Chapter 1: Competing Views of Government

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Contents

"The aim of every political Constitution, is or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of society; and in the next place, to take the most effectual precautions for keeping them virtuous whilst they continue to hold their public trust."– James Madison (*The Federalist Papers*, LVII)[1]

1 The Issues

Economic analyses of government divide into two broad camps. One emphasizes government in the public interest. It outlines the range of activities that government can undertake to improve the lives of its citizens. Government provides the underpinnings of the market system by establishing property rights and a means of adjudication through the courts. Government can regulate externalities which private actions fail to internalize. Government can provide public goods which the market will tend to under-provide. Government can regulate abuses of market power in cases where competition is limited. Finally, government can distribute resources towards socially favored groups. The logic behind this has been developed at length and provides the modern theory of the state from a welfare economic point of view.[2]

At the other extreme are accounts of government seen mainly as a private interest. Government can be a focus for rent seeking in which the power to tax results in private, wasteful efforts to capture the state which then rewards the powerful at the expense of citizens at large. Even in fulfilling its apparently virtuous functions, government can be influenced by organized groups and state officials may receive bribes to act against the interests of the citizens at large. Government may lack sufficient incentives for officials (who are less than publicly spirited) to act in the public interest. The latter may choose to divert resources to their own ends or simply slack on the job.[3]

This book strives to understand a view of government and its potential that lies between these two extremes. Its intellectual origins lie in the so-called *Publius* view which is today often associated with the name of James

[1] Madison (1961).

[2] See, for example, Atkinson and Stiglitz (1980).

[3] This view has been at the core of the Public Choice. In the context of public finance, see Buchanan (1967).

Madison, one of the authors of the *Federalist Papers* and an architect of the U.S. Constitution. This view recognizes the potential for government to act in the public interest but understands the tendency for things to go awry. Good government is in part associated with designing an institutional framework which affects the incentives of those who make policy decisions. But good government is not entirely about incentives; it also requires good leaders – persons of character and wisdom. These twin elements of incentives and selection in politics are central themes throughout.

Making progress on these questions requires models of how government allocates resources. At the heart of effective government lies the solution to a principal-agent problem between citizens and government. This approach is a focal point for this book. However, it is located more broadly in the modern political economy literature which develops theoretical and empirical tools for understanding public resource allocation.

The book shares with the Publius view the notion that there are institutional preconditions to effective government. But finding them requires an understanding of incentives and the process by which the political class is selected. It is broadly optimistic – good government *is* possible, but only when the preconditions are right.

2 This book

This book comprises four relatively self-contained essays. This first essay provides an introduction to issues studied here and discussions of government from a political economy perspective. We will place this in its historical context and the traditional public economics approach to the role of government. We will also discuss some of the empirical evidence on differences in the quality of government across countries that motivates these ideas. This essay also discusses the themes of incentives and selection in politics in general terms.

Chapter two is an essay on government failure. Most economists now agree that the idea of government failure needs to be placed alongside the idea of market failure in our discussions of government intervention. However, unlike market failure, there is no agreed upon definition of government failure. The economics literature is also obscure on which aspects of government failure are intrinsic to the fact that government has a monopoly of coercive power and which aspects are a consequence of democratic political competition. Chapter two provides an overview of these ideas and develops some simple economic examples to illustrate the main ideas.

In chapter three, we turn to political agency models. These explore the consequences of limited information in politics. The chapter develops a canonical model which is then used to discuss an array of issues that arise in such models. As well as providing an introduction to the literature, the chapter also throws up a variety of issues that have not been fully understood to date and merit further work. The chapter also emphasizes the empirical potential of these models in explaining real world policy choices. At the heart of the models is the notion of *political accountability* – a frequently used concept that often lacks precise usage. The political agency model is an ideal vehicle for thinking about this idea and exploring how accountability works in practice.

Chapter four applies the political agency model to public finance issues reporting on joint work with Michael Smart. The chapter develops a simple and tractable model which can be applied to thinking about the determination of taxes, debt and public spending in an agency framework. The model is used to think about the merits of restraining government in an agency model. It also discusses how agency models can provide insights into the choice between NGOs and government in delivering public services.

Chapter five offers a few concluding comments and observations. One of its main themes is the need to devote more attention to issues of selection in political economy models and it introduces some of the main ideas that are relevant to this.

3 Background

The discussions in this book centre around policy making in representative democracies. This achieves special poignancy in view of the fact that there is now an unparalleled consensus about the centrality of the market economy and some form of liberal democracy in allocating public and private resources. Indeed, much of the world is now committed to a broadly capitalist model of production regulated and augmented by a popularly elected government. It was not always thus. From 1945 to around 1990, the world was divided into two broad economic systems. On one side were the planned economies based on total subordination of the economy to the state via economic planning. On the other side were the mixed economy with private goods production dominated by the market and public goods production in government. This economic cleavage was largely paralleled by a political cleavage – planned economies being largely autocratic with most mixed economies committed to some form of liberal democracy. The latter swing towards democracy in recent years is illustrated in Figure 1.1 which uses the Polity IV data set. There is a downward trend from the 1950s through to the mid 1970s with a real "take-off" around 1990. The latter is due in part, but not exclusively, to the fall of the Berlin Wall.

Figure 1.1 about here.

While Democratic values have triumphed in recent years, there is still a huge amount of discussion about the impact of different institutional choices.[4] Moreover, there are many debates about the consequences of democratic policy making for economics. The dominant early traditions in political economy emanating from Virginia and Chicago offered competing analyses of how democracy generates policies and whether there are endemic forms of "democratic failures" that need to be avoided. The key challenge remains understanding how government resource allocation works and uncovering the institutional preconditions to effective democratic governance.

3.1 The Size of Government

The remarkable growth in government that occurred in the twentieth century brings the two competing perspectives on government that we began with into sharp relief. Government growth could be seen as confirmation that government is "out of control" with insufficient safeguards in place to restrain its power to tax. However, it could equally be viewed as confirmation of the effectiveness of government in acting in the common interest.

Table 1.1 reproduced from Maddison (2001) illustrates this. Whereas government in the early part of the century consumed only around 10% of GDP, it consumed more than 40% by the end of the century. The trend holds also in Western Europe, Japan and the United States, even though the latter has not adopted the full scale "welfare state".

Table 1.1 about here

[4] See Acemoglu and Robinson (2005) for some important insights about the differences between democratic and non-democratic government.

Figures 1.2 and 1.3 look at these patterns from 1960 onwards.[5] They graph the size of government as measured by the percentage of government consumption in GDP in both real and nominal terms, separating out the experience of the (rich) OECD countries and the rest. These figures show that government is larger in rich than poor countries. The size of government in nominal terms has, however, grown as a share of national income in both countries, although with signs of a leveling off towards the end of the period. The graph in real terms shows that the trend is largely flat in rich countries while the drift upwards is still seen in the non-OECD sample. This suggests that the increase in the size of government in nominal terms in largely due to an increase in the cost of providing a given bundle of services along the lines of the unbalanced growth story suggested by Baumol (1967). He argued that government growth in rich countries is significantly affected by the fact that it provides labour intensive services which have not benefitted from labour saving technological change. Borcherding (1985) estimates that around 31% of the rise in the size of government can be explained this way.

Figures 1.2 and 1.3 about here

How democratization has affected the growth of government is moot. From a theoretical point of view, democracies should put more weight on popular opinion. Acemoglu and Robinson (2005) model democracy as a system of government in which the poor have greater influence which leads to greater redistribution. Mulligan, Gil and Sala-i-Martin (2004) argue that the data give little support to the proposition that democracies have substantially different economic and social policies from non-democracies. However, their data end in 1990, before the important recent increase in the incidence of democracy. In addition, while the Polity IV data may be useful for looking at broad trends, they do a poor job in modeling policy incentives in the aggregate.

Figures 1.4 and 1.5 look at the size of government in democracies and autocracies as measured in the POLITY IV data. They show that there is little difference in terms of government size between democracies and autocracies. The difference in real terms prior to 1990 is largely an income effect – reflecting the larger difference in income levels between democracies and autocracies in this period.

[5] Data from the World Development Indicators is only available from 1960 onwards.

Figures 1.4 and 1.5 about here

Perhaps the most persuasive lesson from recent research is that democracy comes in many forms and looking for an effect of democracy per se is probably misguided. The important work of Persson and Tabellini (2003) shows that there are distinct patterns in terms of the form of government and policy outcomes. Most notably, there is a robust relationship between both parliamentary (rather than presidential) government and proportional representation (rather than majoritarianism) and the size of government.

The growth of government to its modern proportions constitutes a remarkable act of public trust. Government spends a significant fraction of national income and is expected to do so wisely. Such trust can be supported in one of two ways – either we are confident that government is populated by publicly spirited officials or else there must be sufficient safe-guards in place to curtail self-interested behavior. Either way, it does seem remarkable that this position has changed so markedly over a hundred years. This faith in democracy to deliver benefits in return for taxes, that are remarkably high in any long-run perspective, is a core part of the institutional consensus that has emerged.

3.2 Corruption

While it is debatable whether the size of government tells us much about government quality, there is one aspect of government quality that has received a lot of empirical attention, namely corruption. While there is still debate about how far corruption is damaging to the economy as a whole, it is widely agreed to be an important symptom of low quality of government. That said, corruption is often used *sui generis* to stand for a variety of distinct problems in state performance, many of which should require separate analyses. One important distinction is that between bureaucratic and political corruption.[6] The institutional structures that perpetuate these may be related, but can also be quite different. For example, the incentive mechanisms for the control of bureaucrats and politicians tend to be rather different.[7]

[6] Hellman, Jones and Kaufmann (2000) distinguishes "state capture" (corruption to change the laws) from "administrative corruption" (corruption to alter the implementation of laws), and empirically show that the type of firms engaging in state capture is different from that in administrative corruption.

[7] See Alesina and Tabellini (2005) for a recent analysis of this.

As we shall see in the next chapter, there are a number of ways to think about the costs of corruption from a normative point of view. Corruption could be viewed primarily as a distributional problem as those who receive illicit returns from the state are rarely socially deserving, i.e. it is pretty hard to think of a social welfare function that would value transfers between public officials and citizens that arise as the product of corruption.

