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## Article

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## OVERCOMING THE RENT-SEEKING DEFECT IN REGIONAL POLICY: TIME TO RE-THINK THE INSTITUTIONAL DESIGN

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### Regional support policy: Germany and the European Union

Divergence between economically leading and economically lagging regions has been a permanent problem of national states, as well as of the European Union. On the national as well as on the EU level, governments have used transfers of public funds in favour of the backward regions to stop economic divergence and promote economic convergence. Since the first results of regional policy were not convincing, spending has been increased over the past 25 years. In Germany, spending on regional policy became a top priority following German reunification in 1990. Under the programme “*Gemeinschaftsaufgabe Verbesserung der regionalen Wirtschaftsstruktur*” (GRW), national and subnational matching grants-in-aid for backward regions were substantially increased. From 2014 to 2020 about 25 billion EUR will be spent per year for matching grants (Federal Ministry of Economics 2015). The underlying intention was to promote economic convergence in the regions, so that the backward, industrially under-developed German East would catch up with the progressive West.

At the European level, an EU cohesion policy was created in the Single European Act of 1986 when Spain, Portugal and Greece became members of the European Union and has been extended continuously since then. For the period of 2014 to 2020 the European Commission has budgeted 325 billion EUR or about

46 billion EUR per year for regional support policies (ERDF), (Federal Ministry of Economics 2015).

The idea is that federal funds in Germany or the European Union should be spent in backward regions on investments in private businesses and public infrastructure. The supporters of regional policy assume that capital’s productivity is highest where there is the highest necessity. The economic planner is placed in the position of selecting those regions that best comply with these criteria. It is, however, surprising to see that (in the case of Germany) one federal and 16 *Länder* ministers with their administrative entourage struggle to solve such an allegedly simple selection problem. A closer look at this issue, however, reveals that the application process for potential support candidates and the selection procedure is not at all simple and costless, but a Sisyphean task. Applicants need resources to present themselves as eligible and ministers have to make calculations to sustain their selections. The basic goal of the authors of this paper is to show that the costs of application and selection are not trivial. All of the rational applicants together spend as much as the anticipated benefit of all subsidies distributed, so that the net benefit dissipates. Tullock’s “Law of the dissipation of rents” (Tullock 1980) becomes reality in regional policy.

The key to understanding regional policy is to understand its underlying process of rent-seeking. Rational candidates invest in order to obtain the prize up to an amount that equals the benefits of the prize. The net effect is zero. In fact, a large empirical study by Philippe Montfort (2008) from the Université Catholique de Louvain (UCL) in Belgium finds that the net contribution of the EU cohesion policy to regional convergence is not actually visible.

The theory of rent-seeking, which will be further developed in this article and applied to the case of regional policy, can explain in greater detail why regional policy fails. In the next part of this article, different models of rent-seeking will be presented. The explanation provided here can be applied to different concepts of regional policy in federal or quasi-federal systems. After that, the German (GRW) and European Union (ERDF) regional policy will be analysed with the tools previ-

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ously developed. Conclusions from this analysis will be drawn in the last part of this article.

## Different models of rent-seeking

### *Rent-seeking theories: an overview*

All human pursuit is a kind of rent-seeking game. All individuals try to collect resources, particularly when they believe that they can extract more value from these resources than their competitors. Crowding out is a prime character trait of the homo economicus. The result might be profit-seeking in competition or rent-seeking in monopoly (Buchanan 1980). The profit-seeker pays the incumbent a price so that the incumbent leaves the market and the profit-seeker can improve on the current market situation. The process is open to subsequent competitors who can create an additional surplus. Profit-seeking results in an improvement of resource allocation in a competitive market. The consumer pays the competitive equilibrium price  $P_C$ .

