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IS MONOPOLY RENT SEEKING COMPATIBLE  
WITH WEALTH MAXIMIZATION?

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## Is Monopoly Rent Seeking Compatible with Wealth Maximization?

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This article questions whether the *wealth-maximizing efficiency criterion* adopted by the law-and-economics movement is compatible with the implicit theory of social costs contained in theories of *rent-seeking behavior*. My argument is simple: under the wealth-maximizing efficiency criterion, all voluntary market transactions yield welfare gains. Since many types of rent-seeking activities involve purely voluntary market transactions, such market activities must also necessarily lead to wealth gains and not to social costs, as the rent-seeking literature asserts.<sup>1</sup> The theory of rent-seeking activities transforms welfare gains into costs only by introducing arbitrary value judgments into the economic and legal analysis. If my claim is true, it has important implications for the debate concerning the social costs of monopoly. As the participants in that debate recognize, if market based rent-seeking activities do not constitute social costs, then the estimated social costs from monopoly are small, possibly calling into question the need for expensive antitrust enforcement.<sup>2</sup> Moreover, as explained below, without rent-seeking costs from monopoly, there is little defense to claims of the indeterminacy of

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1. See, e.g. Herbert Hovenkamp, *Antitrust Policy and the Social Cost of Monopoly*, 78 IOWA L. REV. 371 (1993); Herbert Hovenkamp, *Antitrust's Protected Classes*, 88 MICH. L. REV. 1, 12-20 (1989); Richard S. Markovits, *Second-Best Theory and the Standard Analysis of Monopoly Rent Seeking: A Generalizable Critique, a "Sociological" Account, and Some Illustrative Stories*, 78 IOWA L. REV. 327 (1993); William H. Page, *Optimal Antitrust Penalties and Competitors' Injury*, 88 MICH. L. REV. 2151 (1990); Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975).

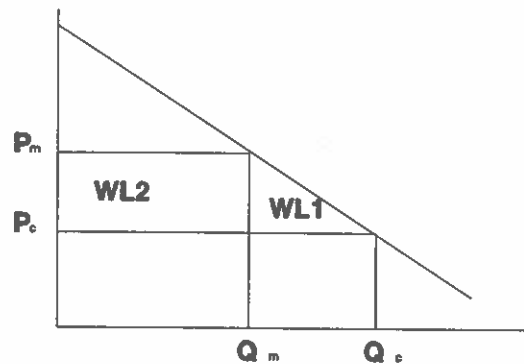
2. See *supra* note 1.

antitrust enforcement outcomes based on the economic theory of "second best."<sup>3</sup>

### I. RENT SEEKING AND THE SOCIAL COSTS OF MONOPOLY

The usual method of measuring the social costs of monopoly is illustrated by the partial equilibrium economic model of monopoly with constant marginal and average costs.<sup>4</sup>

DIAGRAM 1



In Diagram 1 above, the triangle WL1 measures the deadweight loss to monopoly. The deadweight loss represents consumers who would have purchased the product at issue at the competitive price,  $P_c$ , but then substituted to other products once prices rose to  $P_m$  as a result of the imposition of monopoly. The quantity of the monopolist's lost sales because of the higher price is equal to  $Q_c - Q_m$ , and the resulting lost consumer surplus as a result of the consumer substitutions is WL1.<sup>5</sup>

The rectangle WL2 should not be thought of as a deadweight loss, but rather as a measure of income transfer from those individuals who do not substitute away when the

3. See *infra* note 21 and accompanying text.

4. See, e.g., PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, MICROECONOMICS 190-91 (14th ed. 1992); JOSEPH E. STIGLITZ, PRINCIPLES OF MICROECONOMICS 450 (1993).

5. The consumer surplus for a unit of output is the difference between the consumer's reservation price, or amount she is willing to pay, and the price she is required to pay. I discuss consumer surplus in more detail below. Note here that WL1 is an overstatement of the consumer surplus lost to the society, because it does not take account of the additional consumer surplus gained by the consumer in the substitute market.

price increases from  $P_c$  to  $P_m$ . Since these consumers continue to purchase the product at the higher price, all that occurs is a transfer of income from the consumers to the monopolist in the amount of  $WL_2$ . Moreover, from a social point of view, society as a whole is neither richer nor poorer as a result of this transfer. All that has transpired is a redistribution of income between individuals. Rent-seeking theory seeks to transform this income transfer into a cost.

Rent seeking is usually defined as the political activity of persons or groups seeking monopoly rights or privileges granted by the government.<sup>6</sup> Such privileges include subsidies, tax breaks, price supports, tariffs, import quotas and other entitlements.<sup>7</sup> Usually, these activities are said to pose two types of social costs. First, the privileges themselves represent a deadweight loss to consumers. Second, the expenditure of resources on their pursuit arguably represents a rent-seeking social cost because of the more productive alternative uses for such resources.<sup>8</sup> In antitrust literature, many have contended that the rectangle  $WL_2$  reflects just such a social rent-seeking cost.<sup>9</sup> Originally formulated by Gordon Tullock, the rent-seeking theory applied here posits that firms will expend real resources in the search for monopoly profits—for example, by hiring lawyers and lobbyists.<sup>10</sup> If firms are profit maximizing, the amount of resources expected to be used in the rent-seeking process will be equal to the expected profits from monopoly, or the rectangle  $WL_2$ . For example, suppose that five firms are competing for monopoly profits in the amount of \$500 (i.e.,  $WL_2 = \$500$ ). If each competitor believes that it has an equal probability of obtaining the monopoly, each firm will be willing to invest up to \$100 in the process of obtaining market power.<sup>11</sup> Thus, as a direct result of the monopoly, society will

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6. See Robert D. Tollison, *Rent Seeking: A Survey*, 35 *KYKLOS* 575, 587 (1982).

