Rent Seeking into the Income Distribution

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ABSTRACT

This paper uses cross-sectional data from the 50 U.S. states to explore the impact of special-interest groups on the distribution of income. Holding educational attainment, median income, state government expenditures relative to gross state product, population density, race and other factors constant, we find that incomes are distributed more unequally (the Gini coefficient is higher) in states where interest groups have greater influence on the political process. Combined with a further result suggesting that public spending tends to level the income distribution, *ceteris paribus*, a key empirical implication of the analysis is that interest groups promote inequality primarily through off-budget channels.

Rent Seeking into the Income Distribution

I. <u>Introduction</u>

There is a sizeable positive economics literature on the effect of government on the distribution of income. Mueller (1989, pp. 448–58) offers a good summary of such work. Obviously, the distributional impact of the public sector depends on the behavioral features of the model the analyst employs – and the assumptions he adopts – with respect to the incidence of taxes, spending, debt, and regulation. Owing to the wide range of analytical possibilities, no consensus has emerged about the net effects of government intervention on the income distribution. Some scholars have argued that the middle class is the net beneficiary of government redistribution (Stigler 1970), while others have detected net transfers from the rich to the poor (Reynolds and Smolensky 1977). Assessing these conflicting conclusions, Mueller (1989, p. 455) observes that the supposition "that some government policies – taxes or expenditures – are intended to confer redistributional gains on particular interest groups cannot be questioned." He goes on to say, however, that "what the literature does not illuminate is the amount of government activity explained in this way and its net impact on the distribution of income."

This paper addresses at least one of the questions posed by Mueller, namely, what is the net impact of interest groups on the distribution of income? Because the interest-group theory of government (McCormick and Tollison 1981) makes no *a priori* prediction about how incomes are impacted by interest-group activity in the polity, our approach is strictly empirical. The paper is organized as follows. Section II briefly explores the analytical possibilities. Empirical evidence from the U.S. states is presented in Section III. There we find that, other things being the same, incomes are distributed more unequally (the Gini coefficient is higher) in states where the influence of interest groups on the political process is greater. Section IV concludes.

II. <u>Interest Groups and the Distribution of Income</u>

The best articulated theory of how government affects the distribution of income is Director's Law, which is based on the familiar median voter model. In that theory, the middle class benefits from government intervention at the expense of the upper- and lower income classes (Stigler 1970). In the United States, at least, that prediction is borne out by public education, the largest expenditure category at the state and local levels of government. Obviously, however, redistribution from the tails toward the middle might produce greater or lesser income inequality, depending on the relative amounts transferred from the poor and the rich. As such, Director's Law does not generate sharp predictions about the public sector's impact on the income distribution; it unambiguously implies only that median income will increase.[1]

Director's Law and most other theories of the impact of government on the distribution of income nevertheless have been interpreted as suggesting that intervention by the public sector will have leveling effects, making the distribution of income more equal. Income tax codes with progressive rates, supplemented by publicly financed health care programs for the poor and the elderly, public pensions and the many other ornaments of the modern welfare state, ostensibly are intended to raise incomes at the lower end of the distribution and to reduce them at the upper end.

The interest-group theory of government is more catholic. It suggests that no one segment of the income distribution unfailingly is advantaged (or disadvantaged) by the public sector's redistributive activities; its lesson is that individuals and groups having differentially lower costs

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[1] An alternative interpretation of Director's Law is that government is an income-normal good, that is, increases in (private) incomes lead to increases in public spending. That prediction has been tested extensively. Congleton and Shughart (1990), for example, find that social security benefits in the United States are positively correlated with the income of the median voter, *ceteris paribus*.

of organizing to engage in collective action will secure government transfers at the expense of the less-well-organized.

The argument is straightforward. As long as it is profitable to engage in redistributive activities, rational people will do so. Some coalitions for one reason or another have a comparative advantage in organizing to lobby for political favors; they can organize for less than $1 in order to gain $1. Such groups are net demanders of transfers.[2] Net suppliers are those individuals and groups who would be required to spend more than $1 to avoid giving up $1 through taxation or regulation. Clearly, this theory suggests *no* particular impact of government activity on the distribution of income. The well-organized receive net transfers; the less-well-organized or unorganized finance these transfers. There is no guarantee here that government will implement an equality-promoting set of programs and policies unless the costs of organizing fall along certain income lines in the polity at large – the poor are better organized for collective action than the rich, for example.

