

ECONOMICS AND POLITICS

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Economics and Politics

Economics was known as political economy at one time, however, with the development of neoclassical economics as the dominant paradigm, politics gradually disappeared from discussions of economic phenomena. In the last decade and a half, mainstream economics has once again seen a growing resurgence of interest in the intersection of economics and politics. Already this literature is too voluminous and what follows is a very selective survey of some of the key contributions. The survey is restrictive in at least three respects. First, it looks at the theoretical rather than the empirical contributions. Second, it looks at the intersection between economics and politics from an economist's as distinct from a political scientist's worldview. Third, since it is relatively early days in this field, it is unavoidable colored by this author's perceptions and prejudices.

Voting Theory

All democracies have rules and institutional mechanisms, which allow the translation of the preferences of society into collective outcomes. One common rule is to decide outcomes by majority voting. Among the many different alternatives, the one, which wins against all others in a majority voting, is known as a Condorcet winner. There are two issues here. First, will a Condorcet winner exist? Second, what can we say about the desirability, appropriately defined, of a majority voting rule?

A theorem due to Arrow (1963), known as the 'Impossibility Theorem' can be invoked to show that in general there is no guarantee that a Condorcet winner would exist¹. Consider an example, which will be referred to as Example 1 hereafter. Suppose that there are three individuals; A, B and C and there are three alternatives; X, Y and Z which represent say, the level of government spending. Individual A

¹ A textbook treatment of the 'Impossibility Theorem' along with its proof can be found in Mas-Colell, Whinston and Green (1995).

prefers X to Y and both X, Y to Z. Individual B prefers Y to Z and both Y and Z to X. Finally, individual C prefers Z to X and both Z and X to Y. It is straightforward to check that no Condorcet winner emerges because in a majority vote, X beats Y (both A and C prefer X to Y), Y beats Z (both A and B prefer Y to Z) and Z beats X (both B and C prefer Z to X). Thus, one would cycle among the alternatives².

One obvious shortcoming of the majority voting rule is that the only information it requires is the ranking between two alternatives, and not the intensity of that ranking. Thus, it might be the case that alternative X wins over Z, but the intensity of preferences of an individual, say A, for Y over X is so high that he is willing to bribe the other individuals in accepting alternative Y over X. This gives rise to logrolling in legislatures. Legislators vote for issues that are important to others, if others in turn will likewise vote for issues which are important to them.

Another shortcoming of majority voting rules is that they often fail on the economist's commonly used criteria for efficiency, namely Pareto-optimality³. The majority will have its say; the tyranny of the majority, even if the welfare of the minority falls in the process.

One remarkable feature of political institutions is their stability and success in arriving at collective choices. So, it is fair to ask, under what conditions can a Condorcet winner be guaranteed to exist? These conditions turn out to be fairly restrictive. Black (1948) derived a simple condition under which a Condorcet winner exists; preferences of all individuals should be single peaked. Single peakedness implies that if one drew a two dimensional graph with the alternatives on the horizontal axis and the individuals preferences on the vertical, the resulting graph should have only one peak or spike. The reason for the failure to get a Condorcet winner in Example 1 was that the preferences of individual C

² For a detailed discussion of the issues associated with majority voting, see Mueller (1988).

are not single peaked.

A result of substantial importance and interest is that when preferences are single peaked (and hence a majority voting outcome exists) the outcome preferred by the median voter wins. In order to produce a Condorcet winner in Example 1, suppose the preferences of the offending individual C are now single peaked, say that he prefers Z to Y and both Z and Y to X. Call this Example 2. Check that now Y is the Condorcet winner. Notice that individual B prefers Y to all other alternatives; he is the median voter. The intuition is very simple; all voters below the median vote one way and all voters above the median vote the other way so that on net their votes cancel out, leaving the median voter with the decisive choice.

Notice that in all that has been said so far, voters vote on a single-dimensional decision only e.g. the level of government spending. Majority voting runs into major problems if voters are required to vote simultaneously on multiple issues. In this case, single peakedness in each issue is no longer a sufficient condition to guarantee a Condorcet winner⁴.