Corruption also leads to resource misallocation. There are many different ways in which this can happen. For example, corruption could lead to misallocation of investment and public infrastructure away from their most productive use. It can also lead to misallocation of talent as self-interested individuals seek rewards in occupations whose returns are inflated by corrupt activities.[8] Corrupt government may also lead to more self-interested individuals choosing to enter public life in order to capture rents.

While corruption is not easy to measure, there are a number of measures now available, the main ones being those from the International Country Risk Guide (ICRG) and Transparency International. A mini-industry has sprung up that correlates corruption with various historical and institutional factors.[9] Some useful empirical regularities have emerged.

Whether as cause or effect, corruption is associated with low income – see Mauro (1995). While it is extremely difficult to establishing the direction of causation here, it is clear that part of being a poor country is having a lower quality government. Moreover, this observation has affected debates about how to promote economic development. The World Bank and other organizations have push a "governance agenda" which puts weight on combating corruption as means of improving government performance throughout the developing world.

Figures 1.6 and 1.7 illustrate these two claims. Figure 1.6 graphs the ICRG corruption measures between the mid 1980s and late 1990s. Over the entire period rich countries had significantly lower corruption levels.[10] As illustrated in Figure 1.7, corruption is also lower in democracies compared to autocracies over the same period.

Figures 1.6 and 1.7 about here

In support of this, there are a number of strong correlations between corruption and other measures of government performance. La Porta, Lopez-de-

[8]See, for example, Murphy, Shleifer and Vishny (1991).

[9]The empirical literature is surveyed in Triesman (2000).

[10]A high score on this index denotes low corruption.

Silanes, Shleifer and Vishny (1999) investigated the empirical links between corruption and (i) ethno-linguistic fractionalization, (ii) religion, and (iii) legal origins. They find that less diverse societies are less corrupt, as are those with a larger fraction of Protestants. Common law legal origin is also correlated with lower corruption. Even setting aside the question of causation, the policy consequences of these correlations is far from clear. However, they motivate the need to treat quality of government as endogenous and to explore how structural factors affect government performance through their impact on incentives and selection. Some of our findings in chapter 3 which look at determinants of government performance in an agency model are helpful in thinking this through from a theoretical point of view.

The link between openness and corruption has also generated interest. For example, Ades and DiTella (1999) argue that more countries whose economies are more open to trade are less corrupt. This type of analysis is expanded and developed in Bonaglia et al (2001). The main theoretical argument that these studies make is that openness acts as a constraint on the behavior of politicians. In chapter four, we locate such arguments in broader terms, using the political agency model to investigate the quality of government when there is tax competition between nations.

Corruption has also been related to freedom of the media by Brunetti and Weder (2003) and Ahrend (2000) who relate press freedom and corruption in cross-country data. Both of these papers find that press freedom is associated with lower levels of corruption. Djankov, McLeish, et al. (2003) focuses more directly on the effect of media ownership patters on a variety of outcomes. They develop a remarkable data set on media ownership patters in 98 countries to do so. The find that corruption is related to state ownership of newspapers. We show in chapter three that such findings can be understood in a political agency framework where press freedom affects the extent of information available to voters.[11]

Corruption has also been related to political institutions and political outcomes. For example, Persson, Tabellini and Trebbi (2001) consider the link between corruption and political/constitutional variables. They test the idea that majoritarian systems and larger voting districts are less prone to corruption, finding strong evidence in favor of this. Triesman (2000) and Persson, Tabellini and Trebbi (2001) document the fact that corruption is negatively correlated with political turnover. In chapter 3, we will return

[11] This is based on Besley and Prat (2004).

to the links between political turnover that are suggested by the political agency framework which treats *both* turnover and corruption as endogenous.

Empirical studies of corruption provide one of the most thoroughly researched areas of government quality. That said, the links to theory tend to be quite limited. This shows up the choice of what is treated as endogenous or exogenous. For example, the rate of turnover among politicians is often treated as an exogenous variable whereas many theoretical approaches would determine this endogenously. There are also great difficulties in establishing the direction of causation in cross-country data. Nonetheless, it brings into sharp relief the proposition that, even measured in this crude way, there are significant differences between government quality across the world that cry out for explanation.

3.3 Property Rights

Enforcement of property rights has been studied extensively. To motivate this, observe that at the heart of the Weberian view of the state is the notion that the state has a monopoly on the legitimate use of coercion. This coercive power can be used in a benign way to raise taxes to finance public goods and regulate externalities. However, that same power can be used to expropriate wealth. A key aspect of government quality concerns the extent to which this is done. Without suitable restraints on the power of government, it is harder to foster a climate for private investment incentives.

This problem of expropriation arises when government is too strong and overbearing. Alongside government expropriation of wealth is private expropriation in situations in which the government is too weak. In such cases, private contracts may not be enforced which will also have a deterrent effect on trade and investment leading to lower income per capita. Here, the problem is one of private rather than public predation. The role of government is to support market arrangements between private actors and to uphold contracts.

In light of these observations, Djankov, Glaeser et al (2003) see the role of effective government as steering a path between the two evils of authoritarianism and disorder. Effective institutional solutions are those that create the right balance between them. It is clear that political incentives shaped by political institutions provide only a partial picture in understanding these issues. Another key issue is whether there is an effective legal system with sufficient judicial independence to curtail predation by government and uphold private contracts. Djankov, Glaeser, et al (2003) review the extensive empirical evidence relating market performance to the operation of legal systems.

As in the case of corruption, there is a strong correlation between income per capita and enforcement of property rights. This is illustrated in Figure 1.8 using the ICRG measure of "risk of expropriation" by government. The difficult issue is again to establish the direction of causation. In a recent paper, Acemoglu, Johnson and Robinson (2001) suggest the use of settler mortality in colonial times as an instrument for property rights enforcement, arguing that this has lead to institutional legacies. They argue on the basis of this that causation runs from poor property rights to low income. Moreover, the quality of government, in so far as it contributes to property rights enforcement, has long-lived historical roots.

Figure 1.8 about here

The work, however, says little directly about the exact theoretical route by which this effect is mediated. While Figure 1.9 shows that there is a predictable link between protection of property rights and democracy, it is unclear whether it is causal. In an effort to get at this, Persson (2004) relates settler mortality to modern day political institutions using Acemoglu, Johnson and Robinson (2001)'s variable as an instrument for the *form* of democracy. He finds that parliamentary (as opposed to presidential) democracies[12] and proportional representation (as opposed to majoritarian) systems are growth promoting. In tune with the Acemoglu, Johnson and Robinson (2001) results, these government types also tend to have better protection of property rights.

Figure 1.9 about here

Even though political institutions are only part of the story, the structure of government incentives and the quality of the political class are an important input into aims to improve the functioning of a market economy, especially in the creation of secure property rights. The models and analysis in chapters three and four which study principal-agent problems are therefore a useful input into this aspect of government quality.

[12] Parliamentary systems that have a vote of confidence procedure for the executive.

3.4 Trust and Turnout

The pattern of democratization illustrated in Figure 1.1 suggests that liberal democracy is riding high as an institution since around 1990. However, there is an underlying concern about the declining health of the more established democracies.[13] One major symptom of this is the observed decline in voter turnout.[14] This is illustrated for OECD countries in Figure 6 which documents this trend over time by plotting turnout over time for OECD countries. This fell from an average of 84% in 1946-50 to 62% in 1996-2000, the most democratic decline being in the latter part of the period. This OECD experience is mainly driven by the older democracies. A larger sample of countries which includes the new democracies of central and eastern Europe which have enjoyed very high participation rates.

In general, there is a difficulty in assessing the welfare consequences of declining turnout in the absence of any agreed upon theory of voting. The low likelihood that any voter will be decisive in mass elections makes models based on the probability of being pivotal, a questionable basis for the theory of voting. As discussed by Aldrich (1997), political scientists tend to work in frameworks where some extra component of utility (such as social duty) is invoked to explain why people vote in such large numbers. In this case, election turnout could be a barometer for how such feelings of duty extend in the population. To the extent that these are correlated with perceived satisfaction with government, this could create a link between turnout and the quality of government, but the link is tenuous at best. If social duty is the main basis of deciding to vote, then declining turnout could also be linked to a general decline in "social capital", i.e. a willingness by citizens to privately provide public goods.

Other theories of voting put weight on the role of being informed in affecting the decision to turnout – see Feddersen and Pesendorfer (1996). If elections were purely a common values problem, then nobody would mind if only one voter showed up and caste their vote decisively provided that individual was informed. This argument has less force when there are important ideological divergences between groups of voters. This is a particular issue if the informed voters are mainly from one particular ideological grouping.

To get a feel for whether turnout and declining voter satisfaction with politics and politicians are linked requires more than evidence on turnout

[13] See, for example, Pharr, Putnam and Dalton (2000).

[14] See Levi and Stoker (2000) for a wide-ranging discussion of these issues.

along. The National Election Surveys (NES) from the United States provide an interesting perspective. They ask a variety of interesting questions about attitudes to government which can be correlated with the indicators of what governments do and the pattern of turnout. Of particular interest is the composite variable which gauges trust in government over the period 1958-2002. It is, however, important to bear in mind that these are subjective assessments and there is always the possibility that they are a poor reflection of actual government performance. Figure 1.10 shows a declining trust in government. This figure also looks at turnout and shows that these two are broadly moving in the same direction – both trust and turnout having decline over the period. Trust showed some evidence of recovery towards the end of the period. While only suggestive, this illustrates why declining trust is often linked to declining turnout in many discussions.

Figure 1.10 about here.

4 Economic Policy Making

The two views of government discussed above have their parallels in approaches to the study of economic policy. The benevolent government view which focuses on the good that government can do has important figures such as Arthur Pigou, James Meade and James Mirrlees in its ranks. The more cautious view is associated with equally distinguished figures such as James Buchanan, George Stigler and Anne Krueger. The latter place political economy issues at the heart of their approach.

Among the latter group, it is Buchanan who has developed at length the importance of using constitutional rules to improve the workings of democratic institutions.[15] As we noted above, this is the spirit of the approach used by the Founding Fathers of the United States as expressed in the Federalist papers. This approach argues that there is a need for both a *procedural* constitution – rules that define the workings of democratic institutions, and a *fiscal* constitution – rules that define constraints on policy making.[16]

The main purpose of this section is to survey in brief the main elements of the normative approach to policy making. This is important for the

[15] This is particularly true in his joint work with Geoffrey Brennan – Brennan and Buchanan (1980, 1985).

