model and actual experience has been the development of alternative theoretical frameworks, principally the endogenous growth literature (e.g. Romer, 1986, 1994). At the same time, it has been shown that the neoclassical framework can retain a better connection with observed reality when augmented by variables that recognize heterogeneity between countries.

In this study we take the position that those variables which most usefully augment the neoclassical framework are not independent of a country's current state of development. We focus in particular upon "middle income" countries, which are typically launched upon a process of economic development but are still in a transitional phase. In these countries we find considerable heterogeneity in opportunities for rent seeking activity (RSA). When we look across these countries we find that the rule of law is not equally effective, property rights are not equally well-defined, and democratic rights are not equally extensive. Individuals and organizations that have political or administrative authority will not find that authority is equally restricted by checks and balances. Unrestricted authority is an opportunity for rent-seeking behavior that may redirect resources, violate regulations, and focus effort on wealth re-distribution ("bribery"). The consequences for growth can be negative: resources may not be efficiently allocated, externalities may be ignored, and transaction costs may be increased. We do not argue that RSA is absent in more developed economies but believe that there are grounds for expecting it to be "… far more severe in middle and low income countries" (Spinesi, 2009).

Arguments can also be made for some positive macroeconomic consequences of RSA: for example, bribes may facilitate production or trade that would not have happened otherwise, or may serve as signals for growth opportunities; corrupt practices may promote efficiency by allowing private sector agents to circumvent restrictive regulations (Leff, 1964; Méon and Weill, 2010). In this study we offer an empirical assessment of the overall consequences for economic growth of institutional frameworks that reduce opportunities for RSA. To the best of our knowledge, no recent study has investigated this question empirically for a panel of developing/transitional economies. Our modeling framework is the "MRW" model — the "conditional convergence" model of Mankiw et al. (1992), in which we use health, rather than education, as a human capital indicator.

* Corresponding author.
E-mail address: vdaly@kingston.ac.uk (V. Daly).

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We augment the basic MRW model with indicators of the political and regulatory environment, and also augment the dynamics to permit path-dependency. The dynamic nature of this modeling framework leads us to use a GMM approach to estimation and the extent of cross-sectional variation leads us to prefer the "System GMM" estimator of Blundell and Bond (1998).

There is an active research literature concerned with the interplay between economic growth and political and social institutions. Our own contribution is, in summary, to show — using dynamic panel data models, that, for middle income countries in recent years, (i) the MRW modeling framework usefully characterizes economic development, especially where democratic institutions are relatively well developed; (ii) an institutional environment which restricts opportunities for rent-seeking is growth enhancing; (iii) population healthiness, rather than education, is the more important measure of human capital development; and (iv) suggestions of "path dependency"/"momentum effects" in economic development have empirical support, for countries within this group whose democratic institutions are relatively well developed.

The rest of this paper is structured as follows. Section 2 summarizes the existing literature concerned with the macroeconomic impact of rent-seeking behavior; section 3 explains the data sources and methodology to be used here; Section 4 presents our results and Section 5 concludes.

2. Literature review

There are various ways to define rent seeking activity, depending upon the context of analysis. Tullock (1967) defines rent seeking as earning income without being productive. Anderson et al. (1988) offers the complementary perspective that the pursuit of profits via the use of government coercion is rent seeking. Tollison (1982) observes that RSA can also consist of the allocation of scarce resources so as to create and benefit from economically inefficient transactions. In the same vein, Fischer (2006) asserts that RSA is "usually implying the expenditure of scarce resources, to cause and capture artificially-created rents as well as transfers which are not part of society's intended income redistribution". For this present study, RSA is envisaged as any activity through which public power is exercised for private gain; this may involve misuse of public resources or, more generally, any attempted capture and commodification of state, social or commercial authority by politicians, public officials, elites and private interests.

