# PART 1

# POLITICAL POWER AND ECONOMIC ANALYSIS

# 1

# Public Policy: The Lens of Political Economy

## 1.1 Introduction

Conflicts between the public interest and special interests naturally emerge in the design and implementation of public policies. Some public policies pursue the public interest by attempting to correct for market imperfections, lower transaction costs, effectively regulate externalities, or enhance productivity. Still other public policies are the result of manipulation by powerful groups actively engaged in the pursuit of their own self-interest. Regardless, conceptual formulations that attempt to explain or prescribe public policy emphasizing only one type of interest are doomed to fail. Frameworks that neglect the role of special-interest groups have little explanatory power. Models that presume that government has neither autonomy nor any interest in the size of the economic pie will also face serious limitations as an explanatory, predictive, or prescriptive framework.

In any public-policy-making process, political and economic forces are at play in resolving the strategic interactions among the various interests. A schematic representation of the policy-making process reflecting these forces is represented in Figure 1.1. Historically, the right-hand box has been the domain of political science and the left-hand box has been the domain of economics. At the top of the right-hand box, particular governance structures set the constitutional design establishing voting rules, the rule of law, property rights, laws governing exchange, and more generally the rules by which rules are made. Governance structures also determine the nature and scope of the political feedback mechanisms of groups affected by public policies. In its most expansive representation, any causal analysis of constitutional rules investigates the implications of alternative legal, regulatory, and institutional frameworks, as well as various degrees of political, civil, and economic freedoms. In other words, governance structures set

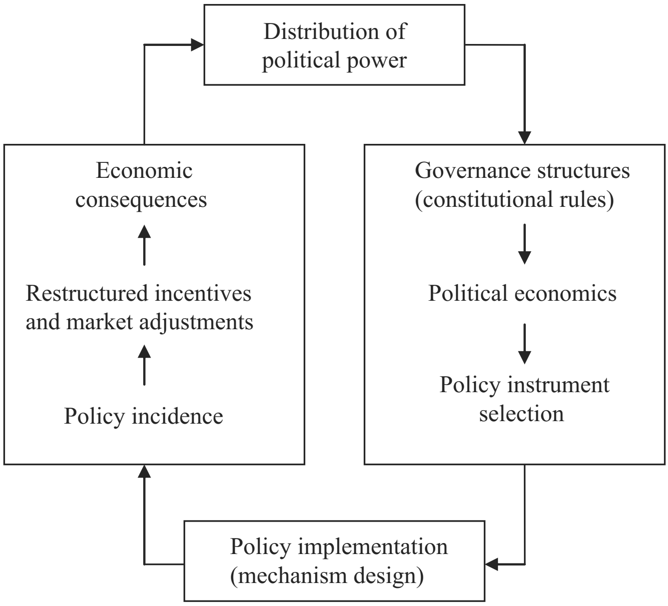


Figure 1.1. The policy-making process and economic consequences.

the boundaries for the political-economic link. Over the course of the last decade, economists have begun to make significant theoretical and empirical advancements in analyzing the link between governance structures, political economics, and the selection of actual policies.

Political-economic analysis seeks to explain the selection and implementation of public policies. This link in the policy-making process endogenizes the instrument settings as a function of governmental bureaucracy and the actions of stakeholders. Interest groups as agents representing stakeholders rather than individuals are the unit of analysis. In these links of the policy-making process, interest groups compete by spending time, energy, and money on the production of pressure to influence both the design and the tactical implementation of policies.

The box at the bottom of Figure 1.1 recognizes that the implementation of public policies can lead to both intended and unintended consequences. For this link, the potential strategic conduct of both public- and private-sector agents and their representatives becomes critical. Modern economics has used the concepts of asymmetric information, incentive compatibility, participation constraints, and credible commitments to isolate the incentives embodied in specific policy regimes. Unintended consequences often result from hidden actions or hidden information. Hidden actions are typically characterized as moral-hazard problems, whereas hidden information is generally divided into adverse selection or signaling problems.

Once policies are designed and/or implemented, the process of incidence begins with the assessment of winners and losers. Some groups or segments of the market may bear the burden of the public policies and other groups may reap the gains. The actual incidence of any designed and implemented public policies depends on individual-agent incentives and ultimately the market structure. The economic consequences are generally measured both in terms of economic growth or the size of the economic pie and its distribution among various interests. These economic consequences in turn lead to a distribution of political power, represented in the top box of Figure 1.1.