Rent-seekers, however, do not strive for an efficient deployment of resources in a competitive market, but aim to exploit their monopoly position (Tullock 1980). Fig. 1 shows the contrast between rent- and profit-seeking. The profit-seeker enters the market with a price lower than the current monopoly price  $P_M$ . The rent-seeker does not strive for an optimal use of resources, i.e., a competitive price  $P_C$ , but invests  $L$  into building market entry barriers for competitors, so that the rent-seeker can defend the price tag  $P_M$  and collect the monopoly rent  $M$ . In the case of artificial market barriers by regulation, politicians, regulators, i.e., those players who can build or tear down market barriers, sell the monopoly rent  $M$  to the profit-seeker for a price  $L$ .

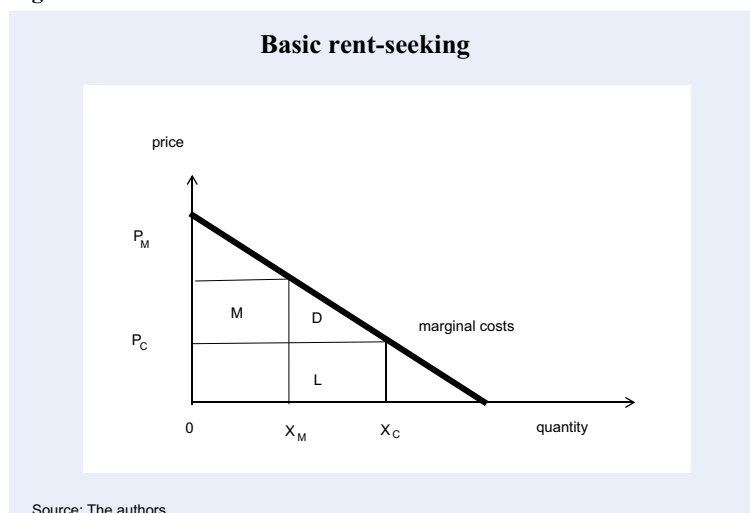
The consumers are worse off in a rent-seeking model. Moreover, the monopolist does not clear the market, i.e., does not exploit the gains from trade options in  $X_C - X_M$ .

A textbook example of rent-seeking is the distribution of cab licenses in New York City. The city administration distributes a restricted amount of licences to long-established cab companies. These licences contain a monopoly

value. Ronald Coase (1959) described how radio frequencies are allocated by the Federal Communications Commission, creating monopoly positions for the incumbent. As far as natural monopolies exist, i.e., where the costs for the creation of an additional or extended access to the market would outweigh the benefits, an efficient allocation can be ensured by auction. Television, radio, or telecommunication licences have been auctioned in Germany as a result. The bidder who expects to exploit the most value from the limited access to the market will submit the highest bid and will be awarded a (temporary) property right to the previously public good.

In the case of rent-seeking, the scarcity is not naturally necessary. Scarcity is artificial and, in most cases, caused by regulation – as the example of the cab licences in NYC shows. Supplier and regulator agree upon a regulation that grants the supplier a monopoly position, which the supplier can exploit. The allocation of artificially restricted access to the market is not distributed in a market-like auction. Typically, market access is not auctioned to the bidder who makes the highest offer, but to the candidate who fits best into the scheme that regulators and suppliers have previously defined. From a market perspective, this process is greatly inferior to the auction model. Suppliers get access not by actually maximising value, but by lobbying for ‘tailor-made’ clusters in advance, so that they have a head start when the pie is finally distributed. Organised cab drivers, for example, may have an incentive to lobby for criteria like driving experience, so as to outpace newcomers in the business. Candidates have to invest a portion of  $M$  in lobbying so as to finally collect the prize in terms of market access. The economic loss of rent-seeking can eventually increase from  $L + D$  to  $L + M + D$ . Such

**Figure 1**



rent-seeking costs can be avoided by drawing the lot of cluster-distribution instead. However, this process does not ensure that the most productive candidate enters the market. Profit-seeking, i.e., the dominance of the most capable candidate, can be achieved by an auction that grants the highest bidder the right to exploit the market. Such an auction is only necessary and recommendable where natural monopolies exist. Where monopolies are artificially created – like in the cab license example – competition in the markets will ensure the ‘survival of the fittest’ without regulatory influence.