One is thus left with an empirical question: does the political process, as impacted by interest groups, lead to more or less equality in the distribution of income? The next section seeks to shed some light on this issue. We do not deny that there is a substantial amount of piecemeal evidence that interest groups redistribute income from the poor to the rich and from unconcentrated to concentrated interests. One only need look at farm subsidies or trade

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[2] The logic of collective action suggests that successful groups will tend to be small in size, have homogeneous interests, and be effective providers of selective incentives to their members. Because political lobbying normally can be supplied at low marginal cost as a byproduct of organizing for some other purpose, established groups, such as labor unions, agricultural cooperatives, and manufacturers' associations, will have comparative advantages in transfer-seeking over start-up groups (Olson 1965). Over the past 20 years, "general business organizations (mainly state chambers of commerce) and schoolteachers (mainly state affiliates of the National Education Association – NEA)" have consistently been the most influential interest groups at the state level (Thomas and Hrebenar 1999b, p. 9).

protectionism around the globe to draw such conclusions.[3] While these observations are

suggestive of the overall effects of interest groups on the costs and benefits of government, we

seek to test the hypothesis in a more general form.

III. <u>Empirical Model and Results</u>

In order to test whether there is any empirical relationship between interest groups and the

distribution of income, we specified and estimated by ordinary least squares the following

empirical model based on data for the 50 U.S. states:

GINI = f (D2–D5, EDUCATION, INCOME, EXPORTS, POPULATION DENSITY,

RACE, STATE GOVERNMENT EXPENDITURES, DEPENDENTS).

Variable definitions and data sources are shown in Table 1.

The Gini coefficient (G) is used throughout the analysis as a measure of the equality in

the distribution of income within a state. The characteristics of G, defined on the zero-one

interval, are well known (e.g., Bronfenbrenner 1971, pp. 45–50). A larger G implies more

inequality in the income distribution, where G = 0 denotes perfect equality and G = 1 denotes

perfect inequality.

The central explanatory variables of interest are members of a set of five binary dummies

reflecting the strength of interest group influence by state, as classified by Thomas and Hrebenar

(1999b). They categorize states as follows. D5 denotes jurisdictions where interest groups are

"dominant", wielding "overwhelming and consistent influence on policymaking" (*Ibid*., p. 12).

D3 represents states where interest groups serve in "complementary" roles and "work in

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[3] In exceptional cases, interest groups have lobbied for deregulation and privatization of industry. See Shughart and Tollison (1985) on the reform of corporate chartering laws and Peltzman ([1989] 1998) for more recent examples.

Table 1. Variable definitions and data sources[a]

Variable	Definition	Source
GINI	The Gini coefficient for family income in a state	U.S. Bureau of the Census, http://www.census.gov/hhes/ income/histinc/state/state4.html
D2–D5	A set of four dummy variables reflecting the relative strength of interest groups by state	Thomas and Hrebenar (1999b, Table 2, p. 13)
EDUCATION	The percentage of individuals in a state with bachelor's degrees or higher	*Statistical Abstract of the United States 1991*, p. 140
INCOME	Median income by state	U.S. Bureau of the Census, http://www.census.gov/hhes/ income/histinc/state/state1.html
EXPORTS	Value of exports to foreign countries relative to gross state product[b]	*Statistical Abstract of the United States 1991*, p. 804
POPULATION DENSITY	State population per square mile	*Statistical Abstract of the United States 1991*, p. 23, and *World Book Encyclopedia*, vol. 20 (2000, pp. 104–7)
RACE	Percentage of state population that is white	*Statistical Abstract of the United States 1991*, p. 22
STATE GOVERNMENT EXPENDITURES	Total state government spending relative to gross state product[b]	*Statistical Abstract of the United States 1991*, p. 291
DEPENDENTS	Percentage of state population under 18 and over 65 years of age	*Statistical Abstract of the United States 1991*, p. 23

[a] Except D2–D5, which correspond to the mid 1980s, all variables are observed as of 1989. See the discussion in the text.