[16] These themes are taken up in Chapter 4.

discussion in chapter two which tries to understand the idea of government failure rigorously. It is also important as a backdrop to the discussion of political economy issues in policy making.

4.1 Foundations

Making sense of good government requires a performance metric. The standard economic notion is *social welfare*. This is usually invoked in a context where the "inputs" into social welfare are individual utility levels. (The idea that social welfare is solely a function of such data is known as *welfarism.*) The task is then to provide a means of aggregating these utility levels to form a societal measure of well-being. Once a criterion for social welfare is established, then policies and other social states can be evaluated and ranked. From this, the notion of good government can be defined.

This approach can be applied to policies, political processes and institutions. It provides an intellectual underpinning for ideas of government operating for the common good or in the public interest. Its historical antecedents include classical Utilitarianism as well as Rawls' theory of justice. But some have taken issue with the coherence of the notion of the common good and hence its usefulness for thinking about good government.

There are two levels of attack. The first questions the very idea of the common good. This would include concerns following the discovery of Arrow's impossibility theorem. Arrow (1951) examined the possibility of *deriving* social welfare from individual preferences in the absence of interpersonal comparisons of utility. By producing his impossibility theorem, his work appeared to be a significant set-back in the quest for giving a scientific foundation for social welfare and hence for notions of common good. However, as Sen (1977) has emphasized, one key issue concerns the assumptions made about inter-personal comparisons. If interpersonal comparisons are allowed, social welfare functions can be derived which satisfy Arrow's axioms. These include Utilitarianism and Rawlsianism.

The second attack on the notion of common good views notions of social welfare, even if logically coherent, as inherently contested. The choice of a social welfare function will hinge to a significant degree of value judgements – for example notions of inequality aversion – on which no consensus prevails. The problem is then that there are too many competing notions of the good for an idea of *common* good to make sense. While the social choice literature has produced elegant axiomatizations of certain kinds of social welfare functions, they are not a particularly helpful way of resolving this issue on a practical level. It is clear that the practical question is whether there are *procedures* that are regarded as reasonable ways of making collective choices, especially when it allocates coercive power to particular individuals. The remarkable thing about representative democracy is how readily it has been accepted as a legitimate way for this to be done.

The fact that there is no readily agreed upon social welfare function for making social decisions is important for the issue of defining good government. Such concerns are echoed in Schumpeter (1943) who rejected classical notions of democracy that saw the aim of democratic institutions as trying to finds ways of pursuing the common good. He recast the problem of democracy in terms of the positive problem of understanding how candidates competed to secure votes, eschewing normative comparisons entirely.

One option is to work without any distributional judgements – focusing exclusively on the implications of Pareto efficiency. As we shall discuss further below, the standard economic model puts weight on Pareto efficiency as a criterion for good policy. The use of Pareto efficiency is broadly uncontroversial in standard economic models. However, it can conflict with other principles that many have invoked as constraints on policies. Respect for individual liberty is one important example. As argued persuasively in Sen (1970), a policy can be Pareto efficient and yet violate the most minimal notions of individual liberty. In fact any side constraint on welfare is likely to have the property of picking Pareto inferior policies (see Kaplow and Shavell (2001)).

Even if this concern about Pareto efficiency as a normative criterion is set aside, there is still the problem that it provides a very weak and ambiguous idea of the common good. There are typically many different Pareto efficient policies with varying degrees of inequality associated with them. It may be an achievement of sorts that policies or institutions guarantee Pareto efficiency, but many policy outcomes become non-comparable on these terms. Having a criterion which allows distributional comparisons would certainly provide a richer theory of good government. But that would require invoking some kind of social welfare function.

Even though it is hard not to have some sympathy with these difficulties, a wholly nihilistic take on normative metrics that invoke some distributional criteria for good government is probably too strong. First, some aspects of distribution, such as helping the poor or particular disadvantaged groups are frequently viewed as broadly desirable. Second, narrowly targeted policies, those that lead to the enrichment on small elite groups are frequently frowned upon and the language of common good can be powerful in getting them thrown out. Indeed, more generally, the calculus of gainers and losers in the policy process often reveals whether there is broad support in societies for particular policies with particular distributional ends.

As we shall see in Chapter 2, there is an important tradition in political economy, which has not had much lay in mainstream economics of appraising the case for good government attaching weight to what would happen in the absence of government intervention. This is central to the normative framework put forward by James Buchanan which we discuss further below and which has its historical roots in Wicksell (1896). They advocate a criterion for good government which emphasizes the principle of *unanimity rule* relative to what would happen in the absence of government. This approach has a libertarian flavour since the government cannot do anything that reduces an individual below his/her status quo (no government) utility. Thus, each individual is given an effective veto over some aspects of government intervention. Below, we will return to a discussion of its implications.

4.2 Good Policies

In the traditional welfare economic model which has dominated modern public economics, good government is largely identified with good *policy*. The latter is typically defined with reference to both efficiency and distribution. Hence, it sets aside worries about the coherence of ideas like social welfare.

Consider a community of individuals (citizens) who have to make a policy choice. There is a set of feasible policies from among which they must choose. Feasibility requires taking into account both technological feasibility and budget balance etc., as well as information constraints on what government knows about its citizens.[17]

In the first instance, the appropriate benchmark for good policy is second best Pareto efficiency, i.e., taking into account appropriate restrictions on policy instruments. A whole tradition of policy analysis in this vein has been developed (see, for example, Atkinson and Stiglitz (1980)). The modern theory of planning has also taken such incentive constraints seriously and sees the difficulties in getting citizens to reveal private information as at

[17] The seminal contributions on incentive compatability in normative public economics are Mirrlees (1971) and Hammond (1979).

the heart of designing good policy. The individuals in that community have heterogeneous policy preferences. The aim is to pick a policy from the feasible set.

The study of *efficient* policies is incredibly powerful. There are many examples of well-known policy rules in economics that are derived from considerations of Pareto efficiency. For example, the Lindahl-Samuelson rule for the efficient provision of a public good says that the sum of marginal rates of substitution should be set equal to the marginal rate of transformation. However, this does not define a unique policy – it is consistent with many different levels of the public good being provided, depending the distribution of resources in society. The Ramsey tax rule is also an example of a second-best Pareto efficient policy. A further important class of second-best policy rules are variants on marginal cost pricing. In all cases, the different Pareto efficient policy levels vary according to distributional criterion being used, the information available to policy makers and the form of the budget requirement for the industry in question.

Invoking a specific social welfare function permits the study of *optimal* policy. The exact policy depends on the form of social welfare function that is selected and, to the extent that social welfare is egalitarian, second-best policy models can formalize the idea of an equity efficiency trade off. Society is willing to have a lower level of total income or average utility in exchange for policies that promote the well-being of socially favored groups.

The welfare economic model is often referred to as the "Pigouvian" model of government, an important antecedent being Pigou (1920) who was the first to systematize the idea that intervention in the economy is guided by a benevolent government pursuing social objectives. Pigou also played an important role in recognizing market failure as a motivation for designing "corrective" policies – taxation to reduce pollution levels being an important example.

The welfare economic model can be thought of as generating "rules for good government", using a systematic model of the economy and what drives human well–being. The model constitutes one of the crowning achievements of twentieth century economics. The welfare economic approach displaced the rather ad hoc policy reasoning displayed in classical economic.

For example, when Adam Smith discussed the role of government in *The Wealth of Nations*, he did so by cataloguing what government should do rather than putting forward a framework. The following passage from the wealth of nations is quite typical:

> "According to the system of natural liberty, the sovereign has only three duties to attend to ... first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, so far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice, and thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain..." Smith (1776, 1976) Book IV, Chapter IX.

Even in Book V of *The Wealth of Nations* where Smith develops various principles of good policy, he does not develop an overarching set of principles, but a catalogue of functions.

The great attraction of the welfare economic model is precisely that it does give a unified way of thinking and a set of powerful lessons. Arguably it is this that elevated the position of economists over other branches of the social sciences in the policy sphere. That said, it has tended to say little about the process of policy choice and implementation. To that extent, it is a highly technocratic perspective.

4.3 The Public Choice Critique of Welfare Economics

The welfare economic approach to policy has been criticized by those working in the public choice tradition, for failing to consider how actual policy choices are made and implemented. Even if we were to understand what optimal policies are, there need be no guarantee that the kinds of decision making institutions that we observe in reality will bring them about. The *public choice critique of welfare economics* says that, by failing to model government, it provides a misleading view of the appropriate role for government. (See Buchanan (1970) for a forceful plea for a level playing field.) The landmark contribution in this regard is Buchanan and Tullock (1962) which showed how choices in a democratic system need not conform to any kind of normative ideal.

The main point of the critique is to remind us that the welfare economic case for intervention offers no guarantee that actual governments making real decisions about policies will actually pick the optimal policies according to a welfare economic criterion. While Pigou (1920) is sometimes thought of as one of the main instigators of the welfare economic tradition, it is clear that he was well aware of this point when he argued that:

> "It is not sufficient to contrast the imperfect adjustments of unfettered enterprise with the best adjustment that economists in their studies can imagine. For we cannot expect that any State authority will attain, or will even wholeheartedly seek, that ideal. Such authorities are liable alike to ignorance, to sectional pressure and to personal corruption by private interest." Pigou (1920) page 296.

While such concerns may sound rather abstract, they have force in real world contexts. A good example concerns designing interventions when corruption is a possibility. In addition to the standard economic benefits from intervention, it is necessary to weigh up the consequences for corruption.

To address these issues, requires models of public resource allocation that enable us to understand when and if government will behave in accordance with welfare economic model. This requires a significant increase in the competence of economists, requiring them to become expert not only in market resource allocation but also in the study of politics and bureaucracy. Moreover, unless economists engage in this analysis, there is a risk that they will become sidelined in many debates about economic policy. Although there is a long-standing interest in these issues, it is only in the past fifteen years or so that mainstream economics has put incentives in government at the heart of the study of policy problems.

5 Political Economy

The term "political economy" has been used in many contexts to refer to different intellectual projects. Hence, it is useful to set the newer usage of this term in its wider historical context. The classical economists used the term political economy synonymously with economics. Sometime in the late nineteenth century, scholars of the economy came to use the term economics apart from political economy and, ultimately use of the term political economy lapsed in mainstream economics.