7. William C. Mitchell & Michael C. Munger, *Economic Models of Interest Groups: An Introductory Survey*, 35 *AM. J. POL. SCI.* 512, 525 (1991).

8. Tollison, *supra* note 6, at 576.

9. See Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*, 5 *W. ECON. J.* 224 (1967); Tollison, *supra* note 6, at 581.

10. See also Tollison, *supra* note 6, at 576 ("[I]f the process by which monopoly rents are contrived is subject to competition (e.g., lobbying), the analytical fiction of these rents as a pure transfer vanishes because resources spent in the pursuit of a transfer are wasted from society's point of view.") (emphasis omitted).

11. See *infra* note 54 (discussing the fact that the expenditures can exceed

waste resources in the amount of WL2, making the total social costs due to monopoly equal to WL1 + WL2.<sup>12</sup> As discussed below, the crucial difference here is that no government action is sought. The rent-seeking activities occur entirely within the private sector on the basis of purely market activities.

This rent-seeking argument is important because it solves two critical problems faced by advocates of vigorous antitrust enforcement. The first problem is that when WL2 is not treated as a cost, the total social costs due to monopoly are very small. For many years economists have been aware that, with certain simplifying assumptions, the consumer welfare loss from monopoly, WL1, is empirically measurable.<sup>13</sup> From Diagram 1 it is evident that (assuming a linear demand curve) the deadweight loss WL1 is equal to one-half the product  $(P_m - P_c)(Q_c - Q_m)$ . This quantity can be shown to be a function of the elasticity of demand and the square of the percentage price increase resulting from monopoly. Arnold Harberger was the first to seize upon the measurement possibilities.<sup>14</sup> He used profit rate differentials to proxy the price distortion and assumed that elasticity was unitary for the years 1924-1928. He found that the social welfare loss from monopoly is less than one-tenth of one percent of Gross National Product (GNP), or about (in 1954) \$2 per person in the United States.<sup>15</sup> Harberger's article fostered a flurry of criticism and recalculation.<sup>16</sup> Most confirmed Harberger's small estimate of the deadweight loss.<sup>17</sup> Others came up with larger estimates,

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the expected profits).

12. See Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291, 295-301 (1974); Tullock, *supra* note 9.

13. See, e.g., Arnold C. Harberger, *Monopoly and Resource Allocation*, 44 AM. ECON. REV. 77 (1954).

14. Tollison, *supra* note 6, at 579.

15. See Harberger, *supra* note 13, at 84.

16. See, e.g., CHARLES K. ROWLEY, ANTITRUST AND ECONOMIC EFFICIENCY 48 (1973); DEAN A. WORCESTER, JR., MONOPOLY, BIG BUSINESS, AND WELFARE IN THE POSTWAR UNITED STATES 210-27 (1967); Abram Bergson, *On Monopoly Welfare Losses*, 63 AM. ECON. REV. 853 (1973); J.A. Kay, *A General Equilibrium Approach to the Measurement of Monopoly Welfare Loss*, 1 INT'L J. INDUS. ORG. 317 (1983); George J. Stigler, *The Statistics of Monopoly and Merger*, 64 J. POL. ECON. 33 (1956); Björn Wahlroos, *Monopoly Welfare Losses Under Uncertainty*, 51 S. ECON. J. 429 (1984); G.K. Yarrow, *Welfare Losses in Oligopoly and Monopolistic Competition*, 33 J. INDUS. ECON. 515 (1985).

17. See, e.g., David Schwartzman, *The Burden of Monopoly*, 68 J. POL. ECON. 627 (1960); John J. Siegfried & Thomas K. Tiemann, *The Welfare Cost of Monopoly: An Inter-Industry Analysis*, 12 ECON. INQUIRY 190, 190 (1974); Dean A. Worcester, Jr., *New Estimates of the Welfare Loss to Monopoly, U.S.: 1956-1969*, 40

some as high as 7% of GNP.<sup>18</sup> My own work indicates that because short-run profit rate differentials primarily capture disequilibrium effects rather than monopoly, most measures overestimate the deadweight loss attributed to monopoly.<sup>19</sup> The consensus among economists is well-summarized by Sherer:

It is hard to think of realistic circumstances under which the dead-weight loss triangle [WL1] would be very large, for it involves the square of the relative price distortion ratio  $[(P_m - P_c)/P_c]$ , whose average value was only 0.036 in the Harberger sample and 0.084 in seven industries with high barriers to entry analyzed by David Qualls.<sup>20</sup>

Because WL1 is typically judged to be relatively small, maybe the costs of antitrust enforcement outweigh their benefits. This is especially problematic since the low Harberger figures were obtained for the middle 1920s—a period of less than rigorous antitrust enforcement.<sup>21</sup> The rent-seeking conversion of the quantity WL2 into an additional cost of monopoly thus critically helps justify massive government expenditures on antitrust enforcement.

A second reason why the rent-seeking argument is important is that it provides a sensible reply to claims that antitrust enforcement actually has a detrimental impact on consumer welfare as a result of second-best problems. As Posner observes, “[O]nce [WL2] is recognized as being relevant to the costs of monopoly, an objection to the economic analysis of monopoly based on the theory of the ‘second best’ disappears.”<sup>22</sup> Second-best problems arise when a substitute for a monopolized product is not sold at the competitive price.