In summary, majority voting cannot be guaranteed to produce a unique outcome, it need not be Pareto-optimal and it performs poorly when several issues are to be simultaneously voted on. However, alternative voting rules such as proportional representation, approval voting etc. have their own associate problems. Attempts to find more satisfactory collective choice mechanisms remain an ongoing topic of research.

An interesting suggestion in the literature argues that rational political actors must take steps to devise appropriate political institutions which would deal with the drawbacks of majority voting, especially

³ A situation is described as Pareto-optimal if it is not possible to increase one individual's welfare without decreasing another's. A situation where it is possible to do so is called as Pareto-suboptimal.

⁴ The conditions for a Condorcet winner in a multi-dimensional issue space are quite complex. See Mueller (1989) and Inman (19??) for surveys.

the problem of cycles among alternatives. This literature gives prominence to the agenda setting powers of individuals. Suppose in Example 1 that the three individuals comprise a legislature. However, a legislative committee (which is not modeled in Example 1) is given the task of bringing items of importance on the floor of the house for a vote. This committee has exclusive agenda setting powers in that it can arbitrarily exclude the alternatives it desires from the agenda⁵. If individual A has sole influence on the committee, the latter will delete the alternative Z and bring up only alternatives X and Y up for a vote in the house. Predictably, A's most preferred alternative, X will be the unique majority voting equilibrium. Notice that this avoids the problem of cycling of alternatives which plagued Example 1. These issues have been modeled by Romer and Rosenthal (1979) and Weingast and ? (198?).

Representative Democracy

Unlike the median voter model, where the median voter directly chooses some policy, and political parties are non-existent, the institutional setup of most Democracies allows individual voters to vote only for candidates belonging to one political party or the other. Economic policy is in turn chosen by the party that wins the elections⁶. Really then, for an understanding of issues relating to economic policy, the appropriate approach is to look at the incentives and constraints facing politicians in the design of economic policy.

In one of the earliest model in this tradition, Downs (1957) postulated that politicians are motivated purely by reelection considerations; they do not have any views on economic policy or issues and are

⁵ This description of the legislative decision making process is close to the one for the US Congress.

⁶ A large part of the literature has derived its results under the median voter model which are then used to examine real life economic policies; the presumption being that the results of the median voter model closely approximate or even coincide with those derived in a representative model. It probably bears emphasizing that the results of these two models need not even be close. See Dhami (1997) for some models and examples.

willing to announce any economic policy so long as it gets them reelected. What would be the Downsian prediction in Example 2? A candidate who promised to implement the unique Condorcet winner i.e. alternative Y against another candidate who promised either alternative X or Z, he would win the election. This is because by definition of a Condorcet winner, a majority always prefers Y to either X or Z. Since, Y is also the outcome most preferred by the median voter, voter B, the outcome of Downsian model is exactly the same as predicted by the median voter. Because all politicians care only for reelection, they will then announce an identical economic policy, namely Y.

The Downsian model has been extended, but it has several shortcomings⁷. First, candidates always implement the economic policy, which they promised in the run up to the election; they never renege, although the reason for this assumption is not spelt out. Second, the prediction that politicians of all hues announce an identical economic policy is counterfactual; even a cursory glance at real world economic policy reveals that economic policy is partisan. Third, the assumption of pure office seeking behavior contradicts empirical studies which show that politicians also care about ideology, if only to an extent. The subsequent literature can in some sense be viewed as addressing these three shortcomings of the Downsian framework.

The Political Economy of Monetary Policy

Kydland and Prescott (1977) examined the possibility that politicians might renege on their promises and in the process have spawned a huge literature on the issue of the time inconsistency of economic policy. An economic policy for a future time period, say period $t + j$, $j > 0$, but announced at date t ,

⁷ A notable extension of the Downsian framework has been to a situation when candidates are uncertain about the exact preferences of the median voter. It can be shown that in this case there is only a 'partial convergence' of platforms proposed by different candidates. The intuition is easiest when different candidates perceive the preferences of the median voter differently, but the partial convergence result also holds when candidates hold identical views on the median voter's preferences.

is said to be time consistent if it is also the optimal policy for the government when the period $t + j$ actually arrives. To fix ideas, suppose that in order to encourage investment in the housing sector, the government announces all new construction to be exempt from property tax for the next twenty years. Once the new houses have been built, the government can then renege and impose a property tax. However, being rational, the housing sector is well aware of the incentives of the government to renege and will correctly foresee that taxes will be levied once the houses are built. Thus the initial government announcement does not have the desired effect and housing investment is not encouraged. If somehow, the government could credibly commit not to use its 'discretion' e.g. through a constitutional 'rule' then its announcement will have the desired effect⁸.