Of particular note in this era is the work of John Maynard Keynes' father – John Neville Keynes – who published his *The Scope and Method of Political*

Economy in 1891. On page 34, he identifies three branches of economics: positive science (what is), normative or regulative science (what ought to be) and the art of political economy – which he refers to as "formulation of precepts". As for John Stuart Mill, it is apparent that John Neville Keynes views the art of political economy as the branch of economics by which practical maxims are formulated. He remarks:

> "when we pass ... to problems of taxation, or problems that concern the relations of the State with trade and industry, or to the general discussion of communistic and socialistic schemes – it is far from being the case that economic considerations hold the field exclusively. Account must be taken of the ethical, social, and political considerations, that lie outside the sphere of political economy regarded as a science." Keynes (1891), page 55.

There is little evidence, however, that studying the art of political economy as described here was of great interest to mainstream economists in the first half of the twentieth century. Nonetheless, the modern political economy literature is re-engaging with the art of political economy as envisaged by the classical economists.

Throughout the twentieth century, the term political economy remained in use in discussions of comparative economic systems – particularly in debates about the relative merits of socialism and capitalism. This brand of political economy was in part the preserve of Marxist thinkers. But it was also evident in Austrian thinkers such as Hayek and Schumpeter.

Political economy considerations surfaced particularly in the market socialism debates of the 1930s where once again they intersected with mainstream economics. Lange and Lerner had proposed a centralized system which could replicate the market system by using a social planner. Hayek's position turned on two key problems of planned systems: (i) that government is not omniscient and that the informational requirements assumed are too demanding (ii) that it hinged on a model of government that was too optimistic in assuming benevolence. Hayek (1948) argued persuasively that recognizing the role of markets provided the answer to the first of these. The resolution of the second problem was less clear. Clearly some guarantees of liberty were necessary given the limitations on personal freedom under socialism. However, how democratic systems could be organized to improve the workings of the economy and government was left unclear. Resolving this issue would require a model of democracy which Hayek plainly did not have.[18]

With the fall of socialism, these debates make interesting history of economic thought but offer little of concrete relevance to contemporary economics and politics. But it is clear that modern political economy does have its roots in a prior set of debates in which political and economic issues were jointly influential.[19]

The immediate post-war period saw debates about what drives government quality being muted in mainstream economics. The move towards systemization and formalization of economics saw mainstream policy economics largely dominated by a technocratic mode descendant from Pigou's economics of welfare. By systematizing the notion of market failure, Pigou seemed to promise an economic theory of the mixed economy and the role of government. Much economic theory saw the problem of planning as purely technical.[20]

In continental Europe, the schism between economics and politics was less marked than in the English speaking world. This was particularly clear in the field of public finance which remained imbued with law and political science throughout.[21] But it was not until the post war period with the creation of the field of Public Choice that these ideas were systematized into a body of understanding and integrated with mainstream economics in the English speaking world. The key contributors in this enterprise were Buchanan and Tullock whose 1963 book *The Calculus of Consent* provides a landmark analysis of problems of log-rolling and implications of democratic governance for taxation and public expenditures.

In some circles the term Public Choice is used to refer to *any* analysis that links economics and politics.[22] But here, I am using it more narrowly to represent the work beginning in the Virginia School in the 1950s. This has three distinctive features.

The first is the assumption of rational self-interest in the study of political interactions. Thus, Buchanan says:

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[18] See Boettke (2003) and Boettke and Lopez (2002) for discussion.

[19] Referring back to the quote above from John Neville Keynes, it is clear that he saw debates about the merits of socialism as falling under the "art of political economy".

[20] See, for example, Heal (1973).

[21] The excellent collection edited by Musgrave and Peacock (1958) brought these contributions to the attention of the English speaking world.

[22] For example Mueller (2003).

> "Individuals must be modeled as seeking to further their own narrow-self interest, narrowly defined, in terms of measured net wealth position, as predicted or expected." (Buchanan (1989, page 20)).

To most economists, this may seem innocuous. After all, economic agents as rational egoists is a firmly established tradition in a market context. However, below we will argue that setting aside issues of selection in politics constitutes a blind-spot.

The second key idea in public choice analysis is the importance of constitutions as constraints on self-interest. Here, Buchanan says:

> "To improve politics, it is necessary to improve or reform rules, the framework within which the game of politics is played. There is no suggestion that improvement lies in the selection of morally superior agents who will use their powers in some "public interest"" (Buchanan (1989, page 18)).

In this sense, he is firmly interested in the project of designing effective political institutions.

The third key aspect of Public Choice is its normative framework. Economists have tended to work with a particular (broadly Utilitarian) framework in which good and bad outcomes are seen in terms of their impact on individual's utilities taken as an indicator of well-being. Various proposals have been made for how to trade these off to get measures of "social welfare" which allows the analyst to engage in policy debates about good and bad policies. But the Public Choice approach is rooted in a quite different normative tradition – one that goes back to classical eighteenth century views of the state (particularly John Locke). The main idea is that the legitimate domain of the state is related to what freely contracting individuals would be willing to agree to, but only that.

While Buchanan has been a champion of these ideas, it was the Swedish economist Knut Wicksell who first applied these ideas in a concrete policy setting – the provision of public expenditures. (see Wicksell (1896)). He studies the problem of public provision via unanimity rule and observed that with benefit taxation, the allocation would obey the contractarian ideal. This approach conflicts with a standard welfare economic framework which appeals to some other authority (the guardian of social preferences) as the arbiter of the justness of the allocation.

This intellectual framework gives rise to the Public Choice critique of welfare economics observing a conflict between its recommendations and the kind of idealized world that Buchanan and Wicksell envisaged. On the whole, the case for intervention is less permissive than the welfare economic view. Moreover, the framework of the analysis has a libertarian flavour.

As we will discuss in the next chapter, the Public Choice approach also offers a particular slant on the concept of *political failure* – the allocation of resources in democratic process which does not meet Wicksell's test. Moreover, it was a key insight of Buchanan and Tullock (1963) that there is no guarantee that a system of representative government based on majority rule would be immune to such failures.

The Public Choice approach has been influential in thinking about many of the broad issues concerning the proper role of government. However, it is less associated with the creation of specific models for the study of politics.[23]

Chicago political economy views politics as a process of competition for support with policies tending towards those that maximize political support offered either through votes or direct monetary transfers. Its pioneers are Gary Becker, Sam Peltzman and George Stigler.[24] These tend to downplay the significance of particular institutional differences in the policy process.[25] The Chicago approach tends to be associated with relatively reduced form models which does make the models fairly easy to use in complex policy environments. While policies can be distorted by political resource allocation, one of the main intellectual thrusts of the Chicago approach is a tendency for policies to be efficient. This comes from the observation that support maximizing politicians have a tendency to prefer efficient policies. As we shall see, this turns out to be important in thinking about different notions of government failure.

The most influential economic model for the study of political resource allocation is that due to Downs (1957). While Downs' book was filled with many important ideas, the main one that caught on among economists was a

[23] The Leviathan model of Brennan and Buchanan (1980) is perhaps the main exception. This supposes that government picks taxes and public spending to maximize the size of government.

[24] See, for example, Becker (1983), Peltzman (1976) and Stigler (1971).

[25] Mulligan, Gil and Sala-i-Martin (2004) even argue that a failure to find a significant difference in policies between democracies and non-democracies is consistent with the Chicago approach. This is because the latter puts so little weight on the important of voting per se in determining policy outcomes.

justification for the idea that politics would converge to the preferences of the median voter. Downs described politics in the language of competing firms called "parties" where customers were voters. He observed that if parties cared only about winning, then they would have an incentive to converge to the centre. Similar ideas were also being developed in Black (1958) who recognized the importance of preference restrictions (*single-peakedness*) to this prediction.

While it came to dominate economists' approaches to political economy, there are deep-seated problems with the approach. First, the reason that parties pick the median outcome in simple models is that this outcome is a *Condorcet winner*, i.e. an outcome that beats all others in pairwise comparisons.[26] In the absence of a Condorcet winner, there can be *cycles*. This would happen if there are three alternatives $\{A, B, C\}$ where A can beat B in a simple majority vote, B can beat C and C can beat A. Such Condorcet cycles present an insurmountable problem for the Downsian approach since one party can always win an election by proposing something different from the other party whatever that party is proposing. This matters since in just about any interesting policy problem – particularly those with multiple policy dimensions – no Condorcet winner exists.[27]

Countless papers have been written elaborating this point and trying to propose ways around it.[28] But the bottom line is clear. There is relatively little to commend median voter predictions from a theoretical point of view, except in very special circumstances. Even so, the model has gained enormous influence among economists and is presented as a cornerstone of political economy analysis to generations of students.

There is another important theoretical problem with Downs' approach. The model assumes that citizens care about policies while politicians are infinitely pliable – adopting any position to get elected. But if politicians have even a little preference for policies then they will have an incentive to renege after the election. Thus, the model needs to build in reasons why the policy pledges of politicians are credible. One way to approach this is by supposing that politics is a repeated game in which individuals build reputations as in Alesina (1988). However, he shows that this will not typically result in complete convergence. Another is to see credibility

[26] This term is named after the french aristocrat the Marquis de Condorcet.

[27] This is closely linked to the fact that the idea of a median outcome does not make much sense for a multi-dimensional distribution.

[28] See Mueller (1995) for a discussion of many of these.

as coming from picking candidates with appropriate policy preferences as in Osborne and Slivinksy (1996) and Besley and Coate (1997).

The Downsian approach held much more appeal for economists than political scientists. The latter had long been aware of the evidence from polling data suggesting systematic divergence between median preferences and policy outcomes on key dimensions.[29] The model could offer little insight into where convergence might happen and where it would be absent.

The final problem with an agenda building on the Downsian model is the fact that it is not particularly useful in looking at institutional differences. Indeed if politics is about seeking out median preferences among the electorate, there would be little scope for institutional structure in shaping preference aggregation. There is plenty of good evidence that structures matter in practice and hence that something is at work beyond voter preferences in determining policy outcomes.[30]

The more recent literature has not solved the problem of studying political competition in the absence of a Condorcet winner posed by the Downsian model. But it has made sure to keep this firmly in the background. There are some new modeling approaches, but the approach is not built around any kind of dominant political paradigm. A few key approaches are, however, gaining popularity.