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S. ECON. J. 234 (1973).

18. Keith Cowling & Dennis C. Mueller, *The Social Costs of Monopoly Power*, 88 ECON. J. 727, 745 (1978); see also Frédéric Jenny & André-Paul Weber, *Aggregate Welfare Loss Due to Monopoly Power in the French Economy*, 32 J. INDUS. ECON. 113, 128 (1983); Dennis O. Olson & Donald L. Bumpass, *An Intertemporal Analysis of the Welfare Cost of Monopoly Power*, 1 REV. INDUS. ORG. 308, 313-14 (1984).

19. Mark A. Glick & Hans Ehrbar, *Long-Run Equilibrium in the Empirical Study of Monopoly and Competition*, 28 ECON. INQUIRY 151 (1990).

20. F.M. SHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 667 (3d ed. 1990) (footnote omitted).

21. See RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 25 (1976).

22. *Id.* at 13.

Suppose, for example, that the Department of Justice is considering a merger in the butter industry that would raise butter prices by 5%. However, two years previous a cartel had formed in the margarine industry causing margarine prices to rise 5%. As a result of the rise in margarine prices, some consumers switched to butter (resulting in deadweight loss). Because of the pre-existing price distortion in a close substitute, the merger between butter firms, even though it will raise butter prices, will also reduce the deadweight loss by causing butter and margarine prices to conform more closely to the original competitive price proportions. When account is taken of second-best issues, the butter monopoly could result in increased inefficiency. However, if the change in income distribution is considered a cost because of expected rent-seeking behavior, enforcement action in butter can be justified as reducing the rent-seeking cost, independent of any second-best problems. Thus, the rent-seeking conversion of distribution into a social cost eliminates a major source of uncertainty concerning the impact of antitrust enforcement. It is therefore important to consider whether the rent-seeking arguments have sound foundations.<sup>23</sup>

## II. THE WEALTH MAXIMIZATION PRINCIPLE

When economists discuss efficiency, they generally mean Pareto optimality. A transaction is Pareto-improving if it can enhance the welfare of at least one individual without making anyone else worse off. Pareto-optimal distributions are states of affairs in which no further Pareto improvements can be made. It follows that for a transaction to be Pareto-improving there must be unanimous consent by all affected. Put differently, the requirement that no one is harmed provides every potentially affected individual with veto power over every transaction. It is generally recognized that this property of the Pareto criterion imposes severe limitations on its applicability.<sup>24</sup> As a result,

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23. The characterization of WL2 as income distribution or as a cost does not impact the optimal sanction for antitrust violations. The optimal antitrust fine will equal the total net harm to others. In the monopoly context, this will be equal to WL1 + WL2. WL2 is a net harm to consumers whether it is characterized as a distribution loss to consumers or a social cost resulting from rent seeking. See Robert H. Lande, *Are Antitrust "Treble" Damages Really Single Damages?*, 54 OHIO ST. L.J. 115, 125-26 (1993); William M. Landes, *Optimal Sanctions for Antitrust Violations*, 50 U. CHI. L. REV. 652, 653-61 (1983).

24. See Richard A. Posner, *The Ethical and Political Basis of the Efficiency*

the law-and-economics approach has adopted an alternative criterion, called wealth maximization, or the *Kaldor-Hicks compensation principle*.<sup>25</sup> Although economists rarely openly admit using any criterion other than Pareto optimality to explain efficiency, the contrary is evident from a reading of any economics textbook or observing the actual application of the efficiency concept. According to Posner,

Because the conditions for Pareto superiority are almost never satisfied in the real world, yet economists talk quite a bit about efficiency, it is pretty clear that the operating definition of efficiency in economics is not Pareto superiority. When an economist says that free trade or competition or the control of pollution or some other policy or state of the world is efficient, nine times out of ten he means Kaldor-Hicks efficient.<sup>26</sup>

As opposed to the Pareto criterion, a transaction is Kaldor-Hicks efficient, or wealth maximizing, if the individuals that benefit from a transaction experience a benefit that exceeds anyone else's loss, such that they can still retain a net gain after potentially compensating any individuals that experience diminished welfare.<sup>27</sup> Obviously, actual compensation is not required, or else the wealth maximization principle would be transformed back into the Pareto criterion.

The intuition behind wealth maximization is that efficiency can be conceived of as the maximizing of the social "pie," while distribution of the parts of the pie can be considered as a separate issue.<sup>28</sup> The pie is *not* the total set of goods and services in the economy. Rather, the substance of the pie is "utility" backed by purchasing power; or, put differently, the pie consists of utility revealed by willingness to pay. The subtle lapse into considering wealth as physical goods and services seems to be almost irresistible in the law-and-economics literature, yet it is clearly not consistent with economic theory.

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*Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 489 (1980) ("Pareto-superiority criterion is useless for most policy questions").

25. See J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939).

26. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 14 (4th ed. 1992).

27. Posner, *supra* note 24, at 491.

28. For a criticism of the consistency of this view of efficiency, see Victor P. Goldberg, *On Positive Theories of Redistribution*, 11 J. ECON. ISSUES 119 (1977).