The monetary policy literature immediately latched on to this 'rules' versus 'discretion' approach to successfully examine issues of inflation. There are two essential ingredients of this literature. First, a particularly simple model of how the economy works; the so called Lucas supply curve. Economy-wide output y is written as, $y = \bar{y} + [\pi - \pi^e]$, where \bar{y} is full employment output, and, π and π^e are respectively the actual and expected inflation rates⁹. Inflation is assumed to be fully under government control. Thus, deviations of actual inflation from expected inflation can boost output beyond \bar{y} . Second, a reduced form, but plausible objective function for the government, $W = y^2 - \pi^2$ i.e. the government would like to achieve high output and low inflation.

In such a framework, although the government would ideally desire zero inflation, but an

⁸ In Greek mythology, Ulysses asked to be tied to the mast when his ship approached the island of the sirens, who would lure a ship to its doom; by doing so he made a credible commitment to his crew. See Chari, Kehoe and Prescott (1989) for a useful review of the time inconsistency issues.

⁹ There are many stories that can justify this simple view of how the economy works in a variety of frameworks, such as the Neoclassical and the New-Keynesian. See any standard macroeconomics textbook e.g. Romer (1997).

announcement of zero inflation would not be trusted. For if, it is trusted and hence $\pi^e = 0$, the government would renege later to produce unexpected inflation $\pi > 0$ and be successfully able to increase output y . Thus the government's announcement of zero inflation is not 'time consistent'. It can be shown that only announcements of a strictly positive inflation by the government are believed. The major contribution of this literature then is to show why episodes of inflation might take place even when governments and society dislike inflation.

These and extensions of such ideas really constitute the mainstream literature on the political economy of monetary policy. In an interesting model, Rogoff (1985) suggested that one way in which inflation can be avoided is to install a conservative central banker, who could e.g. have an objective function $W = -\pi^2$ i.e. he cares only about bringing inflation down. Using the reasoning developed above, an announcement of zero inflation by such a central banker is immediately believed and is time consistent. There are at least two conditions for this model to work well. First, the central banker must be independent i.e. he should be delegated complete power to make monetary policy, without any political interference. Second, politicians cannot arbitrarily fire him or determine his salary once he is in office. There is empirical evidence that independent and conservative central bankers are indeed associated with lower rates of inflation.

What if politicians cannot hire independent conservative central bankers? Barro and Gordon (1983) have shown that it is still possible to achieve low inflation, provided that the game is repeated several times. Suppose that in an infinitely repeated version of the static model introduced above, politicians announce a zero rate of inflation in the first period. Citizen's beliefs are such that they will continue to believe the politician's announcement if he has never reneged on them in the past, but if he ever reneges once, he is never trusted again. Given these beliefs, there is a cost and benefit to the politician if he reneges on his promise of zero inflation and creates a strictly positive inflation. The benefit occurs

immediately; since actual inflation exceeds expected inflation, output increases, which immediately increases W . However, citizens never believe the politician's promise of a zero inflation again; the only believable promises now will be those in which inflation is strictly positive. But this lowers W for all periods in the future. If the politician cares sufficiently enough about the future, he will then not have an incentive to ever renege and inflation will continue to be low.

One drawback of the Barro-Gordon model is their neglect of political institutions¹⁰. In real life, politicians must face re-election if they are to remain in office. Fortunately, this only changes the story, but not the conclusion. In a slightly different model, but one that can be applied to the current setting, Alesina (1987) argued that politicians who renege on their promises could be punished in the next elections. This model works very much like the Barro-Gordon model, except that the cost of renegeing is the possible loss of future office. If politicians care sufficiently about the future (and being in office) then they can be disciplined to produce low inflation. Subsequently, Alesina (1988) presented evidence from US presidential elections in support of his model.