### *Rent-seeking in legislation*

Rent-seeking via networking is rife in politics and legislation. Interest groups compete for favourable legislation. The benefits that politicians may receive for legislating in favour of organised lobby groups might consist of campaign donations, in mobilising voters of a certain group, in information provided by the lobby groups, et cetera. The more interest groups try to influence legislation to their benefit, the more expensive the lobbying effort becomes, and the more likely a dissipation of rents is. Browning (1974) suggests that lobbying is less a problem in legislation than in the case of established monopolies. A monopoly that a rent-seeker tries to defend is the concrete and exclusive source of a monopoly rent. If, however, an individual invests in lobbying, other members of the group of potential beneficiaries participate in the public good created by legislation. The availability of rules as a public good limits the willingness of individuals to invest in lobbying. Olson (1965) already pointed out that the public good, or free rider problem makes it more complicated for individual rent-seekers to

achieve their goals, especially with growing numbers of potential rent-collectors.

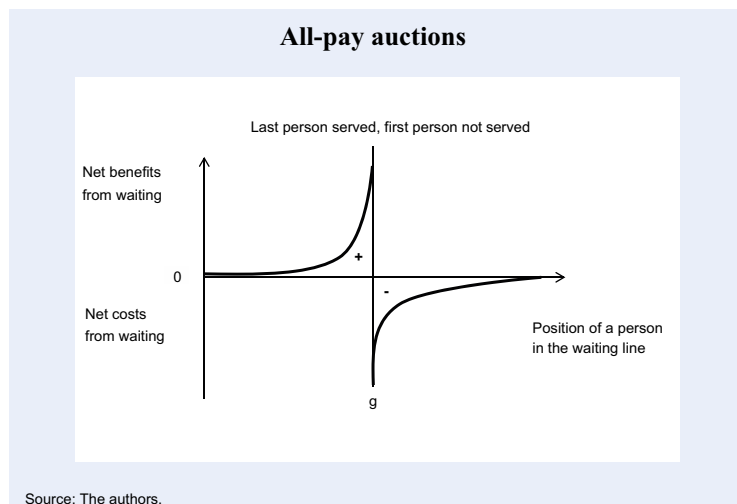
Later on, Olson (1982), however, stated in “The Rise and Decline of Nations” that the free-rider problem diminishes in societies with stable institutions between potential beneficiaries. The higher the degree of organisation (fortified by informal rules and reputation mechanisms) within a certain society, e.g., in trade unions, employer, and/or industry lobbying groups, the more likely rent-seeking investments are. Accordingly, Olson sees rent-seeking as a problem of complex and stable societies, rather than of those societies that are in a transformation or re-organisation process, e.g., after a war, a revolution, or system change.

### *All-pay auctions*

In planned economies, rent-seeking by queuing is a well-known issue. A limited amount of goods, for instance, an unknown number  $g$  of indivisible bunches  $B$  of bananas, is distributed at a given instant of time to each of the  $g$  persons first in the line. Everyone who queues pays an equal individual waiting price  $P_W$  per unit of time waited, although s/he might not collect a bunch of bananas. The first  $g$  persons in the line take all bunches  $B$ , while everyone behind them leaves with empty pockets. Everyone joins the queue until they expect that the benefits to collect a bunch of bananas  $B$  times its respective probability  $p_B$  minus the waiting cost  $P_W$  times the units waited  $tn$  equals zero, i.e., everyone queues as long as  $B \cdot p_B - P_W \cdot tn \geq 0$ . Eventually, the  $g$  bunches of bananas are distributed according to individuals’ position in the queue, i.e., the individual’s waiting time. The first player who joins the queue receives a bunch  $B$  after a high waiting time.