A simple example can illustrate the distinction. Suppose good W is bartered from Individual A to Individual B. Assuming B values the item higher than A, putting W in the hands of B increases social wealth, even though our measure of GNP remains constant. Posner is therefore correct when he proposes the following example:

Before the transaction you had a bag of oranges worth less than \$5 to you and I had \$5; after the transaction you have \$5 and I have a bag of oranges worth more than \$5 to me. We are both richer, as measured by the money value we attach to the goods in question.<sup>29</sup>

An absolutely critical corollary of the wealth-maximizing efficiency criterion is that voluntary trade between individuals results in welfare gains to both parties to the transaction.<sup>30</sup> This proposition forms the basis of the most fundamental prescriptions of law and economics.<sup>31</sup> As a result of gains to trade, it is universally argued that entitlements should be protected by property rights when transaction costs are low.<sup>32</sup> Property rights force others who wish to obtain an entitlement to buy it from its holder in a voluntary transaction in the market. Such private property rules are only efficient because (according to the wealth maximization criterion) voluntary transactions are expected to yield wealth gains to both individuals. If one of the individuals to the transaction were a potential loser he or she would simply refuse to undertake the transaction. If this were not true the case for private property rights would not follow.<sup>33</sup> In contrast, liability rules, such as negligence, are only necessary when transaction costs make

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29. Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 120 (1979).

30. One difficult issue is defining the boundary between voluntary transactions and duress. See MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES ch. 3 (1987); Robert L. Hale, *Bargaining, Duress, and Economic Liberty*, 43 COLUM. L. REV. 603 (1943).

31. See, e.g., DAVID W. BARNES & LYNN A. STOUT, CASES AND MATERIALS ON LAW AND ECONOMICS 180 (1992) ("If two parties contract voluntarily and with full information, both must expect the contracted-for exchange to improve their welfare. . . . Only when voluntary cooperation breaks down does the law intervene.").

32. POSNER, *supra* note 26, at 15.

33. The reason is that property rights force individuals to transact voluntarily in the marketplace. The case for private property dissolves if it cannot be assumed that voluntary market transactions are efficiency-improving.

voluntary market transactions infeasible.<sup>34</sup> This explains, for example, why negligence rules are necessary in the tort area. A tort involves strangers in a situation unlikely to be amenable to negotiation and private contract.<sup>35</sup> The economic explanation of liability rules also assumes that if individuals could successfully privately negotiate, then social gains would result.

### III. DEADWEIGHT LOSS FROM MONOPOLY: WL1

It is universally argued that monopoly is inefficient. Many argue further that the goals of the antitrust laws should solely be to increase efficiency.<sup>36</sup> But in what sense is monopoly inefficient and competition efficient? Only two possible answers exist: Either competition is Pareto-improving, or it is wealth-maximizing. The first possibility cannot explain why monopoly is inefficient. It is obvious that a movement from monopoly to competition is not Pareto-improving. Under the Pareto criterion, an efficient change is one in which some gain but none lose, yet a transition from monopoly to competition harms the monopolist in the form of lost profits, or WL2.<sup>37</sup> Therefore, eliminating monopoly cannot be Pareto-improving. In fact, it is possible to have Pareto-optimal distributions with or without monopoly.<sup>38</sup>

Accordingly, the only possible ground on which it can be claimed that competition is more efficient than monopoly is wealth maximization. The argument is evident. When competition is restored in Diagram 1, consumers gain WL2 and WL1, but the potential compensation necessary to make the monopolist whole is only WL2. Thus, after potential compensation, consumers would retain WL1, and the move

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34. POSNER, *supra* note 26, at 164.

35. See generally Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106-10 (1972) (discussing the need for liability rules).

36. See, e.g., ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 51 (1978) (discussing the goal of antitrust to "maximize consumer welfare").

37. See Warren J. Samuels, *Welfare Economics, Power and Property*, in *LAW AND ECONOMICS: AN INSTITUTION PERSPECTIVE* 9, 23 (Warren J. Samuels & A. Allan Schmid eds., 1981); see also Victor P. Goldberg, *Public Choice—Property Rights*, 8 J. ECON. ISSUES 555, 556 (1974).

38. Samuels, *supra* note 37.

from monopoly to competition is wealth-maximizing, or Kaldor-Hicks efficient.

It might be objected that, if wealth maximization is the basis of the claims of monopoly inefficiency, then private transactions between the parties themselves should lead to the efficient level of output. This is predicted by the famous Coase Theorem.<sup>39</sup> In the monopoly case, this would require that consumers bribe the monopolist with some amount of money (between  $WL_2$  and  $WL_2 + WL_1$ ) to expand output from  $Q_m$  to  $Q_c$ . Such a transaction is inconceivable because of the enormous transaction costs involved in consumers collectively undertaking to make such an offer. It follows that when transaction costs present a barrier to private transactions, liability rules (like the Sherman Act and the Clayton Act) should be employed to mimic market outcomes. Viewed in this way, antitrust policy is consistent with the law-and-economics approach to other areas of the common law.

It is instructive to compare the above discussion of the inefficiency resulting from monopoly with the standard economic analysis of consumer surplus (assuming cardinal utility). In the simple, single-good context, social efficiency is maximized when the following condition holds:

$$MC = MU,$$

where  $MC$  is the marginal cost of producing output and  $MU$  is the marginal utility that consumers derive from the output.<sup>40</sup> Like the wealth-maximizing criterion, the above efficiency condition maximizes total utility measured in willingness to pay. Notice that, in the monopoly case, this efficiency condition is not satisfied. Because the monopolist produces output to a point where price is above marginal cost (while consumers continue to purchase products to the point where prices equal marginal utility), under monopoly  $MC < MU$ . This implies that wealth can be increased if the monopolist were to expand output.

