



Tullock and the welfare costs of corruption: there is a “political Coase Theorem”

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Abstract

Gordon Tullock developed an approach to understanding dynamic processes of political change and policy outcomes. The key insight is the notion that political insiders have a comparative advantage—because they face lower transaction costs—in manipulating rules. The result is that political actors can collect revenues from threatening to restrict, or offering to loosen, access to valuable permissions, permits, or services. To the extent that the ability to pay for such favorable treatment is a consequence of private activities that produce greater social value, there is a “political Coase theorem”: corruption makes bad systems more efficient. But the dynamic consequences are extremely negative, because of the inability to institute reforms resulting from application of Tullock’s “transitional gains trap.”

Keywords History of economic thought · Rent-seeking · Corruption · Economic development

1 Introduction

In 1967, Gordon Tullock noticed a potential problem for public policy. The then-current conception of the “welfare costs” of monopoly omitted two crucial elements. The first was “rent-seeking”, or the resources dissipated in acquiring and defending monopoly rents. The second was a kind of lock-in that Tullock dubbed “the transitional gains trap”. What that meant is that inefficient technologies, obsolete production processes and inferior products persist far longer than economic logic would dictate, because those obsolete or redundant jobs or rents are still very valuable to the workers or owners.

Much, though by no means all, of the attention the 1967 paper later received focused on the first insight. Tullock himself later (1975) noted that the “lock-in” problem should be counted, *ex ante*, as an additional cost of policies designed to transfer valuable—though artificially created-rights, such as monopolies or permits to be exempt from competition.

Still later, Tullock added—almost casually and without much fanfare—a third missing element, one that may have been the most important implication of all, at least for

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developing economies, in Tullock (1996). The puzzle, commented on by many (Easterly 2001; North 2005), is to explain why some nations develop and others, though apparently similar in culture, climate and resource endowment bump along near the bottom of the feasible range of growth paths. We might call this the “un-development trap”, though it’s really the “corruption causes rent-seeking, locks in corruption and that blocks development trap.” As Holcombe (this issue) notes, the last trap often is thought of by reform-oriented outsiders as simply a practical obstacle. But it can be thought of as an advantage for insiders who face lower transaction costs, a kind of “political Coase Theorem”, with the difference being that the political Coase Theorem requires attention to disparities in transaction costs rather than assuming that such costs are everywhere equal, and low.

This line of reasoning suggests that, if it is to have so central a role in the analysis, corruption should be defined. Corruption may be illegal, but it need not be. Corruption involves the divergence of actions by a public official away from the public good, something like Madison’s “impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community” (*Federalist* #10). Such a definition has problems, of course, including the idea of an objective definition of “the aggregate interests of the community.” I have tried before to argue for a Pareto standard for corrupt exploitation of public position (Mitchell and Munger 1993), but many analysts would insist on a real comparison between (1) the honest services of a public official and (2) choices or actions “corrupted” by considerations that are not legitimate. To paraphrase Lessig (2004, p. 199), corruption occurs when a decision is improperly, even if only subtly, influenced by a government actor’s anticipation of some sort of indirect economic gain or loss. Corruption is the abuse of public office for private gain. So, this establishes that corruption is *morally* wrong. Is it *bad*, in consequentialist terms?

Suppose that it normally takes 6 months to have a telephone or internet line set up, because the state monopoly utility company is notoriously inefficient. But if you pay *kitu kidogo*, or “a small thing,” in Swahili, or *ashaan as-dukhaan*, “something to get cigarettes,” in Egypt, the truck and a happily willing, competent work crew will be there tomorrow. Who can afford to pay? Whomever values the service most. An obvious “Coase theorem” application is operating here: in an inefficient system, tacit endorsement of corruption *improves* the working of the system. The more inefficient the system, the greater the efficiency increase in the near term, as scarce resources are directed first to higher value uses.¹

But then, as Tullock correctly notes, two things happen. First, the scarcity of the resources is artificial, and discretionary. Consequently, the state actors who formally and informally control those resources adjust access to those resources strategically, increasing the quantity of rents they receive. In my example, the phone company might announce a mandatory two-year waiting period, increasing the value of access to the “informal” (corrupt) workaround using bribes. Second, the occupants of the positions that have such control, and therefore access to the bribes as income, compete to maintain those positions and likely were forced to make bribes of their own to acquire those jobs in the first place.

Consequently, what seemed to “work out quite well” in the short-term, in a moderately corrupt system that managed to provide a Coasian work-around, becomes over time a rigid and seriously corrupt system wherein any attempt at reform aimed at cleaning up corruption is met by fierce opposition and quite likely state-sponsored violence, as middle and upper-level officials struggle to keep their wealth intact and their income sources protected.

¹ For a review of some of the literature on whether corruption “greases” or “sands” the wheels of development, see Méon and Sekkat (2005).