[b] Gross state product is from *Statistical Abstract of the United States 1993*, p. 444.

conjunction with (or are constrained by) other aspects of the political system" (*Ibid*.).[4] In

"subordinate" states (D1), interest groups are "consistently subordinated to other aspects of the

policymaking process" (*Ibid*., pp. 12–14). Finally, the "dominant/complementary" (D4) and

"complementary/subordinate" (D2) classifications include states where interest-group influence

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[4] The "other aspects of the political system" are, "more often than not", robust inter-party competition, but "could also be a strong executive branch, competition between groups, the political culture, or a combination of all of these" (Thomas and Hrebenar 1999b, p. 12).

alternates between the two categories "or is in the process of moving from one to the other" (*Ibid*., p. 14). Since no states are classified as "subordinate", we utilize the four remaining dummy variables, D2 through D5, to measure, in ascending order, the impact of interest groups on the political process. Table 2 displays the Thomas and Hrebenar groupings, which we have adjusted, using the information they provide identifying states that have changed categories over time, to reflect classifications as of the mid 1980s.

Table 2. Classification of the 50 U.S. states according to the overall impact of interest groups in the mid-1980s

Dominant (9 states)	Dominant/ Complementary (17 states)	Complementary (19 states)	Complementary/ Subordinate (5 states)	Subordinate (0 states)
Alabama	Arizona	Colorado	Connecticut	
Alaska	Arkansas	Illinois	Delaware	
Florida	California	Indiana	Minnesota	
Louisiana	Georgia	Iowa	Rhode Island	
Mississippi	Hawaii	Kansas	Vermont	
New Mexico	Idaho	Maine		
South Carolina	Kentucky	Maryland		
Tennessee	Montana	Massachusetts		
West Virginia	Nebraska	Michigan		
	Nevada	Missouri		
	Ohio	New Hampshire		
	Oklahoma	New Jersey		
	Oregon	New York		
	Texas	North Carolina		
	Utah	North Dakota		
	Virginia	Pennsylvania		
	Wyoming	South Dakota		
		Washington		
		Wisconsin		

Source: Thomas and Hrebenar (1999b, Table 2, p. 13).

Thomas and Hrebenar's categorization is based on a survey methodology with a lengthy pedigree in the political science literature addressing the relative power of interest groups across states (Zeller 1954, Morehouse 1981). Questionnaires were sent to four or five knowledgeable

people in each of the 50 U.S. states, most of whom were academic political scientists (Thomas and Hrebenar 1999a, p. 141). Content analysis, a standard tool in survey research, was then applied to the responses in order to classify interest-group influence according to one of the five categories shown in Table 2.

The resulting classifications offer at least two advantages over alternative measures of pressure group power, all of which are unweighted and do not take account of differences in the identities of the groups that are active in particular states or regions. First, Thomas and Hrebenar improve on the earlier studies of Zeller (1954) and Morehouse (1981), which distinguished only three categories of interest-group influence on the political process, "strong", "moderate" and "weak" (Thomas and Hrebenar 1999a, pp. 135–36). Second, their classifications incorporate more nuanced assessments of policy influence than is contained in, for example, raw numbers of interest groups by state. The latter variable fails to distinguish Florida, where the American Association of Retired Persons is a powerful political force, from Michigan, where labor unions and automobile industry trade associations tend to dominate state politics. The classification of interest-group influence Thomas and Hrebenar have constructed seems more empirically useful than a simple count of the number of interest groups in a state.[5]

As noted above, we make no *a priori* predictions about the algebraic signs on D2–D5. The other independent variables are control variables about which we can only hazard guesses as to their *ceteris paribus* effects on the Gini coefficient. For example, although one might expect incomes to be distributed more equally in states where larger fractions of the population have earned at least a bachelor's degree, it is an empirical question whether increases in educational attainment in fact promote income equality or, alternatively, that, by creating cognitive elites,

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[5] Indeed, the correlation between the number of interest groups per state (Gale Research Co. 1999) and the Thomas and Hrebenar classification is very low: the Pearson correlation coefficient is -0.052 ($p = 0.720$) for the raw number of interest groups; it is -0.180 ($p = 0.212$) for interest groups per capita.

reinforces existing inequalities. Similarly, do higher income jurisdictions reflect more or less equality in the family income distribution? The data will have to tell us.[6] Income obtained from foreign trade likewise may increase or reduce income equality in a state, depending on the extent to which that income is distributed broadly or narrowly within the local economy.