Part of the difficulty in the Downsian paradigm is the fact that there is little institutional restriction on policy *proposals*. It is very difficult to get a stable point when any policy can be proposed by any political actor at any time. By adding more institutional structure to a model, the degree of freedom open to political actors is diminished and it may be easier to understand policy formation. This idea was a key insight of Shepsle and Weingast (1981) who discuss how restrictions of the structure of proposal power within a legislature can be used to generate a stable point in a multi-dimensional policy space. Roemer (1999) restricts proposal power by modeling within-party conflict. Such restrictions improve the odds of developing a model that predicts an equilibrium outcome in a particular policy context, providing a basis for empirical analysis. Restricting proposal power is also at the heart of the "agenda setter" model of Romer and Rosenthal (1978).

Another way to create the possibility of an equilibrium is to relax the requirement that the equilibrium be in pure strategies. A number of au-

[29] See, for example, Weissberg (1976).

[30] See, for example, Persson and Tabellini (2003).

thors have investigated this (see, for example, Banks and Duggan (2000)).[31] Predicting the outcome now becomes an involved process and lacks the simplicity of the median voter outcome. Hence, the Downsian model loses many of its attractions after going down this route.

Probabilistic voting features in many recent contributions. This recognizes that there are random shocks to voter intentions which make the mapping from policy choices into political outcomes uncertain. This simple device is powerful in making concrete progress in studying political strategy.[32] The influential monograph by Persson and Tabellini (2000) makes extensive use of this device in exploring the policy implications of different models. This approach often assumes that there are some fixed and some pliable policy dimensions with competition taking place on the latter.[33]

Old style political economy paid little attention to the selection of politicians. For example, the Downsian model sees policies, not politicians, as the currency of political competition. But in a representative democracy, it is politicians who are elected and are charged with making policy. This idea has been formalized recently by Osborne and Slivinski (1996) and Besley and Coate (1997). These models suppose that citizens elect politicians who then implement their preferred policy outcomes. An implication of the candidate centred view of political competition discussed above is that the identity of candidates matter to policy outcomes.[34] Such models can work in complicated policy environments although equilibria may also be in mixed strategies.

Models of extra-electoral policy making are important as well in the political economy literature. Recent contributions have been heavily influenced by Grossman and Helpman (1994) who formulated the problem of lobbying using an approach in which policy favours are auctioned to the highest bidder.

[31] See also Myerson (1993).

[32] It also helps to overcome some of the technical difficulties associated with finding an equilibrium point in a Downsian model which has an inherent ‘discontinuity’ in the payoff function around the point at which a party switches from winning to losing or vice versa. A probabilistic voting model tends to make the probability of winning a smooth function of policy choices over some range.

[33] Lindbeck and Weibull (1987) is an important precursor. They assume that parties care solely about winning. Calvert (1985) and Wittman (1977) consider parties with policy preferences.

[34] Lee, Moretti and Butler (2004) has looked at close elections (i.e. those determined by a few points) and argue that the data support the candidate centred view of politics for U.S. elections.

Policy outcomes then reflect the "willingness to pay" of organized lobbies. This approach has provided a much more transparent way of thinking about lobbying compared to the previous generation of models which typically had a black box "influence function".[35]

The recent literature has a core concern with empirical testing of ideas. There is a wealth of data to be exploited as well as scope to generate new data sets. There are many studies that look at cross-country variation – exploiting the many differences in institutions that we see between national governments.[36] The great advantage of this is that the extent of institutional variation is vast creating many possibilities for comparisons of institutions. However, on the downside, such institutions tend to be relatively fixed over time and there are many sources of heterogeneity across countries which it is difficult to control for in a convincing manner. The difficulty then lies in discerning the difference between the effect of institutions on outcomes versus some other unmeasurable factor that is correlated with institutions. This can only be overcome with extreme ingenuity.

Another class of studies exploits variation within countries – where there are differences in politics across sub-jurisdictions.[37] This is not immune to the problems of unobserved heterogeneity discussed in relation to cross-country studies. The fact that many institutions remain fixed over time is also an issue. However, there are sometimes cases where a change in institutions can be exploited or some suitable interaction with a time-varying factor exploited. More generally, sub national data probably suffer less than cross-country data in having highly heterogeneous cross-sectional units. But such studies typically have less variation in interesting outcomes and institutions to exploit.

Finally, there is scope for increasing collection of bespoke data sets to examine specific policy issues. Economists have long undertaken household survey work to investigate economic behavior. There is similarly a tradition of collecting data sets to examine political behavior – voting, activism etc. But only rarely have the two been put together to get a more complete picture. There is growing interest in doing so and in developing pictures of how policy choices evolve. Bespoke data sets can also be used to supplement

[35] See, for example, Becker (1983).

[36] Persson and Tabellini (2003) is an excellent compendium of what can be achieved using such sources.

[37] See Besley and Case (2003) for a review of what has been achieved for cross-state variation in the U.S..

standard data from official sources.

Public resource allocation has both short and long run effects on the economy. One distinctive feature of the recent political economy literature is the attention that it pays to the dynamics of politics and economics. A key aspect of democratic political life is that governments are typically short-lived while the consequences of many policies are not. Kydland and Prescott (1977) observed that even benevolent governments would have an incentive to make promises that were not credible – for example promise low taxes to encourage investment and subsequently renege on the promise. But the problem is much worse with short-lived government.

A variety of issues have been studied in models that emphasize this feature of political life. A key example is the incentive to incur public debt as a strategic measure to constrain future governments.[38] The political business cycle is another example. Accounts of government incentives to inflate the economy before an election have been around for a long while. But only fairly recently has it been understood how to think about this when voters are not being systematically fooled.[39]

It is also now clear that long-run patterns of development are tied up with the process of political development. Problems of state failure are endemic in low income countries and their study has been to central to appreciating the forces that shape economic development.[40]

It is clear from this brief overview, that there is already a lot of work on issues of incentives in politics – most of the approaches to political resource allocation discussed above are concerned to understand how particular assumptions about the structure of political institutions and organization shape policy choice. For the most part, the conflict of interest being resolved in the models discussed here is that between different groups of citizens who have divergent policy interests – the classic spatial model of politics is the "ideal type" of this kind. Politics is then predominantly about the problem of preference aggregation. In the next section, we look models which focus more on the conflict of interest between citizens and government – political agency models.

[38] See the discussion and references in Persson and Tabellini (2000).

[39] Rogoff (1990) uses a dynamic model with imperfect information to develop a "signalling theory" of equilibrium business cycles.

[40] See Acemoglu and Robinson (2003) for a recent insightful discussion of these issues.

6 Incentives and Selection in Politics

Most of the analysis of this book – especially that in chapters three and four – is focussed on how elections can resolve the conflict of interest between citizens and government. When political authority is delegated to politicians, then they hold the public trust between elections. Constitutions offer only limited provisions for the control over politicians – punishing them only for the grossest of abuses. The main sanction for poor performance is electoral – those who perform badly will not be re-elected. Hence, politics is about achieving *accountability* of politicians to voters.

The importance of elections as an accountability mechanism has long been recognized. For example, Alexis de Toqueville viewed U.S. presidential elections in this way when he noted that

> "The President is chosen for four years, and he may be re-elected, so that the chances of a future administration may inspire him with hopeful undertakings for the public good and give him the means to carry them into execution," de Tocqueville [1835, 1994], page 121.

In similar vein, Madison recognizes this in the Federalist papers when he notes that:

> "the House of Representatives is so constituted as to support in the members an habitual recollection of their dependence on the people. Before the sentiments impressed on their minds by the mode of their elevation can be effaced by the exercise of power, they will be compelled to anticipate the moment when their power is to cease, when their exercise of it is to be reviewed, and when they must descend to the level from which they were raised; there forever to remain unless a fairful discharge of their trust shall have established their title to the renewal of it." Madison, Federalist Papers No. LVII.

Information is important in thinking about electoral accountability. Voters who hold politicians to account are likely to do so more effectively when they can observe what they are doing. This brings to the fore the role of information providers such as the media and civil society (think tanks and policy analysts) in increasing accountability.

As we shall see in chapter 3, it is useful to think about the distinction between formal and real accountability. A politician is formally accountable if there is some institutional structure that allows the possibility of some action to be taken against him or her (such as being voted out of office) in the event that he/she does a poor job. But there is no guarantee that this ensures that such accountability mechanisms are used effectively. *Real* accountability requires that those who hold politicians to account have sufficient information (for example about the politician's action) to make the system work.

This approach to studying political life was pioneered by Barro (1973) and Ferejohn (1986). They showed how the threat of not being re-elected could curtail rent extraction by politicians. The focus, therefore, is on elections as an incentive mechanism. The problem of opportunism is then essentially like a problem of moral hazard in the contracting literature.

The second generation models –such as Rogoff (1990) and Coate and Morris (1995) have looked at the implications of agents who differ in their type, thus adding concerns of adverse selection. Elections then serve two key roles – creating incentives and selecting the best candidate.

The idea that there are some individuals who are better suited to public life than others is an interesting one. The great American political scientist V.O. Key certainly regarded political selection to be an important issue when he remarked

> "The nature of the workings of government depends ultimately on the men who run it. The men we elect to office and the circumstances we create that affect their work determine the nature of popular government. Let there be emphasis on those we elect to office." V.O. Key (1956), page 10.

Selection could matter for two main reasons – differences in competence between individuals and differences in motivation. With motivation comes concerns about integrity, honesty, altruism and policy interests. The quote from Madison at the beginning of this chapter suggests that he had both in mind. Having "wisdom" is akin to competence and "virtue" is akin to motivation.

The idea that individuals differ in terms of their competence as politicians is similar to the idea that individuals have match-specific skills in models of the labour market. Whether this is innate or acquired is far from clear. It is also unclear whether previous career experience is a reliable guide to whether an individual has greater competence. Madison's reference to wisdom suggested that he had in mind the need to have politicians with generally high levels of human capital and innate ability.