Interestingly, one way to define “get rid of corruption” is “outlaw all side payments involving buying favors from government officials.” Of course, buying favors from government officials is wrong. But as Buchanan and Tullock (1962, p. 156) pointed out, “With all side payments prohibited, there is no assurance that collective action will be taken in the most productive way.” This is straightforwardly the negation of a “political Coase Theorem” (Acemoglu 2003; Parisi 2003), but with the twist that—from the perspective of the corrupt state actors—value is created by *raising* transaction costs, reductions in which can then be profitably sold off (Munger forthcoming). Given inefficient or corrupt institutions in high transaction costs settings, it is quite true that tolerating additional corruption may foster modest prosperity, if corruption takes the form of being able to buy one’s way out of inefficient rules (Leff 1964), or if some groups face lower transaction costs as a result of “inside” positions (Holcombe 2018).²

This paper proceeds as follows. In the next section, I consider the problem of Pareto improvements that don’t happen, because in systems with high transaction costs many mutually beneficial activities simply fail to be undertaken. In such a setting, perversely, corruption can—as Tullock noted—have good consequences, at least in a static sense, because corruption allows high-valued activities to go forward through Coasian side payments. Those side payments are illegal, but socially beneficial. The third section asks whether morality is a solution in a corrupt system and finds that the problem is likely to operate outside of morality, or to breed cynicism about morality as a social construct. Morality is as much a dynamic set of conventions as it is a rigid social concept, and Merton’s “functional corruption” assimilates what was once immoral as part of what is acceptable, precisely because everyone is doing it.

The fourth section connects Tullock’s observation about the static sustainability of corruption with the dynamic problem of the transitional gains trap. North et al. (2009) distinguish open access orders and closed access orders, and give an account of how closed access orders are locked-in. That account is a very congenial extension of Tullock’s basic insight and helps flesh out the conditions under which economic development is possible. The fifth and final section concludes.

2 In inefficient systems, corruption reduces transaction costs

The idea of “potential Pareto” dates to the Kaldor-Hicks-Scitovsky (KHS) contributions to welfare economics (Hicks 1939; Kaldor 1939; Scitovsky 1941). The most interesting problems of social welfare analysis in economics lie in the choice among Pareto optima. Two mechanisms for making such choices are voting and bargaining. As I noted in an earlier paper (Munger 2014), both KHS and Coasian bargaining try to discover the better (best) alternative in choosing among Pareto optima by either *considering* (in the case of KHS) or *requiring* (in the case of Coase) side payments.

We tend to muddle together two distinct questions, but it is important to keep them separate, at least analytically. First, do real-world political-economic systems manage to

² In a static sense, bribes are usually just cash transfers that carry minimal, if any, social welfare costs—except foregone productive opportunities. But the opportunity bribes afford either to break the law, or to set up mechanisms to facilitate the collection of bribes, can be very costly. Buchanan and Tullock (1972) recognized that the accumulation of successful bribes and collection of rents can result in the “dead hand of monopoly,” the costs of which are significant but hard to measure.

achieve efficiency (Pareto optimality)? Second, do real-world political-economic systems select “good” Pareto optima when several possible Pareto optima are available from which to choose?

The Coasian contribution was to recognize that, in the presence of transaction costs, the answer to the first question might be “no”. Of course, if one allows that transaction costs are just costs like any other, that result is hypothetical, since market processes lead to the transaction-cost-contingent “efficient” solution. But a problem arises with this view, to the extent that transaction costs are the product of state-selected institutions, going to the heart of North’s (1990) claim: institutions might well be inefficient, in the sense that transaction costs are too high to allow efficient market processes.

But very soon after the Coase (1960) conclusion about transaction costs and efficient solutions—to wit, if transaction costs are low, private bargaining with side payments will “find” the efficient solution—Buchanan and Tullock (1962) extended the logic to the study of institutions themselves. Specifically:

If full side payments are allowed to take place, *any* decision-making rule for collective action will lead to positions that may properly be classified as Pareto optimal, although Pareto optimality may not characterize the process or processes through which the positions are attained. (Buchanan and Tullock 1962, p. 190; emphasis added)

An unspoken, and perhaps at the time unrecognized, assumption of that claim is exactly the Coasian assumption that transaction costs cannot be prohibitive. In effect, Buchanan and Tullock were arguing for the existence of a “political Coase theorem”, with the decision process playing the role in politics that property rights or liability assignments play in markets. Buchanan and Tullock claim that, *regardless* of the assignment of decision rights in the collective choice process, the system will achieve efficient outcomes if bargaining and side payments are allowed. But Buchanan and Tullock themselves would reject the utilitarian calculus unless explicit compensation is paid.

In a standard economic system, transaction costs can be thought of as frictions. Friction, in a physical system, produces heat and slows movement, dissipating the system’s energy without producing anything. Transaction costs have many sources, ranging from problems of information, to negotiating terms of agreements, to trust that agreements will be carried out. But some transaction costs take the form of delays in seeking permissions necessary to proceed with investments or building new production facilities, or delays in arranging and completing installation of infrastructure ranging from transportation to communication.

Tullock later elaborated the claim made in 1962 about the efficiency of outcomes being independent of the decision rule, because he (in effect) recognized that transaction costs could prevent the contracting for side payments that efficiency-improving moves require. In fact, his notion of the “transitional gains trap” (Tullock 1975) is precisely premised on the inability to contract around artificial rents in a way that all parties find credible. The result is that *inefficient* systems are *contingently efficient*, given the high level of transaction costs that prevent Pareto-improving side payments.

The simplest version of the claim I want to make is that, in a pathological economic and political system, corruption reduces transaction costs—and increases prosperity—in the short term (Leff 1964). But government agents can sell reductions in transaction costs, so they first improve their wealth positions by creating more transaction costs. These new barriers to efficiency have no basis in problems of organizing the bureaucracy, but rather are the intentional consequence of government hold-up activities. The transitional gains trap operates precisely because it is very difficult to make a credible commitment to

compensate the “owners” of the current (illegitimate but valuable) rents (for a formalization of this insight, see Coate and Morris 1999).