Population density is a proxy for the cost of organizing collective action. To the extent that these costs are lower in more densely populated states because, for example, pressure groups can more easily identify potential members and can more readily monitor their individual contributions to the collective effort, more interest groups will form. Because the division of labor is limited by the extent of the market (Stigler 1951), pressure groups also have access to more specialized complementary inputs in more densely populated states. There are greater numbers of lawyers, lobbyists, and advertising agencies available to help promote the group's cause. Both of these considerations point to more effective interest-group activity, but whether this leads to more or less equality in the distribution of income is again an empirical question.

Conventional wisdom suggests that incomes are distributed more equally in states having more racially homogeneous populations. If so, then the sign on RACE will be negative, indicating less inequality where whites comprise a larger fraction of the population. Such a prediction is also consistent with the logic of collective action, which stresses that interest-group effectiveness is inversely related to group size (Olson 1965). Racial minorities may be more successful in redistributing incomes to themselves in states where their population proportions are smaller and, hence, they are better able to monitor and control free-riding than are the members of the white majority.

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[6] Kuznets (1955) argued that, beyond a certain threshold (about $1,500 in today's dollars), increases in per capita income are accompanied by an improvement in the distribution of income. According to him, the decline in income inequality follows from an easing of capital scarcity, which triggers an increase in real wages.

The effect of government spending on the distribution of income depends on the net direction of its transfer activities. Does the public budget tend to redistribute income from the rich to the poor? Or do government's tax and spending programs instead primarily benefit the middle and upper income classes? Finally, how is the Gini coefficient related to the age distribution of a state's population? One might expect incomes to be distributed more equally in states where a larger percentage of the population is of prime income-earning age, in which case the sign on DEPENDENTS will be positive.

We estimated two versions of our empirical model, with and without the interest-group dummy variables. States where interest group influence is defined by Thomas and Hrebenar as complementary/subordinate (D2) is the excluded category, about which more below. The results are reported in Table 3.

The two regression specifications address questions of endogeneity and multicollinearity. In particular, it is possible that interest-group influence in a state is correlated with the size of the state's government and, furthermore, that the impact of pressure groups on the distribution of income operates primarily through the public budget. Neither of these possibilities is evident in the empirical results: the estimated coefficient on STATE GOVERNMENT EXPENDITURES carries the same sign, is of the same numerical magnitude, and is estimated with the same level of statistical confidence in both models.

The OLS estimates suggest strongly that the distribution of income is more unequal in states where interest-group influence is dominant (D5). Other things being the same, the Gini coefficient is 0.024 higher in such states than it is in states where interest-group influence is complementary/subordinate (D2). In order to assess the relative impacts of interest groups across states, we also ran Model 1 using the three other possible combinations of Thomas and

Table 3. OLS regression results (dependent variable: GINI)[a]

Variable	Model 1	Model 2
Intercept	0.597 (0.073) [< .0001]	0.663 (0.072) [< .0001]
D5	0.024 (0.010) [0.0209]	
D4	0.013 (0.009) [0.1485]	
D3	0.002 (0.008) [0.7526]	
EDUCATION	0.001 (7.52E–4) [0.0800]	0.001 (7.90E–4) [0.2115]
INCOME	−3.24E–6 (8.63E–7) [0.0006]	−3.82E–6 (9.06E–7) [0.0001]
EXPORTS	0.077 (0.059) [0.1992]	0.096 (0.063) [0.1332]
POPULATION DENSITY	4.11E–5 (1.33E–5) [0.0037]	3.65E–5 (1.36E–5) [0.0103]
RACE	−0.082 (0.021) [0.0004]	−0.115 (0.019) [< .0001]
STATE GOVERNMENT EXPENDITURES	−0.280 (0.099) [0.0075]	−0.234 (0.103) [0.0292]
DEPENDENTS	−0.149 (0.134) [0.2716]	−0.178 (0.140) [0.2126]
Adjusted R^2	0.67	0.59
F-statistic	7.81 [< .0001]	8.37 [< .0001]

[a] Standard errors are shown in parentheses; p-values are in brackets.