Economists can also directly measure the deadweight loss triangle by estimating the compensating and equivalent

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39. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), reprinted in RONALD H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 95 (1988).

40. See WILLIAM J. BAUMOL & ALAN S. BLINDER, *MICROECONOMICS: PRINCIPLES AND POLICY* 257-58 (6th ed. 1994); see also Lewis A. Kornhauser, *A Guide to the Perplexed Claims of Efficiency in the Law*, 8 HOFSTRA L. REV. 591, 592-93 (1980).

variations. Suppose that a consumer is consuming a consumption bundle consisting of butter and margarine. The price of butter increases and the consumer reduces her butter consumption and increases her margarine consumption. How much did the change hurt the consumer? In other words, how much money would the consumer have to be paid after the price change to be just as well off as before the price change? This is called the *compensating variation in income*. An alternative way to measure the same harm is to ask how much money would have to be taken away from the consumer before the price change in order to make her as well off as she would be after the price change. This alternative method is called the *equivalent variation in income*. In most situations the two measures will not be the same.<sup>41</sup> However, both of these techniques can be used to empirically measure the utility loss resulting from a price increase if we assume utility is measured by willingness to pay and we can construct utility functions that capture individual preferences. The consumer surplus measure of utility loss is directly related to compensating variation and equivalent variation.<sup>42</sup> As Professor Willig demonstrates,<sup>43</sup> the change in consumer surplus due to a price increase generally lies between the compensating variation and the equivalent variation.<sup>44</sup> Two observations can be made in connection with the comparison of the law-and-economics approach to monopoly and the standard economic analysis. First, both approaches are completely consistent regarding WL1, and second, it is obvious that in both models the deadweight loss resulting from monopoly is a loss of utility, not a loss of physical goods and services.

#### IV. INCONSISTENCIES BETWEEN WEALTH MAXIMIZATION AND RENT SEEKING

While the deadweight loss from monopoly, WL1, is consistent with the wealth-maximizing efficiency criterion, the

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41. The two measures are only the same when utility functions are quasi-linear.

42. The economist's approach to consumer surplus thus underscores the fact that wealth maximizing means expanding the pie of utility measured by willingness to pay, not by a set of physical goods and services.

43. See Robert D. Willig, *Consumer's Surplus Without Apology*, 66 AM. ECON. REV. 589 (1976).

44. See the appendix for an illustration of compensating and equivalent variations.

rent-seeking argument that treats WL2 as a cost is not consistent. To see why, consider the types of expenditures typically conceived of as rent seeking. Lawyers and lobbyists usually receive the brunt of the criticism. Therefore, suppose that a firm interested in obtaining a monopoly hires a lawyer to undertake sham litigation (unbeknownst to the lawyer), and that the sum of the legal fees charged is equal to WL2. Can such a transaction be called a social cost? I do not believe it can. The problem is that this transaction between the potential monopolist and the lawyer is being undertaken voluntarily in the market. It is exactly the kind of transaction that property rules are designed to encourage. Under the wealth-maximizing criterion, we must expect social gains, not social costs, from the transaction.

What the wealth-maximization criterion specifically does not allow us to do is look behind preferences or treat some preferences differently than others, but this is precisely what rent-seeking theories ask us to do.<sup>45</sup> We cannot turn the voluntary transaction between the monopolist and the lawyer into a cost by simply stating that the purpose of the desire or the preference on the part of the buyer of legal services was to achieve a monopoly, even if the monopoly itself is wealth-reducing. Once we begin to inquire into the purposes of preferences, the foundations of law and economics that derive from wealth maximization are seriously compromised. It will no longer be sound policy to simply defend property rights that channel disputes into the marketplace, because no longer will all voluntary transactions be unambiguously wealth-maximizing. Instead, society will have to monitor voluntary transactions to filter out those that are for rent-seeking purposes. Symmetrically, it might also be prudent to ask whether non—wealth-maximizing activities that we condemn under the wealth-maximizing criterion might not, in fact, have some ultimate wealth-increasing goal.<sup>46</sup> Thus, rent-seeking

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45. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 23 (1988) ("Economists leave to other disciplines, such as psychology and sociology, the study of whence these preferences came. *We take them as given.*") (emphasis added); see also Goldberg, *supra* note 37, at 556-57 (discussing public choice—property rights literature that considers "individual preferences [as] the ultimate data" and "tastes as given exogenously").

46. It is possible that the concept of rent seeking is best explained by a reliance on a concept of production efficiency. Production efficiency requires that a given level of output be produced with the least cost combination of inputs for a

theories force us onto a slippery slope by asking us to value different preferences differently.

An alternative way to approach the problem is illustrated in the following example. Suppose that we observe a consumer going into a department store to purchase a pair of shoes. However, once in the store, the consumer observes that a storm is brewing outside. As a result, the consumer decides to buy boots rather than shoes. In this example, we would say that the consumer's preferences have changed, but that there is no deadweight loss. Suppose instead that the same consumer upon entering the store notices that shoes have gone up in price because of a monopoly in the shoe industry, and so she decides to purchase boots. As opposed to the first scenario, now we would maintain that a deadweight loss has occurred. My argument is that rent seeking is more like the first example than the second. When people purchase locks because they notice their neighbor's house has been burglarized, or when they buy lawyer services because of the lure of monopoly profits, their actions merely express a change of preferences, not a social cost.

