# PART ONE

# INTRODUCTION

This book evaluates democracy in terms of its consequences and uses macroeconomic performance as the setting in which to assess these consequences. Chapter 1 introduces the question the book is designed to address. I will contrast realistic and opportunistic models of democratic politics with the assumption that government is benevolent, wise, and motivated to do the right thing.

Chapter 2 reviews what is known and not known about macroeconomics. There is a well-developed body of theory about the relationship between a government's policy choices and macroeconomic outcomes. I will draw on that theory, recognizing that there is much less consensus among economists about macroeconomics, the study of broad economic aggregates such as inflation, unemployment, and economic growth, than there is about microeconomics, the study of individual behavior, prices, and quantities in markets.

# 1

# Macroeconomic Politics and the Costs and Risks of Democracy

The United States, which sometimes thinks of itself as the world's leading democracy, is showing that democracy does not always work well. The American fiscal crisis is the clearest evidence of this. Federal deficits and federal debt are matters of political choice as well as of circumstance. Some good choices have been avoided and some poor choices have been made by the U.S. government. The links between democratic politics and the financial crisis of 2007–9 are more subtle and contestable, but this book will show how various decisions and practices leading up to the crisis and various responses to the crisis can be linked to democratic politics.

This is not to say that formal democratic institutions in the United States are flawed. It is to say that formal democracy works best when supplemented by informal institutions of prudence and caution. Such informal norms and practices have weakened in recent decades and the U.S. economy is showing the effects; it will probably continue to do so into the foreseeable future.

Nor is it to say that the message of democratic politics as benign in the first edition of this book was not correct for the time it was written. What has happened since to make for a more mixed message about the consequences of democratic politics has two sources. The first is the failure to act on problems that were foreseeable in 1995 or, worse yet, decisions that made the fiscal outlook worse. The second is that random events have made the economic world more dangerous, and American institutions were not prepared to deal with unforeseen random shocks to the financial system.

According to one conventional view of macroeconomic politics in contemporary democracy, governments are responsible for performance regarding inflation, unemployment, and income growth. Periodic elections give voters an opportunity to judge that performance and to approve or disapprove, choosing new leaders if performance has been unsatisfactory.

From that perspective, democratic institutions provide ways to ensure both the accountability of public officials and the adequacy of government performance. A persistent or unusual problem may lead to a reform that is designed to resolve the problem, such as the creation of a quasi-independent monetary authority in 1913 or the establishment of a new set of budgetary procedures in 1974.

According to another conventional view, the democratic process is not so benign. In that view, politicians are selfish and opportunistic, and voters are naïve. Incumbents manipulate their performance to appear misleadingly good at election time, and both challengers and incumbents make unrealistic and insincere promises. Voters are myopically oriented to the present, which makes them unprepared to hold incumbents accountable for their performance over entire electoral periods or to relate electoral choices to future well-being in a meaningful way. Economic performance deteriorates. Politicians exploiting popular discontent propose simplistic and superficial reforms that fail to solve the problems.

The truth is likely to be some mixture of these extreme alternatives, which I designate as the benign and the malign views. The truth is likely to vary over time and place. The purpose of this book is to address the validity of these alternative views and to map the territory in between. In the original 1995 edition of this project, my conclusions regarding the United States leaned toward the benign, but events since then have made me less sanguine and more pessimistic.

## THE COSTS OF DEMOCRACY

This book addresses questions about the effects of democratic institutions on economic performance when such institutions are taken to mean generically the institutions of accountability and of government by consent of the governed. Do democracies produce efficient results, as Wittman (1989) contends? Or do they lead to the accumulation of special privilege and protections from market competition that reduce efficiency and growth, as Olson (1982) contends? Democratic institutions are, of course, designed to be meaningful bulwarks against tyranny and against the rulers' exploitation of the ruled. But periodic elections themselves might generate perverse incentives to manipulate the macroeconomy.