Much of the academic literature compartmentalizes the links depicted in Figure 1.1. This compartmentalization has allowed at least four analytical dimensions of public policy to be distinguished in accordance with their imposed assumptions or maintained hypotheses. Until the last few decades, the vast majority of public policy analysis has focused on an incidence-analytical dimension represented in the left box of Figure 1.1. For this dimension, the impact of existing policies and/or the consequences of alternative policy instruments are evaluated. In this evaluation, the maintained hypotheses imposed often include perfect implementation, no-feedback effects from interest group or coalition formation, and a given governance structure. Because the typical benchmark for any implemented public policy is a perfectly competitive partial or general equilibrium market structure, any public policy is often characterized as government failure.

The second analytical dimension generally takes place at the policy implementation link of Figure 1.1. For this dimension, the perfect implementation assumption is relaxed while still maintaining no-feedback effects from interest group or coalition formation, as well as a given governance structure. This typically involves exercises in mechanism design used to isolate the consequences of asymmetric information, misalignment of incentives, and the structured interpretation of signals. This analytical dimension highlights incentive effects, potential strategic behavior on the part of private sector and governmental agents, and the credibility of sustainable public policies.

Modern political economy is a third analytical dimension that comes in many shapes and forms. All of these formulations, however, relax the assumption of no-feedback effects from interest group or coalition formation but typically impose a given governance structure. The inherent value of this analytical dimension is that it formally recognizes that the groups and agents affected by public policies are not passive and can pursue strategies to influence and alter the selection and implementation of policies.

A fourth analytical dimension that has gained recent favor focuses on governance structures that delineate the boundaries on the negotiations and bargaining that takes place among stakeholders and governmental agents. In its most general form, this analytical dimension relaxes the assumptions of perfect implementation, no-feedback effects among interest group or coalition formation, as well as given governance structures. As reflected in Figure 1.1, this dimension is capable of analyzing how the distribution of political power leads to alternative governance structures. A maldistribution of political power can be expected to result in governance structure reforms. This causal link is the basis for conceptualizing the bargains and compromises that undertaken to shape governance structures that are acceptable to those who have the greatest capacity to obstruct such structural reforms, as well as to others who have stakes in the outcome. Formally, this analytical dimension evaluates alternative collective choice or constitutional rules governing access to the policy-making process, how admissible coalitions are formed, the space of the issues over which tradeoffs are structured, and the specification of default options.

## 1.2 The Lens of Political Economy

This book will focus on the links in Figure 1.1, stretching from political economics all the way to the distribution of political power. Thus, the different forms of government as well as electoral and legislative rules will be taken as given in most of our analysis. We embrace the lens advocated long ago by Steiner (1969: 31) on the distribution of political power or, in his terms, the weighting problem in public policy analysis:

If objectives were genuinely multidimensional and not immediately comparable, some solution to the weighting problem is implicit in any choice and that solution reflects someone's value judgment. Formally, we now accept in principle that the choice of weights is itself an important dimension of the public interest. This choice is sometimes treated as a prior decision which controls public expenditure decisions (or at least should) and sometimes is a concurrent or joint decision that is an inseparable part of the process of choice.

Inherently, policy-making outcomes reflect personal exchanges and relationships. Accordingly, the relative positions and influence of agents, players, or interest groups must represent the core of political-economic analysis. In personal exchanges, relative positions and influence can be characterized by relative power. In this context, the argument advanced by Russell (1938) is compelling: "The fundamental concept in social science is power in the same sense in which energy is the fundamental concept in physics."

The historical origins of the political-economic lens can be traced back to the original architects of the economics discipline, namely Adam Smith, Mill, Wicksell, and Marshall. None of these authors was a stranger to political-economic analysis. In fact, the foundation of the discipline of economics emerged from an integration of political science, economics, and philosophy. With the introduction of the Walrasian framework, however, mainstream economics swept aside our political-economic origins. This process was accelerated by the remarkable elegance and clarity of the Arrow-Debreu extensions of the basic Walrasian model. Essentially, many features of reality were discarded by mainstream economists in order to facilitate theorizing.