When corrupt hold-up activities are successful—and how could they not be, given that it is easier and more profitable to manufacture delay than to achieve neutral efficiency? — then corruption is locked in. Tullock (1996, pp. 6–7) lays out the problem:

[T]he problem of corruption is real, and it is connected with rent seeking.... Comments by 19th century businessmen, missionaries, and others visiting China contain continuous complaints about corruption [saying] that the officials actually write laws with the intent of being bribed to permit people to avoid carrying out the law. This is rent seeking.

Consider an official in Fukien, a number of whose citizens illegally go to the Indies to work and then return with considerable money. The official could set up a program under which going to the Indies is illegal and then be prepared to accept bribes when those going illegally return. He would have to set the bribes so that people would still have an incentive to go to the Indies to work even though he would be “taxing” them. His calculation would be equivalent to that of a merchant who knows that raising the price on a product lowers the number of units sold.

[E]vidence suggests that officials tended to draw a large part of their personal income from bribes.... Indeed, it is almost certain that once a government structure has been set up so various people make profits, changing the structure in such a way to shrink the profits will be extremely hard, regardless of whether the profits are legal or not. Firing civil servants may be even harder than firing college professors.

Of course, earlier in the same paper, Tullock had made a provocative claim about the origins of corruption. In effect, Tullock recognized a theme that I have since tried to develop elsewhere (Munger forthcoming): in countries with inefficient and ineffective institutions, corruption can sometimes “work out quite well” (Tullock 1996, p. 5; but see Lambsdorff 2002).

In corrupt systems, the likely consequence is that the “salaries” of many public officials are negative: Agents pay the principals, rather than vice versa. One possibility would be to make public positions more prestigious and increase the pay and benefits of officials. The empirical evidence is mixed, showing (Le et al. 2013) that in very low-income countries pay increases can reduce corruption, but in wealthier nations suffering from corruption the benefits to the existing system may resist the implicit buyout.

A passage from a recent *New York Times* article on illegal “sand-mining” in India is worth quoting at length:

Criminality and graft have come to be seen as such incontrovertible facts of life in India that, in my experience, people seldom mind discussing them openly.... Construction is the business where criminals have the best opportunities to launder the most money, he explained, and a cascade of bribes go “to the topmost levels in the government”.... To get a typical government construction commission, he explained, you pay 6 percent in bribes up front. Then, after the first payment, you pay another 7 percent, half of which goes to the state’s top politicians. The development authority’s junior engineer gets 3 percent. The associate engineer gets 1.5 percent. The senior manager gets 3 percent, and so on — until the total reached an astonishing 30 percent. “When this is given, then almost anyone can be managed,” Kasana said. “This is the system. This is India.”

“The thing to do is to get a job in the authority,” my translator joked. “This can also be done,” Kasana said. To get a job as a junior engineer, he said, requires a bribe of 10 million rupees. (Romig 2017)

Note that both parts of Tullock’s claim are illustrated here. First, “almost anything can be managed”, even in a system notorious for being slow, inefficient, and deadly to entrepreneurship. Since corruption reduces the frictions, it may “work out rather well.” This is straightforwardly the Coase theorem at work: more resources go to the businesses that can produce enough value to be able to afford bribes. If you have a good idea and financial backing, you can build apartments, create new factories, or set up a new business. The system is terrible, but corruption makes it function moderately efficiently, because—as a Coasian analysis would predict—the value of placing resources in activities that produce greater revenue overwhelms other considerations. Even systems constrained to inefficiency tend toward greater local efficiency, in other words.

The second point is that the rewards from having an official position lock in corruption, and later give strong incentives to expand the scope of that system. Having discretion to award a permit, or to sign an inspection form, mean that enormous rents are created, and capitalized in the “prices” of jobs. The legal authority to create new opportunities for holdup just make the bureaucrat’s position more valuable. The downside is that the value of the appointed position comes to depend entirely on the maintenance and expansion of the inefficient restrictions that make bribery and corruption necessary.

That’s why any attempt to rationalize the system will be met with bitter reactions from those who benefit from the status quo. No individual corrupt bureaucrat could be certain he would profit enough from a rational, legal system to make up the difference. There is no way to borrow against that future surplus and buy out the valuable “rents” enjoyed by corrupt bureaucrats. And so “successful” corruption creates an inescapable transitional gains trap.

3 Is morality a solution?

I have tried to explain why corruption might persist, and the answer may seem paradoxical. Corruption in bad institutional settings is useful, because it reduces transaction costs. Still, humans generally disapprove of corrupt acts. In fact, it appears that we have innate, and in fact evolved, brain architectures that nearly force us to react angrily to seeing others violate social norms (Haidt 2007). However, several moral considerations may be operating at once, and things that are objectively “corrupt” if no one does them may be perfectly socially acceptable in a context where, as the saying goes, “everyone does it” (Dungan et al. 2014). That doesn’t mean that there is no such thing as morality, but it may imply that our reactions to corruption are deeply contextual.

Many acts are almost corrupt, but common. As I described in Munger (forthcoming), when I was in college I had a job as a night manager of a “Burger Chef”, a shabby fast food joint in Florida. A Winter Garden city policeman would sometimes drive by around 10:30 p.m., when we were counting the night’s receipts before we closed. The patrolman could have been somewhere else, but he drove by Burger Chef. No pattern was evident, other than being near closing time, but we were visited at least once a week. I had the counter workers give him a friendly greeting, and immediately make a fresh pot of coffee (giving him an excuse to stand and chat for a moment), and then give him the coffee, along with a fried apple pie, for free.

One night the owner of the store was in late and saw that little show. I could see he was angry, but he waited until the cop had left and then called me into his office. The owner said, “Look! If a cop comes in just before closing time, you give him a burger and fries, *plus* a coffee and a pie!” The owner had several stores in challenging neighborhoods, and a police car nearby reliably but randomly was beneficial, both as insurance and as showing a connection with local authorities.