In American political institutions, the system of checks and balances and the Bill of Rights provide constraints on government and on popular majorities that may control the government. But there may be ways in which the short-term incentives inherent in a popularly based political process need further restraint.

What are the counterfactual alternatives to democracy as it exists in the United States? One is authoritarian governmental institutions. Very few authoritarian governments have a good record of economic performance. Among contemporary countries, China and Singapore stand out. South Korea, Taiwan, and Chile moved significantly toward being efficient, modern, wealthy economies under authoritarian government and have since become democratic. But authoritarian government is not an option for the United States.

A strategy of comparing real-world democracies with real-world dictatorships is not appropriate for a comparison that would include the United States, because there is no authoritarian system at a comparable level of economic development. Latin America provides a more appropriate setting for comparing democracies and dictatorships at comparable levels of development.

Human nature is reflected in both authoritarian and democratic governments. The aspects of human nature that are most threatening to good economic performance are selfishness and greed, on the one hand, and a present orientation on the other. Competitive markets can harness selfishness and greed on the part of individuals for the general welfare, as Adam Smith long ago pointed out. And the separation of powers can have a comparably constructive effect of setting ambition against ambition, as "Federalist #51" observed. As *The Federalist Papers* (Hamilton, Madison, and Jay 1961) make clear, American political institutions were designed to provide good government in spite of the foibles of human nature. But few formal institutions work against a self-defeating present orientation. The leading example in the American context is a bicameral legislature with a Senate elected for a six-year term in order to counteract the present orientation of a House of Representatives, which is never more than two years from the next election.

I follow the suggestion of Robert Dahl's *Democracy and Its Critics* (1989) and consider "anarchy," or the absence of government, and "guardianship," or government by the wise, as abstract and generic conceptions of desirable alternative procedures. Unlike government by the wise, anarchy has some negative connotations, but Dahl is emphasizing its lineage as a leading competitor to democracy and guardianship. Here the term "anarchy" should not be taken to imply chaos. The theory of competitive markets addresses how a spontaneous order with desirable properties emerges from minimal government. Of course, the desirable characteristics of competitive markets implicitly assume the protection of property rights, the enforcement of contracts, and a basic level of law and order, which are presumably provided by such a government.

For this analysis of the nature of democratic institutions and their consequences for macroeconomic policy, we focus on concrete, observable experience in the United States. Although the book has this focus, it is not just a book about American economic politics. The focus on a single country has several advantages. Much of the literature in the field of political macroeconomics has been written about the United States and is therefore directly useful. Also, the focus on a single country will facilitate attention to the historical development of institutions, to the time dimension, and to the process of democratic politics in ways that would be less feasible if many countries were included. Both institutional choice and process will be substantively important in the analysis and conclusions.

There are also disadvantages to the focus on the United States: it is only a single country, and though it is an important one, it is far from typical or representative. Also, its macroeconomic experience covers only a limited range. Unlike some other democracies, it has never experienced hyperinflation.[1] It has experienced sharply rising ratios of public debt to gross domestic product, but until the present, that experience has been tame compared to what Japan, Italy, Belgium, Ireland, and Greece have seen. Focus on a single country forgoes the advantages of systematic and explicit comparisons, but I hope by the end, the reader will agree that the advantages outweigh the disadvantages.

For alternatives to democratic procedures, we consider incremental changes within those procedures, either toward anarchy or toward guardianship. For example, a reform in the direction of less government intervention in private markets, such as the deregulation of the banking industry that has taken place since the 1980s, will be considered a move in the direction of anarchy. Similarly, a reform in the direction of insulating economic policy from popular influence, such as lengthened terms for members of the Federal Reserve Board, will be considered a move in the direction of guardianship. Thus, democratic institutions can include features of both anarchy and guardianship, and those institutions may perhaps be improved by trying different mixes of the two.

[1] There was very high inflation in the colonies between 1775 and 1783, as well as in the Confederacy, caused by the printing of paper money to finance war (Sachs and Larraín 1993, p. 728).