Hrebenar's categorical variables. These additional results are summarized in Table 4, which

reports the estimated coefficients on the dummy variables when each is in turn excluded from the

regression model and, hence, impounded in the intercept. The last column reproduces the coefficients from Model 1, the next-to-last column shows the *ceteris paribus* impacts of the interest groups in the D5, D4, and D2 states relative to D3 states, and so on. Table 4 also reports the corresponding percentage changes in the predicted value of the Gini coefficient, calculated at the means of the independent variables.

Table 4. Relative interest-group influence on the Gini coefficient[a]

Included variables↓	Excluded variables→			
	D5	D4	D3	D2
D5		.012[*] (2.93%)	.022[***] (5.69%)	.024[**] (6.36%)
D4	−.012[*] (−2.84%)		.010[*] (2.69%)	.013 (3.33%)
D3	−.022[***] (−5.39%)	−.010[*] (−2.62%)		.002 (0.63%)
D2	−.024 (−5.98%)	−.013 (−3.23%)	−.002 (−0.63%)	

[a] Asterisks denote significance at the 1 percent (***), 5 percent (**) and 10 percent (*) levels of confidence. The *ceteris paribus* percentage changes in the predicted Gini coefficients (shown in parentheses) are calculated at the means of the continuous right-hand-side variables.

These comparisons suggest the following ordering: D5 > D4 > D3 = D2. Other things being the same, incomes are distributed most unequally in D5 states where interest groups are dominant, followed by D4 (dominant/complementary) states and D3 (complementary) states, which do not differ significantly from D2 (complementary/subordinate) states. To put these differences in perspective, the Gini coefficient for households in the United States as a whole increased by 7.23% (from .415 to .445) between 1979 and 1989, the era of so-called Reaganomics.[7] The level of income inequality in D5 states is greater than it is in D2 states by nearly the same percentage. Put differently, the Gini coefficient is predicted to be slightly more

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[7] Gini coefficients for family income, the dependent variable we employ, are available only for 1969 and 1989. By that measure, income inequality increased by 14.68% over the two decades. See http://www.census.gov/hhes/income/histinc/state/state4.html.

than one standard deviation higher in states where interest-group influence is classified as dominant, compared with states where interest groups are complementary/subordinate to the political process.[8]

Other results of interest are the strong negative signs on INCOME, RACE, and STATE GOVERNMENT EXPENDITURES, and the strong positive sign on POPULATION DENSITY. The last of theses results may be evidence that interest groups are more successful in more densely populated states (because, for example, the cost of organizing collective action is lower). Higher income jurisdictions with larger public sectors and more racially homogeneous populations all exhibit more income equality. These states seem to be the American analogs of Scandinavia.

Education tends to increase income inequality, as do exports. On the other hand, the distribution of income is more equal in states where larger fractions of the population are either young or old (and correspondingly smaller fractions of the population are of prime income-earning age). The estimated coefficients on the last two variables are not different from zero at standard levels of statistical significance, however.

As an additional empirical test, we included dummy variables in Model 1 corresponding to three of the four regions of the United States (Northeast, Midwest, West and South), as defined by the U.S. Census Bureau. Although there is no clear-cut theoretical reason for expecting geography to have an impact on the distribution of income, it is possible that the observed variation in Gini coefficients across states has systematic North-South or East-West components. None of the regional dummy variables was different from zero at standard levels of statistical significance, however. What is more important is that, with the exception of EDUCATION, whose positive coefficient declined in significance from eight to 15 percent, the

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[8] The standard deviation of Gini in our data set is .022.

remaining independent variables, including D3, D4 and D5, were not materially affected by this change in specification.[9]