Dealing with differences in motivation provides more of a departure from standard economics. We are used to assuming, for most aspects of market behavior, that individuals are self-interested. Whether this should be extended to their behavior in public life is debatable. As we noted above, Buchanan puts weight on the idea that ruthless self-interest is the correct assumption to make. The idea of modeling political choices from the premise that actors are self-interested is also characteristic of the Chicago approach to political economy. Thus, Peltzman (1980) assumes that "political preferences are motivated purely by self-interest."(page 16). The self-interest model is also thought to underpin the growth of government that we observed above. For example, Holsey and Borcherding (1998) comment that the "political paradigm, .., views public services as selfishly redistributive (i.e., transfers of purely private goods to politically favored groups), hence government expenditures are determined by the most influential agents." (pages 565-566).[41]

The idea that self-interest assumption should be applied to the conduct of public life is far from new. The philosopher and economist David Hume, a contemporary of Adam Smith, argues eloquently in favor of this when he says:

> "In contriving any system of government and fixing several checks and controls of the constitution, every many ought to be supposed a knave and to have no other end, in all his actions, than private interest. By this interest, we must government him, and by means of it, notwithstanding his insatiable avarice and ambition, cooperate to the public good" Hume (1742).

Smith himself had a somewhat schizophrenic view. He viewed markets as the perfect outlet for self-interest channeled in the common good. But his theory of moral sentiments attached great weight to altruism in non-market contexts. Hayek proposed the following extension.

> "Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should

[41] Although explaing the *growth* of government requires that the self-interest of politicians has increased over time due, say, to a decline in civic virtue.

> have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they are now, but which makes good use of men in all their given variety and complexity, sometimes good and sometimes bad" Hayek (1948), 11-12.

This has echoes of Madison – the key question is how institutions shape actions and how they can – if at all – promote selection of those most suited to public office.

Of course, accepting that individuals are broadly self-interested is consistent with a wide variety of utility functions for politicians. For example, liking policies that help the poor can be regarded as a form of self-interest in so far as politicians gain satisfaction from doing this. Hence the real issue is how narrowly this assumption is interpreted. It is clear that very often self-interest is defined in terms of something like consumption of private goods.

Applied to politics, it is this kind of narrow self-interest motive which underpins accounts of political corruption. It is this notion of self-interest which underpins the agency models of Barro (1973) and Ferejohn (1986). There is little doubt that this kind of self-interested behavior is important in practice and its importance has been recognized increasingly in recent discussions of the role of the state. The most egregious examples – the overwhelming kleptocracies of the world – have been in non-democratic systems where electoral sanctions are limited or non-existent.

There are three other models of motivation in politics: ego-rent, policy preference, and fiduciary duty. We discuss each in turn.

Political economy models often assume that politicians seek solely to win office. Perhaps the best known political model founded on this is Downs (1957) which assumed that parties do whatever it takes to win office. The desire to win could be interpreted as another manifestation of self-interest. However, conceptually, the desire to hold office could be distinct from narrow self-interest. Moreover, the psychology literature attaches weight to the way in which winning an election can bolster self-esteem which would create a reward to holding office which was neither dependent on policy nor on extracting private goods. This model has been invoked by Rogoff (1990) and Maskin and Tirole (2000) among others to describe the preferences of politicians who are otherwise benevolent. This is often referred to as an "ego-rent" derived as a non-pecuniary benefit from being in office. Pure ego rents are distinct from a monetary rent since reducing the possibility of malfeasance while in office does not diminish the re-election incentives of agents who earn them.

As we mentioned above, the motive to enter for office could be to influence policy.[42] As citizens, politicians are affected by policies and hence have self-interested reasons to be policy motivated. This view encompasses at one extreme a very narrow view in which individuals care about specific issues such as the environment or tax policy. However, policy preference can also be mediated through vaguer ideas like ideologies – world views that shape a broader set of policy predilections.

One important model of motivation in politics that has received less attention in modeling the behavior of politicians, but which in line with the models developed in the chapters below, is the *fiduciary model*. The term fiduciary comes from the Latin verb *fidere* – to trust. It is most often applied in describing the duties of trustees and directors of company boards.[43]

Fiduciarity has two main aspects – a duty of care and a duty of loyalty. The idea of political office as trusteeship runs through Madison's essays in the Federalist papers who refers to leaders as upholding public trust. In modern parlance, the duty of care could be interpreted as refraining from moral hazard. The duty of loyalty is less clear in some models, but broadly refers to the duty of politicians to act in the interest of citizens at large – eschewing narrow self-interest. The models that we develop in chapters 3 and 4 have politicians who if elected would fulfill their fiduciary duty on behalf of voters. These are contrasted with narrowly self-interested politicians.

Just why some individuals take their fiduciary duties seriously while others do not is not clear. Performing a fiduciary duty could be thought of as a form of *intrinsic motivation*. This idea, which originated among psychologists has only recently been brought into economic thinking.[44] It refers

[42] See especially Calvert (1985) and Witmman (1977). Persson and Tabellini (2000) reviews the literature.

[43] This trustee view of political representation is most closely associated with Edmund Burke who put it forward in a speech to the electors of Bristol in 1774. It also found favor in the writings of J.S. Mill.

[44] See, for example, Frey (1997), Murdock (2002), Benabou and Tirole (2003) for exam-

to a case where actions are driven by internal factors and are pursued "for their own sake" rather than because of some well-defined external reward. Thus, a politician who upholds his duty of loyalty may be willing to do so even though he is forgoing an increase in his utility by doing so. On this view, being a trustworthy politician is a type rather than a consequence of incentives. The role of elections is to find ways of sorting in such politicians rather than incentivizing them.

To assume that politicians who take their fiduciary duties seriously are completely immune to influence by incentives is perhaps too strong. The extent of incentives may depend on whether they agree wholly with the ends that they are pursuing. Besley and Ghatak (2005) develop a model of agent motivation in which the extent to which agents take care depends on the extent to which they agree with the *mission* being pursued by an organization. Thus, a politician could be much more motivated when he/she agrees with the cause. This naturally creates some ambiguity in the exercise of the duty of loyalty in such cases. Those voters whose mission preferences are most closely aligned with politicians will tend to receive more attention from incumbents. This suggests that citizens may care about which sort of fiduciary politician they select.

Invoking broader notions of motivation is consistent with wide-ranging evidence on behavior in public and private life – especially that emerging from laboratory experiments. It has long been known that narrow assumptions about human motivation have not fared well in explaining individuals' contributions to public goods when these are studied in the laboratory. The evidence from experimental work reviewed by Ledyard (1998) catalogs many important anomalies to narrow self-interest models. Even in the context of market interactions, Fehr (2002) documents how concerns about fairness in resource allocation are needed to explain behavior.[45]

Once it is recognize that politicians are heterogeneous in important ways, it is necessary to develop models that explain who will be selected. Let us suppose that there are some individuals who will make better politicians and

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ples.

[45] Moving beyond narrow self-interest is necessary to create a satisfactory theory of voting. The possibility that individuals vote on the basis of narrow self-interest runs foul of the fact that the probability of being decisive is so low in mass elections. This has lead to a wide varieties of alternatives being proposed which are based some kind of broader motivation such as duty (see Aldrich (1997) for a review). This notion of duty fits very well with the fiduciary model that we are suggesting.

that all citizens would prefer a better politician in office – politician quality is a valence issue. Then, we can study the process by which political selection takes place and understand why some low quality politicians can survive. The citizen-candidate approach of Osborne and Slivinsky (1996) and Besley and Coate (1997) provides a useful framework for thinking about this. They model the entry, voting and policy making stages when citizens can choose to become candidates for political office.

This approach suggests three main reasons why some low quality politicians get into office. First, there is the possibility of restrictions on entry and voting. If the cost of political campaigns differs across candidates of different quality, then either poor or high quality candidates may be deterred. Political elites may also prefer corruptible candidates in order to preserve their rents. If they control entry (through party systems) then high quality candidates may also be deterred. This mechanism can also work by controlling the voting process to prevent high quality candidates from being elected, even if they stand.[46]

The second reason for low quality candidates is informational. Bad politicians may enter since there is some chance that the voters will not be able to identify them during election campaigns. This has been studied by Caselli and Morelli (2004). This results in bad candidates entering as rent seekers if there are significant private benefits from running for office.

The third reason for existence of low quality politicians is developed in Besley and Coate (1997) which considers the implications of coordination problems among voters. Suppose that there are two low quality candidates running for office who are polarized in the policy space. Then entry by high quality candidates can be deterred if these candidates fear that voters would be unable to coordinate on the high quality candidates. Otherwise, the result would be for entry by high quality candidates to increase the probability that a candidate with the opposite policy preference will win.

If the process of entry, campaigning and voting cannot weed out low quality politicians, then observing their performance while in office will play a role. But the initial situation is one of uncertainty about the type of the

[46] Poutvarra and Takalo (2003) develop a model in which the value of holding office impinges on candidate quality via its effect on election campaigns. Gehlbach and Sonin (2004) apply a citizen candidate framework to ask when economic elites (such as businessmen) will choose to run for political office. Running for office is in this world an alternative to lobbying for influence. They argue that business candidates lead to greater misuse of public office.

incumbent (adverse selection). Hence, combining this model with one where incentives matter requires taking the twin informational problems of moral hazard and adverse selection in politics seriously.

To summarize, while it is clear that incentive issues are important in understanding conflicts of interest between government and citizens, there are good reasons to think that selection is important too. This could be selection of more competent politicians or those who will take their fiduciary duty seriously. Much of this book is devoted to understanding how politics and public resource allocation works when both incentives and selection are taken seriously.

7 Concluding Comments

If government is to work well, then problems of incentives and selection must be dealt with. In situations where either good politicians are selected and/or incentive problems are dealt with, we have a world approximating the standard normative model of government. At the other extreme, there is a preponderance of self-interested politicians who use public office to further their personal ends. To the extent that the incentive mechanisms available are weak, this will result in low quality government. In this sense, understanding the political economy of public resource allocation in settings where selection is an issue is a useful step along the way to understanding the possibility of benevolent government.

Following in the footsteps of the pioneers whose work we refer above, there is now a considerable body of knowledge to draw upon. The remaining chapters of this book are largely synthetic. They develop frameworks which are useful to explaining the main ideas. However, by developing their own frameworks, there is some hope of bringing unity to the area. But this is a preliminary report on work in progress.

The modern political economy literature is having some success in extending the competence of economists in the direction of understanding policy processes as well as policy outcomes. The project coheres well with Madison's vision in the Federalist papers. This is not a project about restraining government, but of understanding the institutional preconditions for government to work. With this in mind, we turn to the project at hand.