Was it corrupt? If the cop’s patrol pattern was affected, even at the margin, compared to the optimal (random?) pattern of patrol, the bribe seems harmful. The harm comes from selling public policy in exchange for personal gain, which is the essence of corruption. Knowing of the good chance that the patrolman will go by the Burger Chef at 10:30 p.m. means that an informed criminal could plan a robbery somewhere else at that time.

Furthermore, the *appearance* of corruption is evident, because the policeman received free food simply because he was a policeman. This is akin to the “Caesar’s Wife” objection from the relevant chapter in Plutarch’s *Parallel Lives*. Handsome young Clodius was caught “visiting” Caesar’s wife Pompeia. The visit was attempted during the “Rites of Bona”, when only women were allowed in the house. Clodius was identified, and chased, but escaped into the night. When word got out, Clodius was charged with sacrilege, though of course his real crime was in seducing, or appearing to seduce, Pompeia.

Caesar’s reaction was interesting. Quoting Plutarch directly:

Caesar divorced Pompeia at once, but when he was summoned to testify at the trial, he said he knew nothing about the matters with which Clodius was charged. His statement appeared strange, and the prosecutor therefore asked, “Why, then, didst thou divorce thy wife?” “Because,” said Caesar, “I thought my wife ought not even to be under suspicion.”

The reason that Caesar’s reply to Clodius’ prosecutor is important is that the appearance of corruption colors the expectations of others. Police adapt to expect free food and drink as an entitlement of the job. In equilibrium, the salary and benefits of the job adjust downward as more people seek the desirable position to acquire access to the informal rents it provides. But then we have a transitional gains trap: any attempt to end the informal corrupt practice is met with fierce opposition from the police themselves, who “paid” for that benefit. We can say that we expect wages and compensation to rise in equilibrium. But that’s not very persuasive, since all the current police officers can expect is (at best) a restoration of the status quo they already enjoy. At worst, those who had won the rent-seeking contest lose their privileged position.

As DeLeon (2015, p. 31) put it:

For the owner of a diner to give a free lunch to a cop on the beat could easily be construed as low-level bribery, but it might just as justifiably be viewed as a form of direct taxation to pay for a retainer, services rendered, or maybe little more than a tip for overtime; similarly, a bribe might be considered a user’s fee for overcoming bureaucratic bottlenecks. No harm, no foul.

Individual actions may be constrained by formal rules, but “society” can also construct and perpetuate what are essentially soft, moral constraints that people still perceive as binding (Merton 1938, 1949). But what if those rules sharply constrain economic activity? What if state officials themselves raise obstacles to business or obtaining the necessities of everyday life? In that circumstance, Merton (1949) argues that corruption can be “functional”, meaning that society may look the other way rather than punishing

corruption. Is the reason that everyone knows, citizens and officials alike, that corruption makes the system work better?

Johnston (2005, p. 23) also notes the benefits of functional corruption in dysfunctional systems:

Corruption... was a way for elites to build their political backing in society and to win cooperation in both parliaments and bureaucracies, a way for entrepreneurs and investors to break through bureaucratic bottlenecks, an informal price system in tightly regulated economies, and a cushion against the worst social dislocations of development.

Thus, in an otherwise socialist or command system, corruption furtively creates a protected space wherein the price mechanism can function. The size of this “grey” market grows as the needs of the society change, much like Coase’s observation that the sizes of firms grow endogenously in response to changes in the transaction costs of using markets. The informal, but corrupt, workaround creates wealth for many participants, allowing citizens to obtain food, clothing and other necessities in a way that quietly improves efficiency while preserving the formal powers of the state apparatus.

Johnston (2005, pp. 135–136) goes so far as to spell out a set of sufficient (though not necessary) conditions under which Merton’s “functional corruption” will occur.

- First, the “fruits” of government action, or the costs of inaction, must be sufficiently large that there is excess demand for these services. Thus, there must be some reason to want new telephones, to build new factories or apartment buildings, or to need permits to engage in some economic activity. This means that the state needs considerable “capacity,” in the sense that it can enforce sanctions that would otherwise prevent economic activity, and that it can deliver services (roads, electricity, telephone connections) when mobilized to do so.
- Second, these benefits or escape from these sanctions can only be obtained by “dealing” directly with the government. Organized mafias that act as intermediaries can either replace, or thwart, the development of functional corruption. Thus, the state is obliged to secure its Weberian role as the monopoly provider of security and the sole legitimate user of violence and force. This is another kind of state capacity, and it represents a stable alternative to the development path of seeking to negotiate an “open access order,” as we will later see.
- The “routine process” by which needed benefits are created, recognized, or conferred is time-consuming, inconvenient, expensive, and possibly uncertain. Alternatively, sanctions are arbitrary and devastating. These conditions may be endogenous, of course, to create a maximal difference between those who “pay to play” and those who try to avoid paying bribes or speed money.

Calling these points sufficient conditions means that corruption is the expected, contingently rational, outcome. You wouldn’t choose a corrupt system if you were starting from scratch, but corruption can make a harshly managed system a little better.

