# RENT-SEEKING AND HONG KONG'S TEXTILE QUOTA SYSTEM: COMMENT

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IN THE March 1979 issue of this journal, Morkre concluded that the 1976 revision of the export quota system of Hong Kong, with one of the main objectives as the enlargement of the free quota pool, is not in Hong Kong's interest because this squandered her rent surplus [6, p. 118]. He further stated that "it is also possible to suggest that Hong Kong should surrender its priviledged right of administering textile exports to the importing countries. At least in this situation and with a smaller government establishment the burden on local taxpayers could be reduced" [6, p. 118].

His pure theoretical exposition is misleading because he assumed away inter-firm differences and information cost which are, however, vital to the understanding of the operation and related problems of the system. This note attempts to clarify the major issues of quota allocation of Hong Kong,[1] and queries the basis of the farfetching welfare effects stemmed from the author's work.

The operation of the present system can be summarized in Figure 1. Given the export restrictions imposed by importing countries, it is the task of the government to allocate the quota to attain economic efficiency and equity. In order to distribute the quota among firms, the past performance is used as the criterion. This obviously benefits the large and well-established firms mostly. The major argument in supporting this principle is that the past record is the best measure of the expected value of efficiency of the current operation of a firm.[2] Additionally, this system serves the function of rewarding established firms for their previous effort, and indicating to firms, which are pioneering into currently unrestricted products, that their export market share will be guaranteed even if quotas will be imposed upon these items in the future.[3] The incentive offered by this process is similar to the operation of patents and copyrights.[4]

## A. *The Transfer System and the Coase's Theorem*

This allocation procedure, by itself, generates inefficiency under two different situations. One is clearly identified by Lin and Mok as the possibility of variations of export performance from year to year due to changes of distribution

1 Details of the current regulations of the quota system of Hong Kong can be found in [3] [5]. The actual performance of Hong Kong's export against the quota is also carefully analyzed in [5].

2 This point is well documented in [3] [5] [6].

3 A weaker argument of this statement is appeared in [5, p. 52]: "It can also be argued that the existing method provides a measure of certainty which longer term investments require."