Table 1.1: Total Government Expenditure as Per Cent of GDP at Current Prices:
Western Europe, the United States and Japan, 1913–1999.

	1913	1938	1950	1973	1999
France	8.9	23.2	27.6	38.8	52.4
Germany	17.7	42.4	30.4	42	47.6
Netherlands	8.2	21.7	26.8	45.5	43.8
United Kingdom	13.3	28.8	34.2	41.5	39.7
Arithmetic Average	12	29	29.8	42	45.9
United States	8	19.8	21.4	31.1	30.1
Japan	14.2	30.3	19.8	22.9	38.1

Source: Maddison (2001)
Note: The data for the Netherlands is for 1913 rather than 1910.

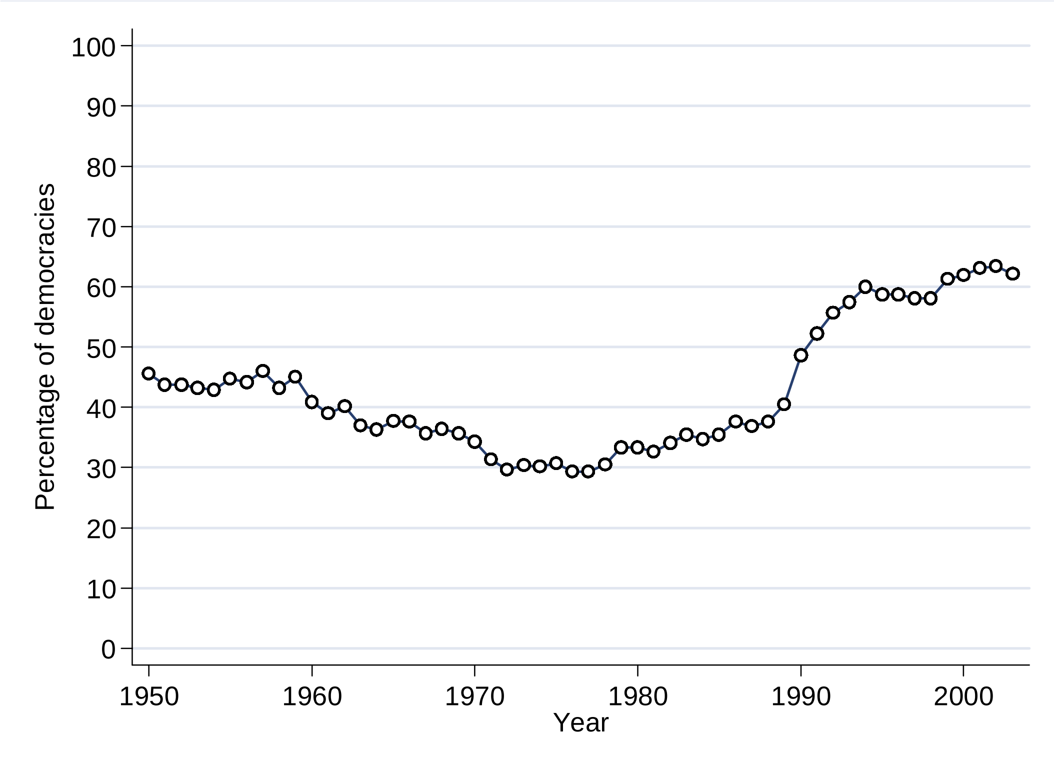

Figure 1.1: Democracies in the world, 1950-2003
Source: POLITY IV
Notes: A country in a given year is classified as a democracy if variable POLITY2 in the POLITY IV dataset is greater than zero. The percentage of democracies is calculated as the ratio of the number of democracies to the number of all countries in the POLITY IV dataset for each year. Note that the POLITY IV dataset only includes countries with the population of more than 500,000 in 2003. Also note that the number of all countries in the dataset changes over time due to the independence of colonies, the break-up of a country, and the integration of countries.

Figure 1.2: Size of government (in nominal terms) in high-income OECD countries and the others

Source: World Development Indicators 2005

Notes: Size of government (in nominal terms) is measured as the percentage of general government final consumption expenditure in current local currency unit over GDP in current local currency unit. The simple average for each group of countries is calculated. High-income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany (the unified Germany before 1990), Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States. The data for year 2003 is excluded as eight out of the 23 high-income OECD countries are missing. For the sake of comparability to Figure 2b, country-years for which the data on the size of government in real term is unavailable are dropped.

Figure 1.3: Size of government (in real terms) in high-income OECD countries and the others

Source: World Development Indicators 2005

Notes: Size of government (in real terms) is measured as the percentage of general government final consumption expenditure in constant local currency unit over GDP in constant local currency unit. The simple average for each group of countries is calculated. High-income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany (the unified Germany before 1990), Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States. The data for year 2003 is excluded as eight out of the 23 high-income OECD countries are missing. For the sake of comparability to Figure 2a, country-years for which the data on the size of government in nominal term is unavailable are dropped.

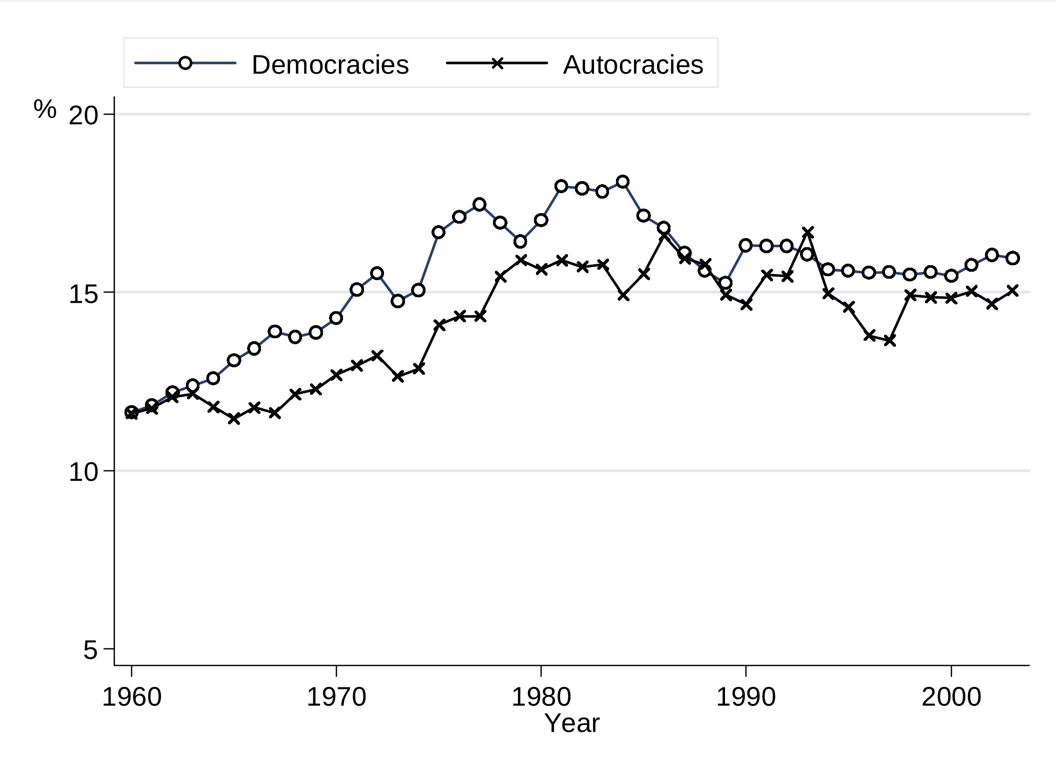

Figure 1.4: Size of Government (in nominal terms) between democracies and autocracies

Source: World Development Indicators 2005 and POLITY IV

Notes: Size of government is measured as the percentage of general government final consumption expenditure in current local currency unit over GDP in current local currency unit. The simple average for each group of countries is calculated. A country in a given year is classified as a democracy if variable POLITY2 in the POLITY IV dataset is greater than zero and as an autocracy if POLITY2 is zero or negative. Note that a country that is a democracy in some year can be an autocracy in another year. For the sake of comparability to Figure 3b, country-years for which the data on the size of government in nominal term is unavailable are dropped.

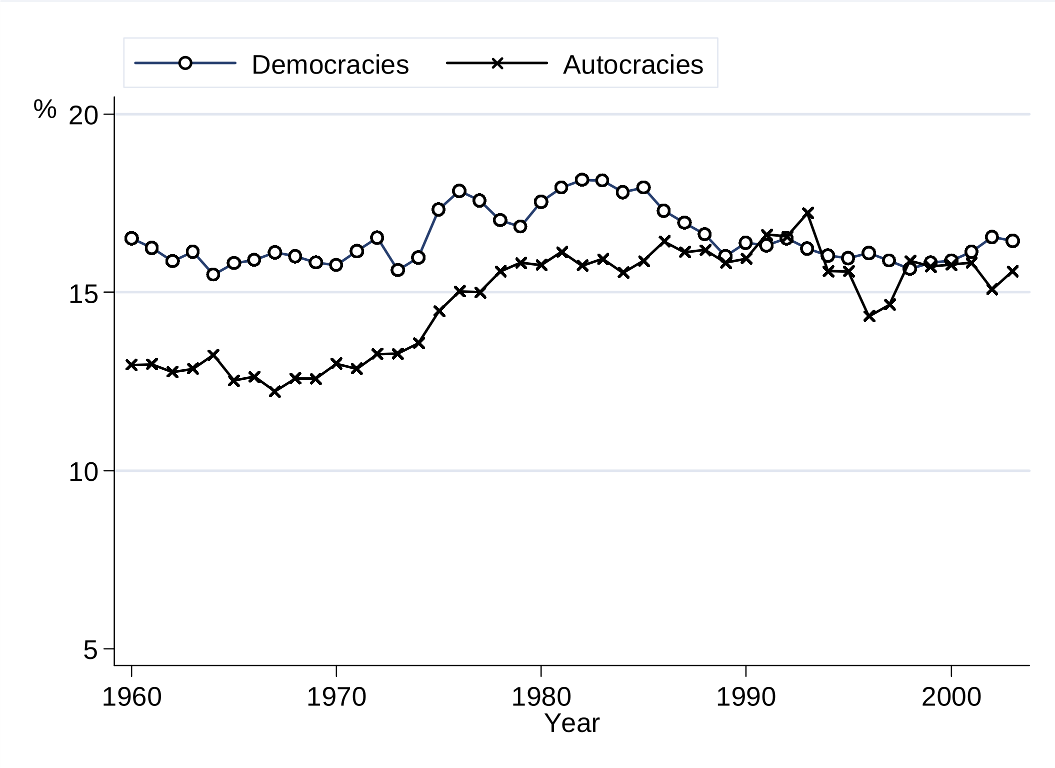

Figure 1.5: Size of Government (in real terms) between democracies and autocracies

Source: World Development Indicators 2005 and POLITY IV

Notes: Size of government is measured as the percentage of general government final consumption expenditure in constant local currency unit over GDP in constant local currency unit. The simple average for each group of countries is calculated. A country in a given year is classified as a democracy if variable POLITY2 in the POLITY IV dataset is greater than zero and as an autocracy if POLITY2 is zero or negative. Note that a country that is a democracy in some year can be an autocracy in another year. For the sake of comparability to Figure 3a, country-years for which the data on the size of government in nominal term is unavailable are dropped.