Corruption is an informal kind of political influence that can break through this bottleneck.... It can speed things along, make favorable outcomes much more likely, and cost less than legitimate forms of influence....The basic pressures and tensions that make corruption so advantageous and tempting are products not of the kinds of people to whom we entrust public power, nor necessary of flawed

institutions, but rather of governments' basic relationship to society. (Johnston 2005, p. 33)

If in fact “everyone” does it, we are all better off with corruption than we would be if we are stuck dealing honestly with bad institutions. But we don't have to be stuck with bad institutions; if we can make side payments, it should be possible to make Pareto-improving moves. That's the real problem with corruption: the need to preserve high transaction costs to preserve the incomes of corrupt officials locks in or perpetuates the closed access order. In effect, the individual has a time-consistency problem: my short run incentives are to participate in, and if possible profit from, the functionally corrupt system. But by doing this I reduce the future growth of the economy in which I participate, and limit the economic and personal choices available to my future self and to my children.

As Merton (1949, p. 126) put it, perhaps for these reasons,

[T]he functional deficiencies of the official structure generate an alternative (unofficial) structure to fulfill existing needs somewhat more effectively.... [But] I trust it is superfluous to add that this hypothesis [i.e., functional corruption] is ‘not in support of the political machine.’ The question of whether the dysfunctions of the machine outweigh its functions, the question of whether alternative structures are not available may fulfill its functions.

To summarize the argument of this section, then: Corruption, when it exists, benefits the participants in the corrupt system. In a system with “good” institutions corruption is clearly a net harm, and violates social norms. Those social norms may be sufficient to self-police corrupt practices in many circumstances.

However, in nations with “bad” institutions, corruption may be a rational response to dysfunctional or badly structured state capacity when substantial economic benefits are available to finding a “work around”. That observation likely means that the systems of socially transgressive and furtive delivery of benefits and protection from sanctions themselves become formally institutionalized, or nearly so. Both the citizens who depend on cozy relations, and the government functionaries who depend on income, are likely to resist efforts at reform.

Merton's breezy summation, that “alternative structures may fulfill [the services now delivered through functional corruption] without necessarily entailing its social dysfunctions, still remains to be considered at an appropriate point”, thus is too optimistic. No one is confused, and having some development aid specialist come over and lecture about “alternatives at the appropriate point” will just make insiders roll their eyes mockingly. If everyone is doing it, and the system is working, no one unilaterally can make him or herself better off by invoking “morality”. What can be done?

4 Corruption as an extension of limited access orders

Political economic systems with “bad” institutions and rampant corruption are stuck in what North et al. (2009) called a “closed access order”. A transition to an open access order would benefit the entire society in the sense that it creates a much larger total GDP and higher average income. But the aggregate benefit ignores the problem of ensuring that those who enjoy substantial rents in the current system have no reason to expect a privileged position in the open access order. In fact, it is precisely the destruction of the

valuable but corrupt control over rent-generating positions occupied by individuals who can hold up economic activity that would cause the economic benefit to the society.

Furthermore, as Tullock correctly pointed out, given the costs of acquiring control of these rent-producing positions the current incumbents are at best earning only a normal return. If a job as a “junior engineer” produces a large supernormal return compared to other jobs, the bribes required to be named to the rent-producing job will be calibrated to make applicants indifferent among various employment opportunities. But if the rent is threatened, or the harmful or restrictive regulation that gave the position value is on the chopping block, the current holder of the job forfeits what he or she (rightly, under the circumstances) sees as an investment.

As North et al. (2009, p. 71) put it:

Politicians in both natural states and open access orders want to create rents. Rent-creation at once rewards their supporters and binds their constituents to support them. Because, however, open access orders enable any citizen to form an organization for a wide variety of purposes, rents created by either the political process or economic innovation attract competitors in the form of new organizations. In Schumpeterian terms, political entrepreneurs put together new organizations to compete for the rents and, in so doing, reduce existing rents and struggle to create new ones. As a result, creative destruction reigns in open access politics just as it does in open access economies. Much of the creation of new interests is beyond the control of the state. The creation of new interests and the generation of new sources of rents occur continuously in open access orders.

Closed access orders, in other words, fall into the transitional gains trap because individuals who informally control rent-collecting choke points cannot credibly contract for anything close to the present value of the stream of rents they enjoy under the existing system. Even if the promise of future compensation is sincere at the time that it is made, there is no reason to expect the promise to be carried out once the source of rent-creating power—the ability to hold up applicants for official permissions—is surrendered.

As a result, corruption may be the only way to get things done in a closed access order. Since corruption allows some economic activity, it seems useful, even though permissionless innovation, creative destruction and innovation all are largely precluded. But closed access orders create rent streams that become entitlements, and these depend on corruption continuing, which blocks transition to a more rational and productive set of institutions.

4.1 Why do good countries have bad institutions?

The major question of development, including the creation and maintenance of institutions in which corruption is controlled effectively, might be asked in either of two ways. First, why is it that many nations fail to develop “good” institutions and thriving economies? Second, why is it that some nations succeed in developing “good” institutions and thriving economies? I understand that this posing of “two” questions where one is just the negative of the other seems facile, but they are in fact completely different questions.

The approach to answering is going to depend on whether the analyst believes that the “natural” state of human society is development and progress, or stasis and entropy. The account of much of development economics is that more efficient (i.e., lower transaction costs) institutions are the key to prosperity. And prosperity is Pareto-improving. The simple version of the Coase theorem would then predict that, if side payments are

allowed and transaction costs are not too high, functional markets always will develop and prosperity always will ensue.

But that prediction is false; in fact, it's absurdly false. Many nations coast along on growth paths far below what would be implied by their endowments of population and natural resources. Failure in development, like entropy in physics, is the default. Our task is to explain the emergence of order, and prosperity. What do successful nations have that failing states lack?