As to when rent seeking might occur, North (1990) argues that the institutional framework is crucial and often provides room for RSA, especially in developing countries. Institutional frameworks that are weak, in the sense of not applying equally and impartially to all individuals — whether by design or in practice, can create opportunities for rent seeking. Examples include the ineffective or partial rule of law, absent or ill-defined property rights and limitations on the extent to which democratic processes exercise authority over key institutions. Such institutional weaknesses provide room for, inter alia, misuse of resources, violations of regulations, and restrictions of trade — thus motivating RSA. When it then occurs, rent-seeking may distort the productive activities of the economy, imposing social costs. RSA may impede the growth process of an economy in several ways. Firstly, it may merely redistribute wealth; rent seekers do not intend to create new wealth (Brumm, 1999). Also, in developing countries particularly, rent seekers may hold key positions in the public and private sectors and cause resistance to the adoption of beneficial economic reforms and institutional change (Fischer, 2006). RSA can further retard economic growth by diverting resources from productive use (Cole and Chawdhry, 2002) and may restrict innovation (Murphy et al., 1993) hence obstructing economic development.

North (1990) emphasizes that rent-seeking is rarely self-limiting; an institutional framework that allows RSA is likely to encourage the expansion of the number of individuals engaged in RSA and construction of additional rent opportunities. He provides various arguments to explain how institutional weaknesses lead to low development in developing countries. First, there may be a conflict between formal and informal rules in countries with poorly developed institutions, with informal rules often overriding the formal laws and regulations. The informal rules can be antagonistic towards free markets, leading to economically inefficient outcomes. Second, the enforcement of formal rules can be poor in these economies and lack of enforcement of regulations facilitates RSA. In summary, the incomplete rule of law, non-enforcement of property rights, inadequate policies and the lack of reliable infrastructure constitute a weak institutional framework that may promote RSA.

In developing countries, where the rule of law is weak, where checks and balances are ineffective and public sector management may be poor, a large part of rent seeking is carried out by government officials — examples include legislators, executing and enforcing agencies, members of the armed services, the police force, judges, public sector managers and employees. In these nations, individuals, groups and institutions invest time and wealth to create or modify rules, laws and regulations that favor rent seeking activities and protect already secured rents. Rent seekers influence the legal, political or economic rules by engaging in activities such as lobbying, sponsoring, bribery and exploiting patronage relations — for example, triggering demonstrations, strikes or riots. Bribes may be in cash or in kind. The latter may be simply re-distributive but may sometimes impose a direct risk of economic inefficiency, as for example the promise to organize a job for a relative of the rent-seeking official. Public officials may generate rent by compromising on rule and laws, by threatening the rent distributing agency or its employees, by smuggling, by engaging in capital flight, or by forcing inefficient decisions within the private sector (Fischer, 2006).

To our knowledge, not many studies have empirically investigated the impact of RSA on economic growth, and even fewer have been cross-national in scope.[1] Laband and Sophocleus (1988), using time series data over the period 1947–1983, use the number of registered lawyers as a measure of RSA and find a negative relationship with growth of per capita income in the USA. Brumm (1999) analyzes the impact of RSA, using several proxies, including an index of lobbying-law restrictions, state government employment and legal services, and finds a negative relationship with economic growth in US states. Cole and Chawdhry (2002) examine the impact of RSA on economic growth of US states over the period 1980–1990 by employing a panel data vector autoregressive (VAR) model. This study uses public sector employment and the number of registered lobbyists as proxies for RSA and concludes that RSA has a negative impact on economic growth. This previous research reveals the difficulty of constructing direct measures of RSA; the present study focuses therefore on obtaining measures of the ease with which RSA may be undertaken, in particular the extent to which institutional frameworks accommodate RSA.

Existing literature, e.g. Murphy et al. (1991), has identified a potential problem of mutual causation between RSA and economic growth. Laband and Sophocleus (1988) and Brumm (1999) do not address this issue; Cole and Chawdhry (2002) accommodate mutual causation to some extent by using a VAR framework. The present study employs a single equation model but applies an estimator that requires only weak exogeneity in the regressors. We do not discount the possibility that a country's growth experience can, over time, influence the evolution of its institutional environment but we do assume that current shocks to growth do not have an immediate impact. We then establish absence of simultaneity by confirming,

[1] See Del Rosal (2011) for a comprehensive review of literature on rent seeking.