The highest payoff is eventually collected by the player with the shortest waiting time who is the last in the queue to receive a bunch  $B$ . The highest loss is suffered by the player just behind the last successful player. With equal waiting costs per unit of time per person, the overall benefits are netted out by the overall costs, see figure 2. If transferred to the case of regional policy, the units of waiting cost equal the units of upfront investment in time, effort, and consultants’ fees for lobbying and application, i.e. the sum of investment to collect  $C$  (all subsidies in a given

**Figure 2**



application period) by all support candidates = sum of the distinct probabilities to collect the expected share of  $C$  by all potential support candidates.

## Rent-seeking in regional policy: Germany and the European Union

### *The present model: GRW and ERDF*

The ERDF regional economic subsidies for the period of 2014–2020 are calculated at 325 billion EUR, i.e., approximately 48 billion per year. Political agents are convinced that a structural economic change cannot only be achieved by supportive structural adjustment policy, but requires concrete measures to be taken that influence economic development. The distinct goals are set in the GRW-coordination committee for GRW subsidies, or negotiated between the European Commission and the member states for ERDF subsidies. The supply of regional subsidies is fixed. Politicians decide how much they are willing to spend on regional support programmes. The demand for subsidies is open. Potential support candidates are encouraged to apply for subsidies in a tender process. This step shall avert suspicion of nepotism, corruption, and arbitrariness. Everyone shall have the same chance to enjoy a portion of the pie. Information is asymmetrical in this process. Politicians know the exact figures of all subsidies, while the actual costs of the tender process are opaque. Support candidates are forced to make ex ante investments in order to increase their chances of eventually collecting the prize. Such ex ante investments push up the economic costs of the tender process, so that the net benefits of the entire process for society ultimately approach zero.

While all economically sensible investments should be made according to the principle that subsidies of  $C$  should yield a utility of  $U$ , where  $U \geq C$ , it is highly doubtful as to whether the current regional policy can achieve this goal. Firstly, citizens have to be taxed with  $C$  so that  $C$  is available to be distributed in regional policy subsidies. Problematically, a sum of money  $C$  extracted from the economy most commonly leads to an excess burden, i.e., a welfare loss higher than  $C$ . In Brennan and Buchanan (1980), it is assumed that the total economic cost (EC) of taxation regularly exceeds the taxed sum ( $C$ ), by  $3/2 C$ . Secondly, the economic benefit (EB) that can be achieved by injecting  $C$  into a certain project is most likely to lie considerably below  $C$ . Only if  $C$  (as a right, rather than a cash subsidy) is auctioned to the candidate that makes the highest bid, i.e., to the candi-

date that is able to contribute the most to GDP, EB may reach  $C$ . Let us recall the example of auctioning television, telecommunication, or radio licences in Germany. Such a procedure, however, is not foreseen in the GRW and ERDF-policies. The GRW coordination committee for GRW subsidies and the European Commission in negotiation with the member states for ERDF subsidies define the criteria for support, i.e., they create clusters such as ‘creative media’, ‘medical technology’, and ‘biotechnology’. The process whereby such ‘innovative’ clusters are established involves extensive negotiations and frequently also entails high fees for consulting firms that do a lot of persuading in cluster design. In Germany, for instance, smaller businesses like hairdressers, butchers, and bakeries that really tend to struggle in less developed regions, not least because of the minimum wage limit, have no realistic chance to argue for a cluster in their favour (Eisenring 2015).