Dahl's (1989) study is a normative analysis of the theoretical arguments for democracy and other candidates vying for the title of the most desirable form of government. But real-world alternatives include several forms of dictatorship, many of which are not defended (or defensible) as desirable by any viable political theory. Ronald Wintrobe (1990) distinguishes "tin-pot" and totalitarian dictatorships on the basis of their guiding motivations. Totalitarians seek to maximize their power over the population under their control, whereas tin-pot dictators seek to minimize the costs of keeping themselves in power in order to enjoy the benefits of office. Totalitarian dictatorships include those (such as the former Soviet Union) based on Marxist ideologies that favor economic development and that pay lip service to the goal of maximizing the welfare of the people. Others (such as Nazi Germany) are based on racial or nationalistic ideologies. The tin-pot type of dictatorship, such as the Marcos regime in the Philippines, provides a more relevant comparison with democracy for the purposes of this book, because it was merely corrupt without grandiose aspirations.

Mancur Olson (1993) provides a direct theoretical comparison between opportunistic democracies and opportunistic, revenue-maximizing dictatorships. The latter are similar to Wintrobe's tin-pot dictators, in that both use their power to enhance their own private economic welfare. To make the comparison fair, Olson assumes that the dictator wants to maximize the revenue that can be extracted from the people being ruled, whereas a democratic majority wants to maximize revenue so that it can be redistributed among that majority. Both the dictator and the democratic majority wish to enhance the society's productivity for selfish reasons. Both are constrained in their selfishness by the possibility that beyond a certain point, further increases in tax rates will reduce the tax base and actually lose revenue that could be redistributed to themselves. Olson explains how the "encompassing interest" of a majority in increasing the income of the society at large is greater than that of a dictator, because it directly receives some of the income that is produced, as well as the redistribution that it votes for itself. So far, democracy does better by the people, even if a selfish majority wants to maximize the politically determined redistribution from the society at large to itself.

However, it does not follow that democracies will redistribute less than dictatorships, because democratic policies are often responsive to small minorities and special interests that have far less incentive than does a majority to consider "the social costs of the redistributions they obtain" (Olson 1993, p. 571). As Olson's rich analysis makes clear, comparison of the economic performances of democracy and dictatorship is a large and complex task.[2]

Instead of comparing democracy and other forms of government, this book will conceptualize the performance of democracy relative to objectively desirable policies, when such policies can be identified. Of course, there is little agreement about what policies are objectively desirable, and that fact is one of the themes of this book. However, it will be possible to characterize certain central features of democratic politics and to show how they relate to the quality of policy. When democratic policies deviate from optimal policies in a systematic way, this will be considered a cost of democracy, whether or not a real-world alternative set of institutions would do better.

The costs of democracy include the reasonable and unavoidable prices of things that are basically desirable. Costs are similar to prices and implicitly are to be compared to benefits. Costs are to be minimized, but some costs are likely to be the inevitable prices of things that are valuable, and they are to be understood and tolerated. Democracy is a system that operates under the logic of the relationship between a "principal" (the public) and an "agent" (the government). I argue that democratic procedures have modest and bearable costs, but that they are comparable to the "agency costs" that are incurred whenever a principal delegates authority to an agent. As William Bianco has said, "the problem is not representative government; rather representative government is an example of a generic and intractable problem" (1994, p. 167).[3]

This book will argue that democracy does not systematically lead to inferior macroeconomic policy. In some situations, however, democracy, like other systems, can produce inferior policy. Also, a democracy may face debilitating conditions that it did not create, and there are ways in which some kinds of democratic institutions may obstruct the cure or correction of such conditions. But democracy comes in many forms, and democratic performance may vary under different conditions and institutional arrangements. A common response to poor performance is to propose changes in formal institutions, such as term limits for legislators or constitutional amendments mandating a balanced budget.

2 An additional important feature of the comparison that is included in Olson's article is the association among individual rights (including property rights), democracy, and prosperity.