4 A brief discription of the economic rationale behind the patents and copyrights can be found in [1].

Fig. 1. The Present Quota System of Hong Kong

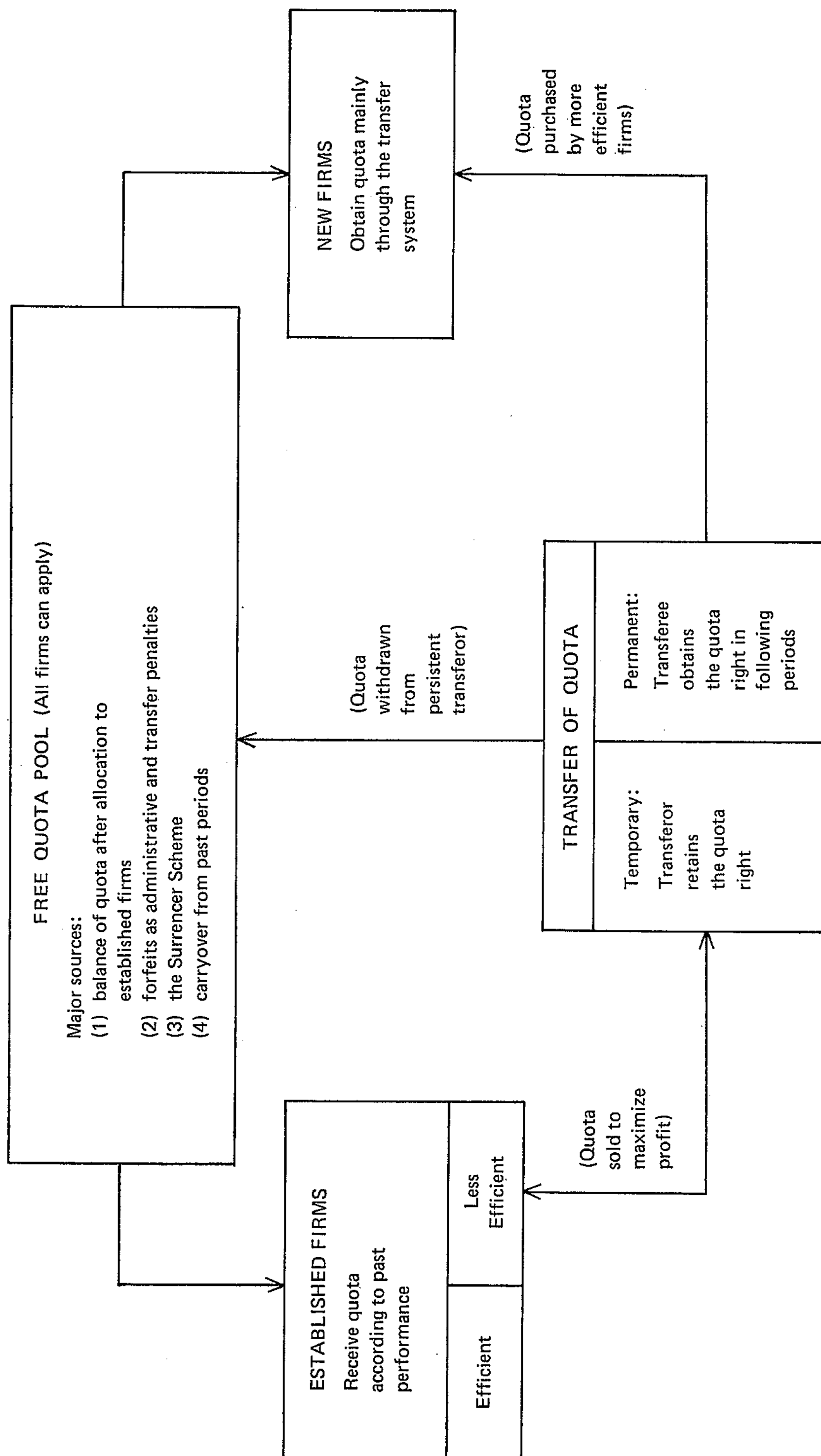
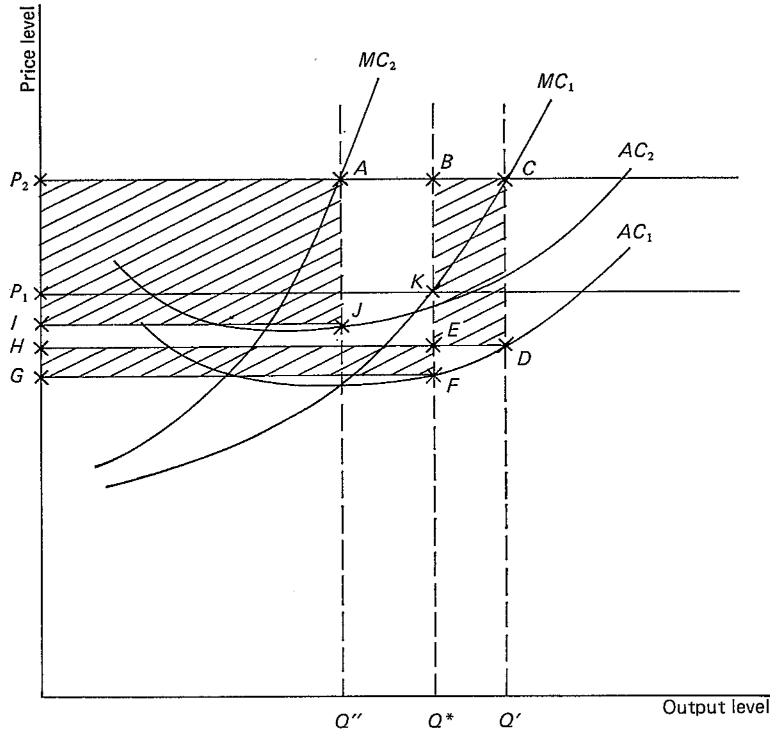


Fig. 2. The Interaction of Quota Utilization and Efficiency of a Firm




Note: $MC_1$, $AC_1$=the marginal and average cost curves of a firm. $MC_2$, $AC_2$=the marginal and average cost curves of the same firm which becomes less efficient later.

of orders [5, p. 51]. The other concerns the changes of relative costs of production among firms. The latter situation deserves further attention because it leads to the necessity of developing a mechanism that can reward efficiency equitably, and this is illustrated in Figure 2.

In the short-term equilibrium of a firm which produces in an export-oriented competitive market, the optimum level of output is $Q^*$ under the international price $P_1$, and the profit is represented by the area $P_1KFG$. Assuming that the imposition of quota increases the international price to $P_2$ and the allocation of quota is based upon past performance, then this firm obtains $Q^*$ quota and a profit of the area $P_2BFG$. Under the new price, the optimum output is $Q'$ instead. There is an incentive for this firm to obtain the quota $Q'-Q^*$ by a payment, either legally or illegally, less than the difference between the areas $BCDE$ and $HEFG$.

Let us examine the condition one step forward, by assuming that this firm becomes less efficient over time. With the cost curves shifting to the left, the profit-maximized output level is $Q''$. The amount of quota, $Q^*-Q''$, will not be used by the firm itself. Unless there is an effective incentive system, it is

unlikely that the firm will return the unused quota to the government in time, so that reallocation to other firms for production is possible. However, it is not costless to identify the different degrees of efficiency among firms.