Extra costs arise ex ante in negotiations over cluster design and ex post in applying for subsidies within the specified cluster. The distinct probabilities  $P_i$  of receiving a share of all subsidies  $C_i$  times the respective share, i.e.  $P_i * C_i$  sum up to  $C$  for all potential support candidates with  $C$  being the total amount of subsidies to be distributed in a given application period. Every support candidate has the incentive to invest his or her expected share  $P_i * C_i$ . Since the ex ante investment in cluster design creates a public good for all support candidates who fit within the same cluster, the ex ante incentive to invest in cluster design is lower than the ex post incentive to invest in the application process. However, as previously pointed out, the higher the degree of coordination and organisation within a specific candidate group is, the higher the chance to avoid the free riding problem, and to bundle efforts so as to secure an as large as possible pool for ‘their’ cluster. After the cluster is defined, the grab race starts. Every candidate has to estimate his/her distinct probability of acquiring the prize, the value of the prize, and the competitors’ investment. The theory of rent-seeking applied to GRW and to ERDF regional policy shows: if all candidates have perfect information about their chances of success and the value of their subsidy, the net benefit of subsidies will tend towards zero. Imperfect information, however, might lead to a negative or positive outcome in the end. The net benefit for society is largely diminished by the ex ante and ex post transaction cost of acquiring the prize. Empirical research that shows either a positive or negative net effect of specific subsidies supports our assumption of a zero net effect on balance. Econometric studies cannot replace a theoretical profound analysis of regional policy.

### *An alternative regional policy: distribution of rights instead of top-down distribution of revenues*

In order to create a sustainable model for regional policy for the future, one first has to recognise the failure and flaws of current regional policy, and secondly, one has to recall the goal of regional policy, namely the strengthening of regional units and in particular of regional business activities. The institution of the GRW and ERDF funds suggests that sub-central regions lack finance, while the federal republic or the European Union have spare funds that can be distributed top-down to regions in need. As shown in this article, the distribution of revenues from tax rights is highly inefficient, as it leads to a dissipation of rents.

An alternative solution, which we would like to propose without the claim of eventually developing and proving this model, but merely as a contribution to the discussion of re-modelling regional policy, is to focus on the distribution of rights, instead of the top-down distribution of revenues from the use of rights. If regions are seen to lack the necessary funds to develop a successful business infrastructure while the central institutions have excess finance on balance that they can distribute, one should give the local units the rights to tax, or the chance to raise sufficient revenues themselves, and to create a supportive environment for their local businesses. Politicians who control the GRW and ERDF funds, however, may have an interest in the current inefficient constellation: an excess of funds and the chance to distribute revenues top-down means political power. But that is a problem of political opportunism.

An important step towards an efficient deployment of resources would be a distribution of rights that would allow the local units to meet their duties with the revenues that they can create from 'own rights'. An allocation of rights to tax and burden towards the local units would, moreover, give them the chance to set incentives for companies and citizens with lower taxes to locate in their region if the region is less attractive in other respects; and, vice versa, to charge companies and citizens for the use of a highly developed infrastructure in other regions. If, finally, some regions struggle because of 'extraordinary' issues (natural catastrophes etc.), temporary support measures certainly can be taken. Endless competition for rents does not, however, strengthen the regions; the desired benefits just fade away.

### Conclusion

Regional policy is unrewarding in almost all countries. In Italy, the central government has tried to bring the relatively poor South closer to the economically prosperous North for over 65 years. Since 1980, the European Union has devoted significant funds to resolving the mezzogiorno-problem. An end, or even a visible improvement of this situation, is not within sight. This article offers an explanation for the failure of regional policy. It may be a first step towards a brighter future for regional development.

The agents of central institutions are generally quite clear about what they want to achieve with their regional support programmes in detail. Projects, the amount of funding available for distribution, and the conditions attached to its awarding are defined. It is, however, unknown who will win the prize, meaning that every candidate has an incentive to invest in transaction costs up to an amount that equals the expected subsidy for their project multiplied by the probability of collecting the prize. The sum of all candidates' transaction costs destroys the benefits of the prize competition for society.

The underlying problem is an inefficient allocation of revenues that arises from the deployment of rights. Negotiations between central and decentral institutions over an efficient re-allocation of rights to tax and to raise revenues in the regions should lead to a socially favourable solution.

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