According to North, Wallis and Weingast, the central fact of human society is the "state", the organization with a comparative advantage in directing violence. Violence can be used to provide social order, but it doesn't have to be. States must prevent or constrain the human capacity for violence against one another, while developing and focusing means of exerting violence through agents the states (mostly) control. Of course, many states fail in both functions, allowing competitors to threaten violence internally, while failing to limit and safeguard even its own capacity to exert violence. Consequently, enormous transaction costs barriers are erected in the face of opportunities for mutually beneficial exchange.

It would seem that the deadweight losses imposed by mutually beneficial exchanges foregone would provide ample incentive for the transition from a system wherein order is imposed by hold-up backed by violence to a system wherein order emerges from voluntary cooperation. Groups of citizens in an open access system can order and reorder themselves into temporary but highly efficient structures such as firms, voluntary associations like non-profits, and other kinds of weakly connected voluntary communities. Such systems of emergent order thrive in an environment of *permissionless innovation*, without extracting rents or blocking the development of the order by requiring permissions in the first place (Thierer 2016, pp. 7–11). The problem, of course, is that the state's capacity to exert violence gives it, or its agents, the informal power to exact payments in exchange for permission, permits, or "protection", which simply is the withholding of threats of force.

North, Wallis and Weingast argue that the "types" of state organization fall into one of three internally stable, often persistent, categories: primitive orders, limited access orders and open access orders. A system of any of the three types develops internal mechanisms for ensuring continuity, because agents will invest in specific physical and human capital only if a credible commitment for such continuity is in place. Once such interests are created, and are dependent on the current system being maintained, we may be stuck in Tullock's "transitional gains trap". Even bad institutions can be reformed only through wrenching transformations that incite violence and destruction of the essential institutions of the old society. A possible exception to this gloomy prediction exists, however, as noted by Koopman et al. (2015): If innovation is in fact "permissionless", then it is possible that the growth of digital platforms for clearing transactions and doing business can leapfrog the difficulties of the transitional gains trap.

Limited access orders use the power of the state to focus violence so as to create artificial rents whose value lie in restriction on competition and innovation. The ability of the state to withhold such protection creates the opportunity to collect revenue from those who "own" the rents. The very survival of limited access orders depends on the capacity of the state credibly to commit to protecting the stream of future rents by threatening violence against competition or innovation. The state has no choice but to continue to protect the very rights that thwart development, and rent "owners" have no choice but to support the current regime.

Open access orders, by contrast, foster experimentation and constrain violence and sustain social order through political and economic competition rather than rent-creation.

Open access orders have developed in about three dozen countries, and all are both economically and politically developed.³

To be sure that the distinction is clear, the latter two types of orders—limited access orders and open access orders—are entirely separate and generally internally stable equilibria. Limited access orders depend on restricting competition to survive; open access orders depend on humanly generated competition to grow.

To see how this approach illuminates the problem of corruption, it is useful to understand North's distinction between "institutions" (the humanly devised rules of the game that shape and direct human activity) and "organizations" (the optimizing responses that emerge spontaneously in response to the incentives and constraints presented by the institutional setting). Each of the three "institutions"—primitive, limited access and open access orders—evoke a different set of organizational responses. As North et al. (2009, pp. 38–39; emphasis added) put it:

The institutional structure of a society determines the kind of organizations that can be created and sustained. Primitive social orders cannot support complex organizations. Limited access societies *support* complex organizations, but *restrict the number* of complex organizations. Limited access orders create and distribute rents by limiting the ability to create organizations. Open access societies support open access to organizations. This fosters economic and political competition, and it results in a rich array of complex economic and political organizations.

We can see how, in a limited access order, restricting the ability to create alternative organizations is crucial for the survival of the system, but it also explains the system's resistance to change. The "junior engineer" in the Indian system who saved up to make a payment of 10 million rupees expects to get a return on that "investment" and that return takes the form of being able to collect fees and speed money for the years it takes the engineer to save enough to be able to buy a position as a senior engineer. Again, North, Wallis and Weingast note the difference: limited access orders severely stunt the development of competitive markets, permissionless innovation and long-term development.⁴

Much of the long-term damage to the system results from the inability to use the information contained in the signals provided by a properly functioning price system. Even a *monopolized* price system will reflect accurately differences in demand and the opportunity costs of resources, though it will incur the costs of deadweight loss and limited innovation that are well-known for monopolies generally. But limited access orders cannot be expected even to generate "efficient" monopoly prices! Shleifer and Vishny (1993) argue that the real problem with using bottlenecks, permitting and other artificial scarcities to create rents is that the price mechanism is almost completely suppressed. Most transactions will be based on an exchange of favors, or the pursuit of political advantage, rather than being based on the scarcity signals contained in prices.

³ Examples include most of the OECD countries, though perhaps not Greece or Turkey at this point, and Asian market democracies such as South Korea, Taiwan, and Japan.

⁴ The characteristic way in which a social order structures human organizations also produces predictable features of the larger society. Limited access orders exhibit systematic rent-creation, market power, privileges, and differences between elites and others; they also preclude thriving markets and long-term economic development. Open access orders exhibit systematic competition, entry, and mobility; they also foster thriving markets and long-term economic development (North et al. 2009, p. 39; emphasis added).

A limited access order wherein elites charged freely varying monopoly prices would be more dynamic than a society where many rent-holders obtained their rents through corruption. In a corrupt system, goods and services are allocated based on political advantage. Each “price” charged is the sum of the value being paid, the waiting costs of the purchaser and the rent determined by the difference between those values and the shadow price represented by the “consumer surplus” of the purchaser or supplicant.