There are also several other reasons why modifying the original wealth-maximizing criterion can cause difficulties. A first issue is boundary indeterminacy. Rent seeking asks us to modify the wealth-maximizing criterion to assert that an activity is inefficient if it is wealth-reducing or if it is a means to achieving some other wealth-reducing activity. But why stop there? Suppose that the lawyer in our example goes to the store to purchase pencils.<sup>47</sup> This is again a voluntary transaction which should be expected to bring social gains and which is wealth-increasing. But what if the pencils were being

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given technology. In the example above, the monopolist is producing widgets but requires the lawyer's services to maintain the monopoly. The lawyer's services are then analyzed as an unnecessary cost of production of widgets. But this approach arbitrarily defines the output solely as a widget. Actually, in this example there is joint production of widgets and lawyer's services. Labelling something as productively efficient does not escape the problem that when the owner enters into a voluntary exchange we assume it is utility- or wealth-maximizing even if not profit-maximizing. The two concepts will be the same only if we correctly identify the joint products being produced. It is not obvious to me that production efficiency can solve the problem. To explain that some voluntary transactions are allocatively efficient but not productively efficient would require that we unambiguously label some purchases purely as means to other ends and others just as ends.

47. For an example of how rent-seeking arguments have entered into the popular culture, see Stuart Speiser & John Maher, *What Are Lawyers Worth?*, A.B.A. J., March 1994, at 122.

purchased to help the lawyer write the brief, the purpose of which, in turn, is to aid the potential monopolist? Is the pencil transaction also a social cost? The potential list of transactions that could be forced under the social cost umbrella becomes endless. At bottom, the rent-seeking exercise resolves into a hypothetical comparison between our existing society and some ideal.<sup>48</sup> The ideal society is one in which all wealth-maximizing transactions have taken place. This is equivalent to defining a market economy without transaction costs and strategic behavior if we accept the principles of the Coase Theorem.<sup>49</sup> Rent-seeking social costs are the deviations of the actual from the ideal society. Although this is the thought experiment that rent-seeking theories ultimately force us to perform, it is unclear whether it is even feasible.

First, specifying a single ideal society may be impossible. Welfare economics has yet to discover a criterion that can distinguish between the multitude of possible Pareto-optimal distributions, and it is well known that the wealth-maximizing criterion cannot be used to extract a single ideal distribution.<sup>50</sup> At least one wealth-maximizing society will correspond to each possible initial distribution of resources. Suppose, for example, in one such initial distribution an individual, X, craves power and is lucky enough to be endowed with significant purchasing power. The society that results after all voluntary transactions take place might include monopoly. Monopoly could conceivably result in such a society because X may be unwilling to accept a bribe from consumers in the amount of  $WL_2 + WL_1$  to relinquish her monopoly because she also enjoys power and requires an even higher payment to forego that enjoyment.<sup>51</sup> Thus, monopoly, and as a

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48. In this respect, rent-seeking theories are identical in structure to Paul A. Baran's arguments in *THE POLITICAL ECONOMY OF GROWTH* (4th ed. 1967). There, Baran argued that third-world development is hampered by excess unproductive labor. Unproductive labor, according to Baran, "consists of all labor resulting in the output of goods and services the demand for which is attributable to the specific conditions and relationships of the capitalist system." *Id.* at 32 (emphasis omitted).

49. See Coase, *supra* note 39.

50. See KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963); T. de Scitovszky, *A Note on Welfare Propositions in Economics*, 9 *REV. ECON. STUD.* 77, 79 (1941).

51. The deviation of utility maximization from profit maximization defines an agency problem. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976).

corollary the expenditures necessary to obtain monopoly, might endure even in the ideal society.

A second problem involves how to classify activities that do not arise in the ideal society but whose effect in the actual society is to reduce transaction costs. For example, advertising activities that reduce search costs would not be necessary if no transaction costs existed, yet their existence in the actual society is explained by their effect in reducing transaction costs.<sup>52</sup> Although such activities come into being because of transaction costs, we would not classify them as rent-seeking.

A third problem involves how to treat institutions. Voluntary exchanges are always made in the presence of given state variables. For example, when it is cold I buy a coat, or when I am sick I buy medical services. Weather and illness, I assume, should be considered state variables in the ideal model, but how should institutional arrangements be treated? For example, I may purchase legal services because of the tax laws. It remains an open question whether there exists a criterion for determining which institutional arrangements would be part of the ideal society in the absence of transaction costs. Yet institutional arrangements will have a dramatic impact on what activities do and do not take place in the ideal society.<sup>53</sup>

It is probably clear by now that the rent-seeking thought experiment leaves us with an unworkable standard. Even if we avoid beginning with an ideal standard, the actual limits of rent-seeking costs cannot be specified. Assume that, "but for" some wealth-reducing activity, a new technology would have been introduced. Or consider an entire industry that operates profitably in the market solely as a result of externalities generated by a wealth-reducing activity. For example, assume that the sole reason for the gun industry is to provide weapons to robbers on the one hand and property owners seeking to prevent robbery on the other hand. If the Department of Justice received a request to review a merger between the only two remaining gun manufacturers which would surely result in higher gun prices, should the Department prevent the merger

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52. See George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); see also Tollison, *supra* note 6, at 582 (describing consumer lobbyists attempting to limit monopoly as rent seeking).