An important feature of the modern economic policy literature has been the level of sophistication imparted to voters; voters are fully rational. In the older 'political business cycles' literature, exemplified in the work of Nordhaus (1975) and Tufte (1979), voters are naïve; they can be systematically fooled by the government. Naïve voters do not form expectations of the government's future behavior and instead rely on the government's current performance in office. In Tufte (1979), for instance, the government engages in lowering taxes and increasing transfers to the voters in order to increase its reelection chances. The rational voters model would however, condition a politician's reelection chances only on his 'expected policies' once he would be in office and not on current

¹⁰ For an extension of the Barro-Gordon model to the situation where citizens have asymmetric information about the type of the politician, e.g more or less conservative, see Backus and Driffill (1985).

taxes/transfers. Most mainstream economics today is about fully rational agents and modern political economy is no exception. Less than fully rational behavior, or bounded rationality, is now a fast developing field, but its implications for political economy models have not yet been investigated.

The Political Economy of Fiscal Policy

The literature on the political economy of fiscal policy lagged behind that on monetary policy for a number of years but it has now been revived and is an active area of research. There are two problems in comparison to the monetary policy literature. First, unlike the Lucas supply curve, which captures the effect of monetary policy, there is less agreement on the appropriate model that would adequately describe the affect of fiscal policy on the economy. Second, it is not clear just what the government's objective function should be?

In one tradition, Hettich and Winer (1988) and Coughlin (1992) have postulated that the government maximizes expected votes. Brennan and Buchanan (1980) imagine that the government is a leviathan who maximizes tax revenues. Romer (1975) and Roberts (1977) have taken the median voter approach to choosing over alternative tax schedules; governments are non-existent in their models. To be sure, unlike the literature on monetary policy, the literature on tax policy has completely shied away from postulating that different political parties have *ideological differences* over their desired tax policies.

In Rogoff (1990), the incumbent politician's competence in providing a public good is private information. Provision of the public good requires the use of scarce tax revenues, but the more competent type can provide such goods at a lower cost. Information on the incumbent's competence is important for the voters in deciding to reelect the incumbent. The incumbent politician can now play a signaling game with the voters. In a separating equilibrium, the more competent type must take some action, which sets him apart from the less competent type of incumbent. In this model, the more competent type provides too high a level of public goods that would be impossible for the less

competent type to provide. Thus, one implication of information asymmetries is that too great a level of public goods might be provided relative to the full information case.

In Dhami (1997), the incumbent's politician's preference for redistributive activity is private information. There could be two types of politicians; a moderate type who prefers only a moderate amount of redistribution and an extreme type who prefers greater redistribution. Obviously voters would like to have this information because it affects their future after tax income. Suppose for the sake of argument that the moderate type has a greater probability of reelection. In this case the extreme type would try to mimic the moderate type's redistributive activity in order to increase the chances of his success in the elections. However, such mimicking is costly because the extreme type does not really prefer to create a moderate amount of redistribution. In a separating equilibrium of this model, the moderate type ends up creating too moderate a level of redistribution which would be prohibitively expensive for the extreme type to mimic. The Cho-Kreps intuitive criterion is used to show that there would be no pooling equilibrium in this model.

The burgeoning levels of budgetary deficits that many western democracies experienced in the 1980's prompted research in an array of interesting political economy models. In a paper with an intriguing title, Persson and Svensson (1989) explained the level of debt as an attempt by one government to influence the level of spending by a subsequent government. Suppose that the current government is strongly conservative; it fears that if it loses the elections, a liberal government might replace it, which would not be able to control its expenditures. One way in which the current government can then influence the future government is by running a high level of debt. Since this debt must be repaid by the next government, and raising additional taxes is always costly (e.g. deadweight losses); its spending propensities are somewhat curbed. Of course, nothing prevents the future government from raising more debt to repay existing debt, but Persson-Svensson deal only with a two-period model.