Elites and rent-controllers generally will charge less—possibly much less—than market-clearing prices to secure political goals and to satisfy prior promises of quid pro quo arrangements. The result is that prices cannot carry out their functions, which is the impersonal coordination of the behavior of individuals.⁵ “Natural” states (as North, Wallis and Weingast call primitive and limited access orders) cripple the ability of prices to coordinate impersonal activity, to enable permissionless innovation, and to convey information about the appropriate margins where cost, demand and scarcity indicate that activity should be focused.

The problem, then, connects to a general argument about the efficiency of cooperation and competition in different settings. Economists often have argued that competition always is beneficial, and that prices always “work” to allocate resources efficiently. But competition can be diverted from the dynamic creation of products and services, resulting in effective creative destruction, and toward rent-seeking competitions to protect inefficient economic organizations against creative destruction. If the form that competition takes is to seek the attention of powerful state actors in protecting artificial rents against new entrants, and if the form that price signals take is to measure out the cost of obtaining such protection, the actual functions of the markets are coopted and corrupted beyond recognition.⁶ What looks like competition is diverted into the particular means—bribes, favors, and the strategic erection of toll booths near bottlenecks—that characterize limited access orders.

5 Lock-in limited access orders

Two threads of argument that have been made separately will be in this section tied together. And an important objection will be considered.

The first thread is the claim that in a nation with dysfunctional or malformed institutions can be improved by corruption. If access to basic services, licenses and permits is controlled by a grossly inefficient bureaucratic system, resort to speed money and make the system more efficient. In fact, if the value created by the activity is sufficient a bureaucratic bottleneck can be overcome. We might think of this as an application of the Coase Theorem: the fact that the value created by the enterprise is large is sufficient to guarantee that it will take place. The details of how the bureaucratic obstacles are overcome are essentially epiphenomenal; entrepreneurs will simply treat those obstacles as one more problem to be

⁵ Douglass North argued that it is the impersonal coordination of human activity that makes markets and prices valuable. See, for example, North and Thomas (1973) and North (1990). Of course, that claim echoes the long-held views of Mises (1952, 1998), Hayek (1945) and Kirzner (1963).

⁶ This was in fact the original argument made about rent-seeking as a kind of destructive competition that distorts price signals and locks in inefficiency. For a review, see Tollison (2012). Murphy et al. (2009) demonstrate the specific barriers that the particular form of rent-seeking we think of as “corruption” plays out, to devastating effect.

worked around, as a coat of doing business, as it were. Institutions of grey or black markets *will* emerge if Merton's three conditions of "functional corruption" are satisfied.

The other thread might be labelled the "transitional gains trap" or "lock-in", really two problems in one: problem A is that attempts to give money to groups will create rents or special benefits attached to certain features. For example, farm land for the very poor might be subsidized. But then the value of the asset associated with the rent will rise, capitalizing the rent. Market price adjustments mean that the subsidy has no net effect because the poor person now earns a normal return on the now more expensive asset that capitalizes the rent. But if the government then tries to eliminate the program, policy, or informal practice a substantial and possibly devastating capital loss to the "owner" is threatened. Having paid more for the asset in the first place, no benefit is gained, but a cost will be borne if the rent is removed.

Problem B is that corrupt systems have exactly that "transitional gains trap" feature, such that any successful attempt to eliminate corruption will impoverish an entire class of bureaucrats, experts and other "mandarins" who worked for years to acquire their current positions. The reason they worked or bribed their way into their positions is that they produce substantial revenues in the form of fees and bribes. The fact that the state itself does not formally sanction or approve of those "assets" does not reduce their value. Eliminating corruption, even if in principle it potentially is Pareto-improving, becomes nearly impossible unless the state can buy out the holders of asset titles in the informal, corrupt economic system.

To summarize, then, corruption (1) makes bad institutions more tolerable, and may go a long way through a Coasian logic toward rendering them efficient; and (2) locks in bad institutions because of the transitional gains trap. We might therefore expect countries with corruption problems to find that any kind of effective reform is very difficult. Corruption is not as growth-inhibiting as you might expect, under some circumstances, and efforts at reform will usually be diverted, exhausted, or even coopted.

5.1 The counterargument

Two quite different bodies of literature can be seen to argue against the correctness of the conclusion I have reached here. The first is the "deadweight loss" argument of Becker (1983); the second is the "efficiency of democracy" argument made by Wittman (1989).

Becker's idea is that the presence of deadweight losses—which are the consequence of mutually beneficial exchanges foregone—provide an opportunity for institutional innovation. Corruption, to the extent that it is an inefficient obstruction to commerce, or a transfer that costs consumers and taxpayers more than is received by the corrupt official, is not an equilibrium phenomenon, in Becker's view. The reason is that it should be possible to remove or reform inefficient taxes or regulations in favor of efficient versions. For Becker, the animating force for this search for efficient policy forms are organized interests.

Wittman reaches something like the same conclusion, but his starting point is the ability of political entrepreneurs to show voters that more efficient policies are in voters' unambiguous, Pareto-improving self-interest. Competition, both for individual office and among organized parties that can be held accountable for long-run economic performance, is sufficient to guarantee that inefficiency and corruption are (again) not equilibrium phenomena.

My claim is that each of these arguments, similar in some ways but relying on different mechanisms, fail on the same grounds. Both assume the existence of some form of reliably transferrable right, the result of a costless but credible commitment, that can be used

to compensate current “owners” of rents, even illegitimate rents. Both assume that some feedback mechanism operates that signals to residual claimants which systems can achieve Pareto improvements.