Although some of us might bemoan the distortions of reality emanating from the separation of our discipline from political science, it certainly had the value of allowing mainstream economics to proceed unencumbered. The separation of economics from other disciplines resulted in the formulation of an abstraction that might not otherwise have been delineated, and it permitted the development of the most significant of social theories, classical microeconomics (Alt and Shepsle 1990). However, the separation of politics and other social relationships from mainstream economics and the focus on impersonal exchange meant that few conceptual frameworks existed for explaining the formation of public policies. Over the last three decades, this circumstance has changed dramatically with the emergence of the political-economic analytical dimension. To varying degrees, the frameworks representing this policy dimension have allowed political forces to be integrated with economic forces.

In our articulation of the political-economic lens, power is distributed between the government and various interest groups, and a maldistribution of power can blunt any and all efforts at improved efficiency.[1] As argued by Williamson (1975), all collective action organizations, government or otherwise, consist of a "center", which directs group actions, and peripheral participants. The center's choices affect individual well-being so that the objective functions of the peripheral participants are, to some extent, expressed in terms of the center's choices. Individual peripheral participants will naturally strive to influence the center's choices. The center also consists

[1] As noted in the political science literature, governments can have some separate autonomy and can seek "leadership surplus" (Froelich, Oppenheimer, and Young 1971).

of individuals with their own private interests; although it is not unreasonable to expect central decision makers to fully internalize the group's goals, it would be unrealistic to ignore their personal interests. As a result, the center is exposed to attempts to influence the center's choices by peripheral participants in a position to award or penalize members of the center. In this setting, the concept of price is not well defined, and unlike the non-personal Walrasian exchange, agents' identities do matter in "political markets."

The foundation of this political-economic framework emerged from the early Nobel Prize – winning work of Nash (1950, 1953) and Harsanyi (1963, 1977) on bargaining. A core concept in these formulations is bargaining power. As Dahl (1957) has noted, A has power over B to the extent to which "he can get B to do something that B would not otherwise do".[2] However, as Harsanyi (1963, 1977) has emphasized, power relationships need not be unilateral; bilateral or reciprocal power relationships also exist. Harsanyi employs these notions to show how structure the incentives for coalition formation are structured, and how they indirectly cause the failure of coalitions to exercise influence.

When a center's choices further the interests of particular peripheral participants, these interests may reward the center by extending material benefits and support. Conversely, peripheral participants may penalize the center by withholding material benefits or imposing penalties when such choices are contrary to their interests. For the case of $n$ peripheral participants, an $n + 1$ bargaining game is created whose cooperative solution constitutes an organizational equilibrium.[3] As we shall demonstrate, a cooperative equilibrium group choice is, in fact, a compromise among

[2] Hirshleifer (1991) has offered the following definition: "[P]ower is the ability to achieve one's ends in the presence of rivals." Bowles and Gintis (1993) offer a sufficient condition for the exercise of power, namely the ability of furthering one's interest by imposing (or credibly threatening to impose) sanctions on another agent when the converse is not also true.

[3] There has been an active debate about cooperative versus non-cooperative outcomes of multilateral bargaining frameworks (Rausser and Simon 1999). In the political-economic context, even though politics appears to be conflict-ridden, it is essentially also a process of conflict resolution. In the Nash-Harsanyi world, when bargaining parties share similar perceptions on their respective disagreement payoffs, it is rational for each party to seek an agreement that will benefit all interests compared to the disagreement outcomes. Essentially, the latter outcomes cannot be a long equilibrium. Accordingly, the tendency will be for the bargaining parties to move from a non-cooperative short-run equilibrium to a cooperative outcome. As a result, Zusman (1976) presumes a cooperative solution or "group rationality" in characterizing a political-economic equilibrium. A contrary perspective is reflected in the work of Hillman and Riley (1989) and Coggins (1995).

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stakeholder or participant interests and the center's interests that reflects the relative power of each group.