A key implication of the empirical analysis is that the influence of interest groups on the distribution of income operates primarily off the public budget. Holding the size of government constant, which by itself has a significant leveling effect, interest group activities work in the direction of increasing income inequality. One way of interpreting this finding is that specialized inputs whose skills enter into the production of lobbying are relatively wealthier in a rent-seeking society (Higgins and Tollison 1988). Institutions that facilitate income redistribution through the political process tend to enrich lawyers, advertising executives, and economists relative to other occupations, thereby raising the Gini coefficient. Alternatively, it may be that well-organized interest groups, evidently representing the interests of individuals and groups at the upper end of the income distribution, succeed in transferring income to themselves primarily through regulations and mandates (e.g., minimum wage laws, affirmative action rules, and so on) whose costs are borne largely by the private sector.[10] In any case, our results suggest that interest-group influence, on balance, tends to promote a more unequal distribution of income. Greater income inequality is yet another item that must be added to the list of the social welfare costs of rent-seeking (Tullock 1967).

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[9] These additional empirical results are available on request.

[10] Suggestive evidence that interest groups promote inequality at the expense of the poor is produced by regressing the poverty rate in 1989 (http://www.census.gov/hhes/poverty/census/cphl162.html) on the independent variables from Model 1. The results of this estimation are: POVERTY $= 40.8870^{***} + 2.6837 \text{D5}^{**} + 1.0046 \text{D4} + .1903 \text{D3} + .0918 \text{EDUCATION} - 7.3355 \text{E}{-}4 \text{INCOME}^{***} + 14.0204 \text{EXPORTS}^{**} + .0033 \text{DENSITY}^{**} - 10.6781 \text{RACE}^{***} - 3.4499 \text{STATE GOVERNMENT EXPENDITURES} - 2.8795 \text{DEPENDENTS}$, where asterisks denote significance at the 1 percent (***) and 5 percent (**) levels, respectively; adjusted $R^2 = 0.84$ ($F = 27.1^{***}$). Other things being the same, the percentage of the population with incomes below the federally defined poverty line is significantly higher in D5 states than it is in jurisdictions where interest groups have less influence on political processes.

IV. <u>Concluding Remarks</u>

This paper has used cross-sectional data from the 50 U.S. states to show that income inequality is an increasing function of interest-group influence. Holding educational attainment, median income, state government expenditures relative to gross state product, population density, race and other factors constant, we find that income inequality is significantly greater (the Gini coefficient is more than one standard deviation higher) in nine states (Alabama, Alaska, Florida, Louisiana, Mississippi, New Mexico, South Carolina, Tennessee, and West Virginia) than it is elsewhere. The common denominator for these nine jurisdictions is that interest groups dominate their political processes. Interest groups have lesser, but still marginally significant impacts on the income distribution in another 17 states where they are classified as dominant/ complementary.

The interest-group effects in our empirical model are *ceteris paribus* results. No doubt, issues of endogenity have not been fully laid to rest because, for example, interest groups in other studies have been shown to lead to greater public spending. Nonetheless, interest groups here are promoters of inequality, while public spending leads to more equality. This suggests that the primary effects of interest groups operate off-budget.

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The rental income from subletting is taxable. Property owners are required to apportion the allowable expenses incurred based on the number of rooms rented out. Date of Taxable Rental Income. Rental income is taxable from the date it is due and payable to the property owner, and not the date of actual receipt. Example 1: Rental income was due in 2019, but was only paid in 2020. Your tenant rented your property from Oct to Dec 2019. The analysis of rents and rent-seeking has been dominated by an economic perspective focused on assessing rents according to their impact on efficiency and economic growth. In economics, the term "rent" is defined as an "income that is higher than the minimum that an individual or firm would have accepted given alternative opportunities" such as the income that they would have received in a competitive market or the extra income that a civil servant might receive for the transfer of the right to a good or service that are. The aspect of the societal distribution of power plays a role in the allocation of rents and in the organization of rent-seeking activities. The effects of rent-seeking involve reduced economic efficiency through poor allocation of resources, reduced actual wealth creation, lost government revenue, increased income inequality, and, potentially, national decline (Wade and Dabla-Norris 2001). All these 'symptoms' have been mentioned by interview participants when discussing the larger political, economic, historical, and social contexts of Croatia. ... By satisfying the axioms mentioned above, the poverty index used in this study takes into account the distribution of the basic incomes of the population as well as the distance between those and the poverty line.