3 See Besley (2006) for a deep and insightful treatment of agency issues in representative government.

I argue that informal institutional changes are often sources of performance problems and that, when this is the case, formal changes are unlikely to be successful correctives. For example, changes in the norms and patterns of behavior were what led to our contemporary problem with federal budget deficits. Formal institutional correctives such as the Gramm-Rudman-Hollings law have not solved the problem because they have not confronted the incentives that created it. A constitutional amendment would be no more successful unless it were to be based on procedures that confront such incentives.

It is also possible that informal changes in behavior can be constructive. The most important decisions about the formal structure of the American central banking institutions were made in the Federal Reserve Act of 1913 and in revisions to that act in the 1930s. However, the institutional change that made the Federal Reserve one of the world's most independent central banks was an informal agreement called the "accord" that was implemented in 1951. The meaning of democracy in any particular context depends not only on the formal constitutional rules but also on informal institutions that define patterns of behavior.

## MACROECONOMIC ISSUES PROVIDE A LENS

Macroeconomics will provide a lens through which we can focus on these questions of democratic theory. The performance issues of central concern are those regarding inflation, unemployment, and income growth. Income distribution will be peripheral, though occasionally relevant. The lens will filter out other important problems, such as the environment, racial justice, war and peace, and so on. This strategy is not meant to imply that those questions are less important than economic performance. I do mean to show that a focus on macroeconomic issues can be especially revealing about the nature of democratic processes, and not simply because they are matters of continuing concern.

Macroeconomic issues are often consensual, in that there is wide agreement on the desirability of the goals, specifically the desirability of income growth and the undesirability of inflation and unemployment. There is plenty of disagreement as well, particularly when it comes to strategy for achieving those goals, but compared with the bitter disagreements surrounding numerous other issues, such as abortion, for example, there is an underlying consensus on the nature of standards. This fact makes it easier to draw conclusions about the performance of democratic institutions on the basis of relatively objective benchmarks. For example, democracies (like dictatorships) may postpone hard decisions whose resolution might improve their future prospects, or they may make decisions that will provide benefits in the present at the expense of the future. Democracies (like dictatorships) may be vulnerable to moral hazard and to time-consistency problems. Macroeconomic issues facilitate systematic attention to the time dimension of political decision making in ways that help us make inferences about the costs of democracy. My concern is less how democracy performs relative to dictatorship than how democratic performance might be improved in areas in which improvement is possible.

Even though macroeconomic issues are relatively consensual and performance oriented, they are, at most, a short step away from conflict of interest. Good macroeconomic performance can make everyone better off, and poor performance can cause everyone to suffer, but the particular policy choices that are made often have distributional dimensions. Even when distributional issues do not arise, there are important differences in beliefs about the desirability and consequences of alternative policies.

Macroeconomic issues will not highlight some kinds of costs or problems of democracy. These include corruption and venality, which, of course, are not unique to democratic systems. Macroeconomic politics is public politics; the incentives for public officials are large-scale vote shifts and personal and partisan reputations. The most important decisions concern large-scale movements of fiscal and monetary instruments. Any possibilities that politicians have for personal enrichment are not likely to loom large in the politics of inflation, unemployment, and growth. And even though this claim must be qualified by the distributive character of many tax and expenditure decisions, this is a book about very general questions regarding how well democracy works, and how reforms of democratic institutions might make it work better.[4]

## SOME ECONOMIC ISSUES

Because our focus is on economic performance, we must address several issues in order to do justice to the topic.

[4] These sentences were written before the financial crisis of 2007–9, which may qualify them. Certainly, many workers in financial institutions saw their incomes rise. Leaders of government-sponsored enterprises (GSEs), such as Fannie Mae got rich (Morgenson and Rosner 2011, ch. 1 and passim). Also, Igan, Mishra, and Tressel (2009) and Mian, Sufi, and Trebbi (2010a, 2010b) show that much money was spent lobbying Congress.