53. See John J. Flynn, *The Chicken and the Egg*, in *FUNDAMENTALS OF THE ECONOMIC ROLE OF GOVERNMENT* 69 (Warren J. Samuels ed., 1989).



on the grounds that it is wealth-reducing, or should the Department allow it because it will reduce social waste?

A final problem is that rent seeking may be impossible to identify empirically. It is virtually impossible to distinguish between fierce competition and expenditures meant to achieve monopoly. Typically, the kind of expenditures that achieve monopoly are also those that either increase information to consumers, improve product quality, or cause innovations to occur. Some expenditures that are naturally classified as competitively desirable may suddenly become rent-seeking social costs if they are too effective and competitors file for bankruptcy.<sup>54</sup>

The rent-seeking literature itself is rife with ambiguity. The seminal paper on rent seeking in the monopoly context is Gordon Tullock's *The Welfare Cost of Tariffs, Monopolies and Theft*.<sup>55</sup> In his paper Tullock provides several examples of such ambiguity—each more confusing than the first. His first example involves a tariff that will provide rents to selected firms. The prospect of rents engenders rent-seeking behavior in the form of hiring lobbyists. According to Tullock, these expenditures are wasteful because “from the standpoint of society as a whole[,] they are spent not in increasing wealth but in attempts to transfer or resist transfer of wealth.”<sup>56</sup>

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54. The only possible way to salvage rent seeking is to justify it by reference to wealth maximization. Consider the monopoly situation again. This time consider a hypothetical bargain struck between the consumers and the lawyer. If the expenditure by the potential monopolist on the sham litigation brief was exactly equal to WL2, then consumers could offer the same lawyer some amount between WL2 and (WL2 + WL1) to abstain from producing the pleading. As a result, no monopoly would be established and consumers would benefit even after making the payment to the lawyer. Thus, total social wealth will have increased.

The problem is that we cannot be sure that this is always possible. Suppose that competitors make sequential investments in order to achieve monopoly, the monopoly rent is equal to \$500, and there are five competitors. If each has an equally likely chance of obtaining the monopoly, the expected value of the monopoly rent is \$100. Each invests \$10 and counters the others' strategic moves. There is now a \$50 sunk cost. But the competitors still have an incentive to invest \$100 each, and there will at minimum be \$550 in rent-seeking expenditures. Or, in the alternative, suppose that the marginal product of a dollar is very small in terms of increasing the possibility of winning the monopoly. Thus, for a variety of realistic reasons, the consumers would be unable to bribe the recipients of the expenditures. For a discussion of both over-dissipation and under-dissipation theories, see Arye L. Hillman & Eliakim Katz, *Risk-Averse Rent Seekers and the Social Cost of Monopoly Power*, 94 *ECON. J.* 104 (1984).

55. Tullock, *supra* note 9.

56. *Id.* at 228.

What is unclear is the meaning Tullock gives to the term *wealth*. As described above, in the microeconomic approach and in the law-and-economics literature, wealth is a quantity of utility measured by willingness to pay, not a set of physical goods.<sup>57</sup> Consider now Tullock's transaction with the lobbyist. Individual A transfers money to lobbyist B in return for B's lobbying services. A values the services more than the money, while B values the money more than the services. Change lobbying services to oranges, and we have Posner's own example of wealth maximizing referred to above.<sup>58</sup> Moreover, transactions that transfer wealth make up a large portion of the economy. Many of these transactions may also perform important economic functions that have effects on other parts of the productive structure. For example, the function of financial markets is to transfer wealth, yet such markets play critical roles in the economy's functioning.

In a second example, Tullock discusses the social costs resulting from theft. Whereas theft should be more correctly viewed as an involuntary transfer, Tullock analyzes theft as a pure transfer: "The theft itself is a pure transfer, and has no welfare cost, but the existence of theft as a potential activity results in very substantial diversion of resources to fields where they essentially offset each other, and produce no positive product."<sup>59</sup> Tullock implies in this example that activities that do not result in a product are wasteful. If he means to say that services are always wasteful, he is clearly at odds with economic theory. Moreover, the diversion of resources because of the theft could easily result in many more physical products in the form of locks and guns.

William Landes seems to make the same error. In discussing expenditures aimed at achieving monopoly, he writes, "Because these expenditures produce nothing of value, they add to the social cost of a monopoly."<sup>60</sup> Or consider Posner, who writes, "The costs incurred in obtaining a monopoly have no socially valuable by-products."<sup>61</sup> In both of these quotations the authors implicitly abandon wealth-maximization principles. Under wealth maximization, value is

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57. See Posner, *supra* note 29.

58. See Posner, *supra* note 29 and accompanying text.

59. Tullock, *supra* note 9, at 231.

60. Landes, *supra* note 23, at 665.

61. Posner, *supra* note 1, at 809.

only revealed by willingness to pay, and gains occur when transactions are voluntary. In the expenditures Tullock, Landes and Posner describe as aimed at achieving monopoly, this criterion is clearly satisfied. When theft or monopoly occurs, preferences do indeed change, but we are not entitled to prejudge such preferences.