Alesina and Tabellini (1990) present another perspective on government debt. In their two-period model the current majority might be different from the future majority. Government expenditure in both periods is to be allocated to two public goods; education and health. The current majority prefers education to health and it knows that in the next period, a different majority who prefers health to education will replace it. The current majority might then engage in excessive debt financing of education. In the following period, the last period in the model, all debt needs to be repaid and no new debt can be issued. Assuming that there is some upper bound on tax revenues, the new majority will slash education (which it would have done anyway), but will also have to slash health because it simply does not have enough revenues to finance both categories of expenditure. The issue then is that the current majority enjoys the full benefits of increased education expenditure in the current period but does not internalize the costs of the loss in health expenditure in the next period; thereby issuing too much current debt to finance current education.

Another interesting line of inquiry has been the relation between income distribution and the size of the government. In models where the median voter is decisive in choosing policy a more unequal distribution of income leads to a higher level of redistributive activity¹¹. The intuition is that when income distribution worsens, the median voter gets poorer and therefore prefers a more redistributive tax policy. In one variant of these models, education is costly to obtain and borrowing/lending opportunities among individuals are severely limited. If e.g. the initial resources of the population are skewed towards the low end, then, since borrowing is ruled out, too many individuals are unable to afford an education. Their descendents remain poor because they do not inherit enough resources and in turn, they are unable to get an education. So, poverty might be perpetuated depending on the initial distribution of resources. Empirically, however, the association

¹¹ See e.g. Meltzer and Richard (1981), Alesina and Rodrik (1994) and Persson and Tabellini (1994).

between income distribution and the size of the government's redistributive activity is not a settled question¹².

A representative democracy approach to the association between income distribution and the size of the government is discussed in Dhimi (1997). It turns out that this association is much more complex than that suggested by the median voter approach to the question. In particular, it matters if an increase in income inequality is anticipated or unanticipated. As might be expected, anticipated changes create changes in the size of the government in advance of the event. It is also demonstrated, at a purely theoretical level, that other important factors which might influence this association are the party affiliation of the current policymaker (e.g. Democrat or Republican) and the range of the income distribution where inequality manifests itself (e.g. at the middle or lower level of incomes).

The Political Economy of Regulation

Governments are multiple-headed organizations. Its many diverse tasks are delegated to several distinct departments or ministries. How must these tasks be delegated and monitored? In an early contribution to the literature, Niskanen (1971) postulated that government bureaus attempt to maximize the size of their budget and supply a public good directly to the government. The government is obliged to fund the cost, which the bureau incurs of supplying the output. One implication of this analysis is that the bureau asks for too high a level of budget. There are many shortcomings of this model. First, although plausible, the objective of the bureau to maximize its budget size does not have adequate microfoundations. Second, it neglects the role of political institutions such as legislative oversight. Third, it does not explicitly model interest groups who might seek to influence the decisions of the bureau. Subsequent literature has partially aimed at addressing these shortcomings.

¹² Lindert (1996) uses data from 19 OECD economies over the period 196-81 to show that greater income inequality reduces government redistributive activity. Persson (1995) also addresses the issue of why taxes in egalitarian

In an approach which has come to be associated with the name of the ‘Chicago school’, the role of interest groups in influencing industrial policy was discussed by Stigler (1971). Stigler identifies four policy areas that interest groups might attempt to influence. First, they might influence the government to erect barriers to entry in the industry. Second, they might lobby for more subsidies. Third, they might lobby for laws on products that are related to their own. Fourth, they could ask for legislation to fix a price ceiling above the competitive price.

Becker (1983) extended Stigler’s work to the case where there could be competition among interest groups for political influence. In Becker’s model, each interest group exerts political pressure, but exerting such pressure is costly; perhaps the interest group has to contribute towards campaign funds. In the language of game theory, Becker looks at a Nash equilibrium in which all interest groups simultaneously decide on the level of political influence.

In other interesting extensions, Baron (1989) looked at the case where interest groups do not know the politician-bureau’s cost of supplying services, which the latter knows. Interest groups can make contribution to campaign funds that the politician values. Baron solves this problem using a mechanism design approach¹³. In equilibrium, the true cost is revealed to the interest group, but such revelation of information is costly. Spiller (1990) has looked at a situation when a government agency is responsible to both, the Congress and to the interest groups. Since the objectives of the Congress and the interest groups might be in conflict, they compete with each other for favorable decisions from the agency.