The government recognized this problem and initiated an open market Transfer System and a Surrender Scheme.[5] In Figure 2, the firm is willing to transfer the quota $Q^* - Q''$ to any firm who is willing to pay a price. As a result, the profit of the firm is the sum of the area $P_2AJI$ and the revenue from the sale of quota. If the market value of quotas is larger than the value $P_2I$, the firm can even obtain a larger profit by the sale of all quotas. This would be true particularly if there were no penalty in terms of reduction of future quotas for the transferor.[6] The phenomenon will be more prominent when efficient firms are able to expand into more profitable line of production of the same quota categories or foreign-owned new firms are having better connections in obtaining oversea orders. This system leads to the efficient utilization of the scarce quota and can be precisely described by the Coase's theorem: "Regardless of the specific initial assignment of property rights, in market equilibrium the final outcome will be efficient—provided that the initial legal assignment is well-defined and that transactions involving exchange of rights are costless" [2, p. 536].

### B. *The Equity Problem*

Besides the efficient utilization of quotas, the transfer system allows the identification of less efficient quota holders. This permits the government to reduce the allocation of quota to them in the succeeding period. Nevertheless, the absence of a clear-cut criterion for a "proper" inducement of exports leaves room for considerable disputes about how long a quota right should be granted, and what kinds of pricing and uses of the quota right should be allowed.

Under the 1976 revision of the regulation, the quota withdrawn from persistent

[5] The Surrender Scheme was introduced to encourage better allocation of quotas, under which holders could surrender to the government their unused quotas with less penalization in terms of the future reduction of their quotas. However, in the opinion of some critics, this scheme is not effective [3, p. 7].

[6] A transfer is mainly classified as temporary or permanent. For the temporary transfer, the transferor retains the right of allocation in the succeeding period while for the permanent transfer, the transferee obtains the right. There is no restriction to the permanent transfer. However, the temporary transfer is subjected to the following conditions: "If a quota holder, over two consecutive years, transfers out on a temporary basis, 50% or more of his total allocations for the two years combined, net of any permanent transfers in or out in the same period, then in the third year his quota allocation for the market concerned will be reduced by a quantity equal to 25% of the total quantity so transferred out in the two years; if that quota holder qualifies for an allocation in more than one category for the market concerned, the reduction in each category will be 25% of net transfers out" [3, p. 5]. Under this penalty system, the marginal cost of temporary transfer in terms of reduction of future quotas is zero up to 50 per cent of the total quota allocation. The marginal cost of the 50th per cent temporary transfer is 25 per cent reduction of quotas of the market concerned. This high cost likely deters the quota holders to sell 50 per cent or more of his allocation in terms of temporary transfer. Even if the market situation allows a firm to sell more quotas, it will choose the option of permanent transfer once its temporary transfer is closed to 50 per cent.

transferors and those from other sources, as illustrated in Figure 1, are put into the free quota pool. This invites applications from all firms and distributes on a "first come first serve" basis upon the evidence of export documents. A firm receiving the free quota, if fully utilized, will be qualified for allocation in the following years.

The channelling of these quotas into the pool is not serving the objective of enlarging the pool, as alleged by Morkre, but is functioning as a device of shifting quotas to reward more efficient firms. Even if the rent-seeking activity, as described by the author, exists to a certain extent, this can be considered as a calculated trade-off. Also the pool is not necessarily enlarging, both in absolute and relative terms, over time because the free quota may become "allocated" if firms fully utilized them in the previous period.

Given the transfer system ensuring efficiency, the new regulation achieves better equity among firms, but not necessarily enlarges the free quota pool. Therefore the analysis by Morkre, which is completely based upon the hypothetical case that Hong Kong is, or will be, adopting a procedure whereby "all quotas are initially placed in a free quota pool open to all firms and proportionate allocations are made on the basis of applications backed by orders. Furthermore, firms cannot transfer quotas" [6, p. 114] is invalid, or at least an imbalanced emphasis of the problem of the present system.

The current controversial issue concerns the equity of the "excess and unearned" profit resulting from the sales of quotas by the "non-productive" quota holders. More efficient firms mainly argue that the penalty measure (as explained in Footnote 6) of temporary transfers should be stiffened. In this case, they can secure a larger share of the rent.[7] The whole system encounters an equity problem fundamentally, instead of an efficiency problem as portrayed by Morkre.

[7] One point that deserves attention is that among the new firms which successfully purchased a large amount of quotas from quota holders, many of them are foreign-owned. An allocation in favor of efficient new firms may therefore facilitate these firms to capture the rent which is created from the export restrictions imposed by their countries.

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