The rent-seeking arguments are reminiscent of the debate concerning productive and unproductive labor that took place in the late nineteenth century. At that time, early economists struggled to develop a consistent criterion by which some labor could be classified as productive, while other labor could be considered social waste. Unfortunately, no such criterion could be found. As Schumpeter observed, attempts to find such a criterion served only "to display the word-mindedness of economists and their inability to tell a real problem from a spurious one."<sup>62</sup>

Tullock's examples bring him dangerously close to Adam Smith's theory of unproductive labor. Like Tullock's second example, Smith argued that only the production of physical goods was productive because only physical goods preserve value.<sup>63</sup> But later economists correctly pointed out that such a distinction is unworkable. What is the difference between a child-care worker who provides a service by reading a story, and a worker who creates a paperback book that is read and then thrown away? Additionally, Tullock asks us to distinguish between activities that create wealth and those that transfer wealth. How should we then characterize transportation services such as trucking, rail service and the like? Do such services create or transfer wealth? It was precisely these sorts of ambiguities and paradoxes that forced the economics profession to abandon the distinction between productive and unproductive labor. Concerns about unproductive labor are now only of historical interest.<sup>64</sup> Rent-seeking theories thus invite us to reintroduce ideas long since abandoned. We should resist the temptation.

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62. JOSEPH A. SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS 631 (Elizabeth B. Schumpeter ed., 1954).

63. ADAM SMITH, THE WEALTH OF NATIONS 314 (Edwin Cannan ed., Random House 1965) (n.p. 1776).

64. See, e.g., ROBERT LEKACHMAN, A HISTORY OF ECONOMIC IDEAS 83 (1959); E.K. Hunt, *The Categories of Productive and Unproductive Labor in Marxist Economic Theory*, 43 SCI. & SOC'Y 303 (1979).

## V. CONCLUSION

The originating question of this paper was whether rent-seeking arguments are compatible with the wealth-maximizing efficiency criterion. I have suggested that, because wealth maximization requires that we treat all voluntary transactions as welfare-improving, and because rent seeking involves voluntary transactions, it is inconsistent to categorize rent-seeking behavior as socially wasteful. This is contrary to what many antitrust economists and lawyers attempt to do when they assert that the total social cost of monopoly includes both an inefficient deadweight-loss component (which assumes a wealth-maximizing criterion of efficiency) and a rent-seeking social cost. What I have *not* argued is that rent-seeking arguments are either meaningless or lack intuitive attractiveness. In fact, the central insight of rent seeking—that certain activities are less socially desirable than others—may have some merit. Unfortunately, rent-seeking theorists have not offered a consistent criterion that can be used to distinguish socially desirable activities from socially wasteful ones. As I point out above,<sup>65</sup> our usual efficiency criterion rejects all such distinctions. Accordingly, a consistent theory of rent seeking would also have to provide a new efficiency analysis, not simply attempt to graft together two incompatible insights.

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65. See *supra* text accompanying note 44.

## APPENDIX

The following example from a popular economics textbook<sup>66</sup> is helpful in illustrating the meaning of the economic concepts of compensating and equivalent variation. As background, we suppose that a consumer has known preferences that satisfy the following conditions: completeness, reflexivity and transitivity. Given these properties, we can assign a real number to every possible consumption bundle, such that more preferred bundles get assigned larger numbers than the less preferred bundles. The resulting "utility" function will reproduce the order of the consumer's preferences.

As a concrete example, we now suppose that the utility function has the form  $U(X_1, X_2) = X_1^{1/2} X_2^{1/2}$ , where  $X_i$  is the output of each of the two goods. If  $m$  is the consumer's income, and  $P_i$  is the price of each good, the demand functions in this example are:  $X_1 = m/(2P_1)$ ,  $X_2 = m/(2P_2)$ . Assume that in the pre-monopoly state the consumer faces prices (1, 1) and has income 100. In this state,  $X_1 = X_2 = 50$ , and the consumer's total utility is  $U = 50^{1/2}50^{1/2}$ .

Now we assume that the establishment of a monopoly in the production of good 1 causes the price of good 1 to increase to 2. With the initial income of  $m = 100$ , we would have  $X_1$  drop to 25 while  $X_2$  remained at 50, causing total utility to drop to  $U = 25^{1/2}50^{1/2}$ . The compensating variation is the amount of income increase that would be needed to provide the same utility at the new prices that one had prior to the price change. This needed income, called  $m_c$ , can be derived from Equation 1 below:

Equation 1

$$\left(\frac{m_c}{4}\right)^{1/2} \left(\frac{m_c}{2}\right)^{1/2} = 50^{1/2}50^{1/2}$$

From Equation 1 it follows that  $m_c$  must be roughly \$141, and the compensating variation is  $\$141 - \$100 = \$41$ . Therefore, the consumer needs \$41 of additional income to offset the price change.

The equivalent variation is the amount of income that would have to be taken away from the consumer at the original

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66. HAL R. VARIAN, INTERMEDIATE MICROECONOMICS: A MODERN APPROACH 252 (2d ed. 1990).

prices to reduce the utility to the same amount as would the price changes. This also can be thought of as the maximum amount the consumer would be willing to bribe the monopolists not to establish the monopoly. This income amount,  $m_e$ , must satisfy Equation 2:

Equation 2

$$\left(\frac{m_e}{2}\right)^{\frac{1}{2}} \left(\frac{m_e}{2}\right)^{\frac{1}{2}} = 25^{\frac{1}{2}} 50^{\frac{1}{2}}$$

From Equation 2 it follows that  $m_e$  must roughly equal \$70, and the equivalent variation is therefore \$100 - \$70 = \$30.

The consumers' surplus for this example will be between \$30 and \$41.<sup>67</sup>

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67. See *supra* text accompanying note 42; VARIAN, *supra* note 66, at 252.