In a distinct approach associated with the name of the ‘Virginia school’, the politicians create artificial scarcities for the bureau’s output. This induces people to compete for the scarce output, maybe by offering a bribe to jump the queue. Politicians are motivated by such bribes/rents, hence their original

economies (where presumably the median voter is richer) are higher.

¹³ For the mechanism design solution see the entry on ‘Economics of Information’ in this volume.

policy of creating artificial scarcities served their ends. This literature is quite large. The early contributors were Buchanan Tullock and Tollison. See Tollison (1981) for a survey of the basic ideas. Subsequent ideas have appeared most prominently in the journal 'Public Choice'.

The Chicago and Virginia schools both suffer from the drawback that they concentrate on the demand side of the story. The mechanisms on the supply side are not adequately articulated. Laffont and Tirole (1991) address supply side issues in a three tiered model in which Congress regulates a bureau which might be 'captured' by private interest groups. The bureau observes some information on the interest groups, which Congress cannot observe. For instance, the bureau might be an environment agency and the interest group might be an industry, which discharges harmful pollutants into the atmosphere. In order to escape penalization for its actions, the industry might attempt to bribe the bureau to turn a blind eye. Congress however is well aware of this possibility and therefore must design appropriate incentives for the bureau in order for it to accurately reveal information about the industry. In technical terms, Congress seeks to design collusion-proof incentives for the bureau. One way in which the stakes of the bureau in collusion with the regulated industry can be reduced, is to pass regulation which influences the industry's output, which the Congress can observe. For instance, a lower output, which reduces pollution and industry profits. Reduced industry profits reduce the possible bribe that the bureau can receive. Recent issues of the Rand Journal of Economics can be looked at for more extensions along this line.

The models of debt discussed above treat the government as a black-box. In reality the budget process is quite complex. Recently, the micro-budgeting literature has made a case for examining the nuts and bolts of the budgetary process. In the United Kingdom, individual ministries or government departments present budget estimates to the treasury which then coordinates the division of scarce tax revenues among the various claimants. In the case of disputes between the

treasury and the individual departments, the cabinet can intervene. In the United States, several house and senate budget committees have control of the appropriations decisions on distinct items of expenditure. In addition the Congress must take account of the President's veto powers. These issues are looked into by Cogan, Muris and Schick (1994) for the United States case. The different budget committees compete with each other for scarce tax revenues. Each committee cares only about its own budget. In particular, if it gets an extra dollar of tax revenues, it does not take account of the decreased total of revenues available to other committees. The outcome is predictable; a 'tragedy of the commons' situation takes place; each committee ends up asking for too large a budget. In the history of the United States, spending authority has not always been dispersed e.g. from 1789-1865, a single committee, the Ways and Means Committee had complete jurisdiction over the entire budget. When budgetary powers are concentrated in a single authority, the problem of the 'tragedy of the commons' disappears. Cogan et. al. present convincing evidence to demonstrate that the explosion in the US budget has always been historically linked to the dispersal of spending authority. Why then is spending power dispersed? One possibility is that too much power might be concentrated in one place if authority for spending rests with a single authority; the benefits of dispersal might then be an increase in checks and balances.

Institutions: This section spells out a political economy approach to some important institutions.

(a) Constitutions

One of the major questions facing the literature is regarding the explanation of diverse form of institutional arrangements which facilitate exchange in a political as well as an economic setting. Why do some countries opt for the Presidential form of government and others for the Parliamentary form. Why are some countries organized on the federal framework and others on

the unitary framework. Why are judiciaries fairly independent even in most democracies. These are only a subset of the interesting questions in the literature. A common theme running through all these questions is who has the power to make decisions?

'Power' has been a nebulous concept in economics and it is only recently that economists, especially those working in an incomplete contracts framework, have been able to define and use it in a more precise way. Many real world contractual situations are 'incomplete' in the sense that the parties to a transaction cannot all possible future contingencies, or even if they could foresee, the costs of writing all the contingencies is infinite. A third possibility for incompleteness is that the two parties cannot describe all the contingencies in a sufficiently clear way in the contract, so that ex-post, an arbiter such as a court of law, cannot clearly decide if the terms of the contract have been violated. Therefore it will be the case that many possible contingencies are simply not written down in the original contract. However, the contract allocates residual control rights, or power, possibly but not necessarily to just one of the parties, to make binding decisions once a contingency, not specified in the original contract occurs¹⁴.