In the policy-making process, the center consists of policy makers constitutionally authorized to make policy choices. Constitutionally, a polycentric structure comprising several centers (e.g., federal, state, local) is required in some instances. Regardless, a hierarchy structures the relationship between the authoritarian center and the subordinate peripheral participants or interest groups. These interest groups may be of many types: organized structures capable of rallying group members into coordinated joint action (Olson 1965); unorganized but responsive interest groups; groups that share common interests but are unable to evolve any machinery for deliberate political action; politically inert interest groups; or groups that not only lack any mechanism for coordinated policy action but also have members unresponsive to policy choices.

The relationship between organized interest groups and policy-making centers defines a reciprocal power structure in which each party employs its means of power in the bargaining process. A political-economic equilibrium can be derived for this process, with a presumed cooperative outcome defined by group rationality. For applications involving policy-making centers and $n$ organized interest groups, the political-economic equilibrium corresponds to a cooperative solution of a $(g + n)$ person bargaining game.[4]

Two early applications of the political-economic bargaining equilibrium were presented by Rausser and Freebairn (1974) and Zusman (1976). Both derive a governing-criterion function or political-preference function for the entire policy-making process.[5] Zusman's work is particularly insightful in isolating the equilibrium threat and reward strategies pursued by various interests attempting to influence the policy-making center. In both studies, the distribution of political power is quantified through reverse engineering from the political-economic bargaining equilibrium. The revealed preference methodology employed in both studies presumes that there is a perfect agency relationship between any lobbying or agents representing organized interest groups as the principals. For imperfect agency relationships, a first

[4] When in addition to the $g$ policy-making centers and $n$ organized interest groups, the group configuration comprises $k$ unorganized but unresponsive interest groups, the ensuing political economic equilibrium consists of a solution to a $(g + n)$ person bargaining game, where each of the $(g + n)$ organized parties takes into account the effects of the reactions of the $k$ unorganized but unresponsive interest groups on its own policy-objective function. Under these circumstances, a bargaining game emerges between $(g + n)$ Stackelberg leaders in the presence of $k$ Stackelberg followers.

[5] In some of the literature, this governing-criteria function has been defined as a policy support function or a policy preference function (de Gorter and Swinnen 2002).

best world no longer exists, and there is not one Pareto frontier, but many. Recognizing that the political-economic bargaining equilibrium is a local and not a global solution, Rausser and Freebairn (1974) suggest the construction of a functional set rather than a unique function. This set reflects the extreme viewpoints and preferences of different decision makers actively involved in the bargaining process, as well as preference sets lying between these extremes.[6]

Using the concepts of new institutional economics articulated by North (1990), the first analytical formulation linking the distribution of political power to alternative governance structures was presented by Rausser and Zusman (1992). Here, as in the analysis of Persson and Tabellini (2003), the focus is on the direct- or reduced-form link between constitutions and policies. However, aside from a large number of empirical applications (de Gorter and Swinnen 2002),[7] the bargaining power formulation remained dormant, in part because of the conscious attempt of the Chicago school of political economy led by Stigler, Peltzman, and Becker to sweep aside the notion of political power, much the same as *taste* is eschewed as a critical component of consumer theory.[8] In recent years, however, we have witnessed a sea change from the lens provided by the Chicago school, as revealed in the literature review presented in the following section. New advancements in political economy increasingly focus on the distribution of political power, the role of governance structures, coalition formation, and the mechanism-design issues that are faced in the implementation of public policies.

## 1.3 Literature Review

There have been a number of surveys of the political-economic literature over the course of the last few years. General reviews of the literature have been presented by Mueller (2003) and Weingast and Wittman (2006). For

[6] One of the purposes of their analysis is to generate information that might contribute to the efficiency of the bargaining process in reaching a consensus.

[7] In the political science literature, there are a number of exceptions, most notably Baron and Ferejohn (1989), who extend the Rubenstein (1982) alternating bargaining game to transcend the boundary between the disciplines of economics and political science. In this model, however, the only source of political power is patience or which actor is assigned the right as a proposer or controller of the agenda.

[8] In the conclusion to "Toward a more general theory of regulation" (1976: 240), Peltzman explains: "In the way I have chosen to model the regulatory process, these power relationships play a role analogous to tastes in consumer choice theory. They shape the regulator's utility function. It has proved a highly rewarding research strategy for consumer choice theorists precisely to beg questions of taste formation and concentrate instead on the behavioral effects of changes in constraints in a regime of stable tastes. With some qualification, there is an analogous history in production theory."