In fact, no reason exists to expect optimality in any given system because of the absence of reliable or interpretable feedback and the instability of the processes that generate information. This is a standard claim in Austrian economics, in which tradition North et al. (2009) are writing. But both Becker and Wittman are invoking the logic of the neoclassical system. In equilibrium, in the neoclassical system, it is impossible for unexploited Pareto improvements to exist.

The two reasons I have claimed that both the Becker and the Wittman counterarguments fail are these: (1) The existence of transaction costs and information problems make it impossible to identify, and then credibly to commit to eradicating, deadweight losses. A promise to provide the present value of a stream of rents enjoyed by a corrupt official is not credible, because once power has changed hands the official knows that the rent payments will cease. (2) Given the costs of contracting, the cheapest way for a corrupt official to produce rents reliably is to raise transaction costs through artificial barriers or delays, and then sell reductions in transaction costs selectively for bribes. Any assumption that low transaction costs are required for a “political Coase theorem” to operate runs afoul of the fact high transaction costs are endogenous, and will be fiercely defended by the corrupt officials who depend on these artificial barriers as a kind of toll booth where they can collect income. Worse (as argued cogently by Murphy et al. 1991) the long-term effects of these income-generating inefficiencies can even distort the focus of talent allocation, further locking in the need to overcompensate corrupt activity.

6 Conclusion

Gordon Tullock recognized a problem for economic development. Or, rather, Tullock noticed two apparently separate problems, and recognized that they connect in a particularly dangerous and persistent way.

At first, Tullock (Buchanan and Tullock 1962) appeared to believe that a straightforwardly “political Coase theorem” could be stated. It goes like this: If transaction costs are not too high, then the form of the decision process is irrelevant to the achievement of efficient allocation of productive resources because side payments can be used to redirect those resources to better uses.

Then Tullock made two very significant discoveries that have not yet been sufficiently appreciated. The first was that rent-seeking was destructive of resources, hence always inefficient, and that state actors have substantial incentives to create rents. Tullock anticipated the arguments of North et al. (2009) in important ways, though the role of the control of violence was not emphasized by him. As a corollary to that insight, Tullock realized that such rents, once created, locked in the system of inferior institutions by creating a “transitional gains trap”.

Second, Tullock recognized a consequence that, as far as I know, has not been clearly identified anywhere else in the literature (though McChesney 1989 makes a closely related point). Having created a set of rents and collected the value of the efforts to compete for the rents, state actors could take an additional step. While the hold-ups and choke points were useful for taxing away value from citizens and businesses, it would be even more profitable if state actors could price discriminate and selectively sell immunity from paying those

costs. Since formal price discrimination was impossible without dismantling the system entirely, informal price discrimination—efficient or functional corruption—afforded an opportunity to make the system more responsive.

Of course, the analogy to the Coase theorem is passed through in straightforward fashion. If bureaucrats and state agents sell immunities to the highest bidder, who will value such immunities the most? Those who can pay the most, which in a dynamic economic system means those businesses that profit most from the immunities. If we are talking about a business license or the installation of a telephone system, for example, the usual process may require 6 months or more and even then the result can be unreliable. But if a new business is expected to produce very substantial profits, it can pay “speed money” and have a reliable system or a valid permit delivered in just a few days. The result is that permits, and telephone systems, are directed toward those uses that produce the most social value.

The problem is that this statically efficiency-enhancing practice simply creates even larger rents for corrupt government officials. The lock-in created by the transitional gains trap is substantially expanded and strengthened to the point where corruption may be nearly impossible to root out. As Tullock summed up the problem, in his underrecognized work on rent-seeking for Palgrave (Tullock 1987, p. 148):

The argument against rent-seeking turns out also to be an argument against political corruption. Suppose you are in a society which has an exchange control system and it is possible to buy foreign currency by bribing an official in the exchange control office....Traditionally, economists have tended to view this kind of bribery as in itself desirable, because it gets around undesirable regulation. However, it leads to rent-seeking. In this case the rent-seeking does not come from the users of the permits but from the competition to get into the position where you can receive the bribe. Throughout the underdeveloped world, large numbers of people take fairly elaborate educational programs which have no real practical value for their future life and engage in long periods of complicated political maneuvering in hope that they will be appointed, let us say, a customs inspector in Bombay....

One of the reasons this work is underrecognized, in the view of the author, is that there is a general connection to what were later called “contestable” markets, except that Tullock’s conception is broad enough to include both public and private arenas for such contests. In fact, the “Tullock contest” has become an important part of the literature of auctions (Tullock 1980; for a review, see Chowdhury and Sheremeta 2011).

To close the circle, then, it is useful to connect back to one of the key insights of Buchanan and Tullock (1962): Public policy creates, as well as possibly solves, externality problems. As they point out on p. 51, “many individuals may prefer to accept the expected costs of private decision-making...rather than to undergo the expected costs of collectivization, which represent yet another kind of externality.” If the state already is mediating and controlling the decision process to create hold-ups that allow the state to collect rents, it is hard to eliminate the choke points without harming the state apparatus. If rogue state actors take the second step and sell reductions in the impediments to efficiency, a further roadblock to economic development is erected.

Any attempt to reduce corruption, even granting that “everyone would be better off”, creates an externality in the form of lost income to precisely the most corrupt officials. Since the actions were illegal, it may be impossible for them to press their claims for compensation for what amounts to a “taking” of a value-producing asset. One can claim that these sources of income were never legitimate or guaranteed, but their current “owners” made large investments in securing them and are unlikely to give them up without a fierce

fight. Corruption is neither efficient nor irrational; it is the result of a pervasive transitional gains trap.

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