Many institutional features of the real world can be understood as the assignment of residual control rights, or power, to parties in a transaction. Dixit (1996) has examined the possibility that this concept of power can shed light on many important politico-economic institutions. Constitutions are an important example of incomplete contracts. The reason is simple, the drafters of a constitution cannot foresee all the possible contingencies that might arise. Therefore constitutions only assign the powers to different political actors/ institutions to act in unforeseen contingencies. The US constitution is only a few pages long. To give an instance, although real

¹⁴ The original reference for these concepts is Grossman and Hart (1986). A recent issue of the Review of Economic Studies surveys the developments in the field.

world fiscal policy is very complex, the US constitution says very little about the details of such policy. It only assigns a broad framework e.g. 'No duty of tax shall be levied on articles exported from any state' and leaves it to the representatives of the people to make detailed decisions on fiscal policy as the circumstances warrant subject to not violating certain liberties or freedoms. Constitutional amendments are allowed but the rules governing amendment make it relatively hard to amend and for good reason. A Constitution is the social contract which governs the rules by which societies chose to live and evolve. If amendment were too easy, the possibility of self serving politicians inducing frequent revisions to suit themselves cannot be ruled out; hence a system of checks and balances is vital.

The incomplete contracts approach contrasts with the public choice approach, familiar from the work of Buchanan and others. The seminal work in this literature is by Buchanan and Tullock (1962). Economic policy in this work arises in two stages. In the first, the constitution is formed and in the second, policy is announced with the constitution acting as a reference point. The constitution formation stage is a 'normative stage' in which the drafters of the constitution are placed behind a veil of ignorance and then choose a set of rules based on some criteria of fairness (such as a unanimity or majority rule). Two problems arise with this approach. First the drafters of the constitution might not be acting behind a veil of ignorance; they could be protecting certain interests, including their own. Second, the framework does not deal with the issue of incomplete contracts which is vital to all constitutions.

(b) Size of the Government: What output of goods and services should the government provide to society? This is an age-old question in public economics and one that has generated substantial controversy. The traditional literature has argued that certain goods and services will either not be

provided in private markets or be provided in socially inefficient amounts¹⁵. This line of reasoning continues to be important¹⁶. A newer literature has applied the property rights approach to this vexed question.

The basic problem is this: Politicians or public enterprise managers have residual control rights over the operation of public enterprises, but they do not have the rights to the cash flows from the enterprise which belong to the whole society. Hence, if politicians have a personal agenda, they might not act in a manner that is socially efficient. In particular, politicians might desire excess employment in public enterprises, because labor unions are important vote banks, or they might choose a location for the public enterprise which maximizes votes but is harmful for social efficiency and so on¹⁷. Boycko Shleifer and Vishny (1995) demonstrate how this lead to inefficient Soviet enterprises. Shleifer and Vishny (1994) use the Coase theorem to show that so long as long as bribes between the politicians (who have control rights) and the treasury (who has the cash flow rights to public enterprises) are possible, the outcome is the socially efficient one. In the absence of such bribes however, the allocation of control and cash flow rights has serious efficiency consequences.

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¹⁵ See the entry on the 'Economics of Information' in this volume for some information related issues of why market failures might take place.

¹⁶ See Stiglitz (199?, Whither Socialism?) pulls together the various strands in a non-technical discussion.

¹⁷ To be sure, such problems arise in private enterprises as well; the conflicts between dispersed shareholders and the managers. However, there are several mitigating factors, which reduce the problem in private enterprises. First, there might be some large shareholders such as a bank, whose stake in the private enterprise is sufficiently great that it monitors the manager closely, by e.g. sitting in the board of directors. Second, efficient managers might structure the debt to equity ratio of the company in such a way so as to signal their types. See the section on the 'Economics of Information' in this volume. Third, private enterprise managers are under constant threat, they can loose their job at any moment, unlike politicians who can be voted out of office only at the end of their term.

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