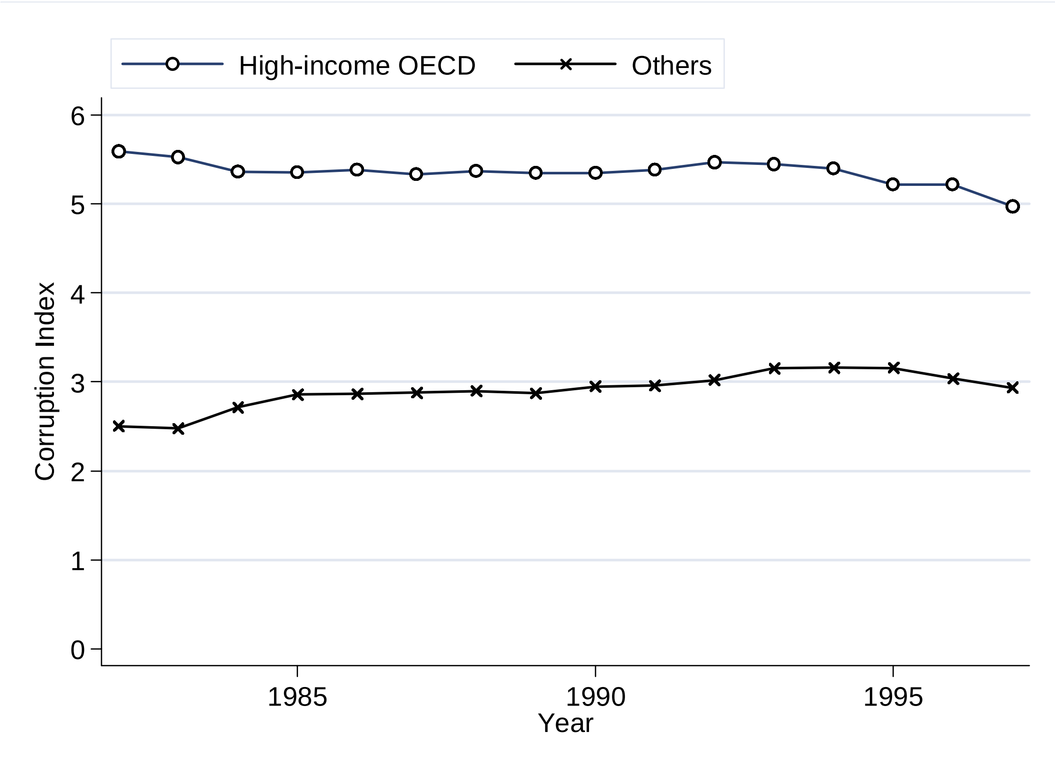

Figure 1.6: Corruption in high-income OECD countries and others
Source: International Country Risk Guide (http://www.countrydata.com/datasets/)
Notes: Corruption Index (variable "corruption in government" in the dataset) ranges in values 0-6 with higher values indicating *less* corruption. The simple average for each group of countries is calculated. High-income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany (West Germany before 1990), Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.

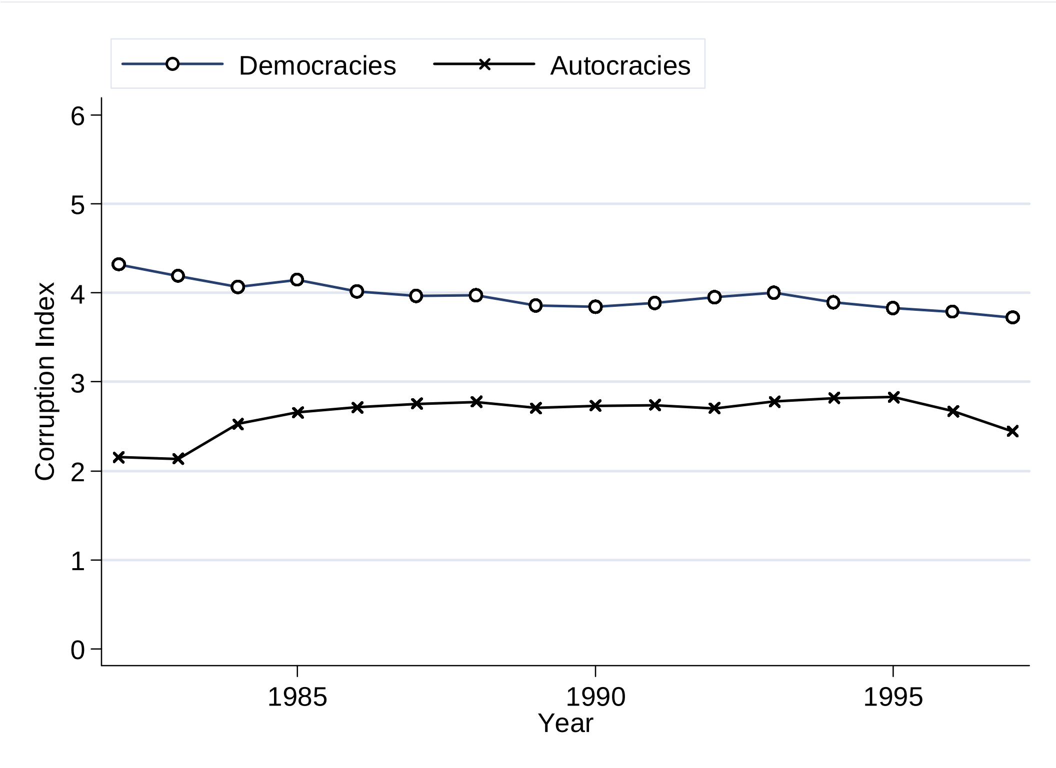

Figure 1.7: Corruption in democracies and autocracies
Source: International Country Risk Guide (http://www.countrydata.com/datasets/) and POLITY IV
Notes: Corruption Index (variable "corruption in government" in the dataset) ranges in values 0-6 with higher values indicating *less* corruption. The simple average for each group of countries is calculated. A country in a given year is classified as a democracy if POLITY2 variable is greater than zero, and as an autocracy if POLITY2 variable is zero or negative. Note that a country that is a democracy in some year can be an autocracy in another year. The International Country Risk Guide dataset covers years 1982-1997.

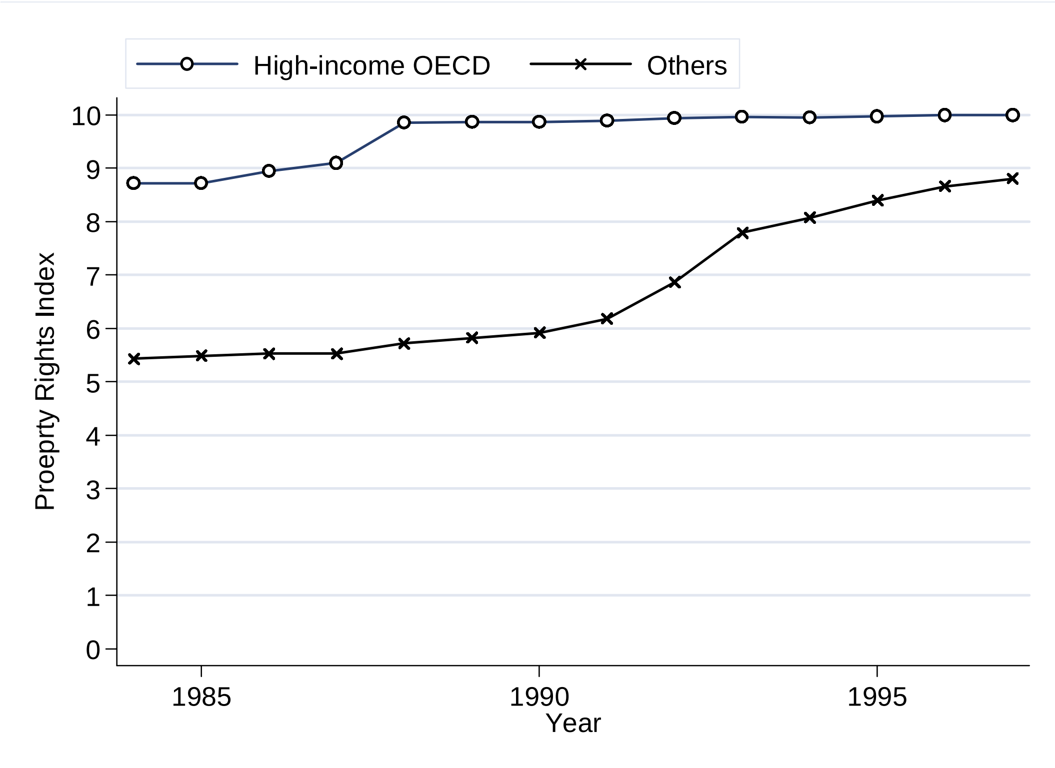

Figure 1.8: Property rights for high-income OECD countries and others
Source: International Country Risk Guide (http://www.countrydata.com/datasets/)
Notes: Property Rights Index (variable "risk of expropriation" in the dataset) ranges in values 0-10 with higher values indicating *more* secure property rights. The simple average for each group of countries is calculated. High-income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany (West Germany before 1990), Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States. Although the dataset covers years 1982-1997, years 1982 and 1983 are excluded because 21 of the 23 high-income OECD countries are missing in the dataset for these years.

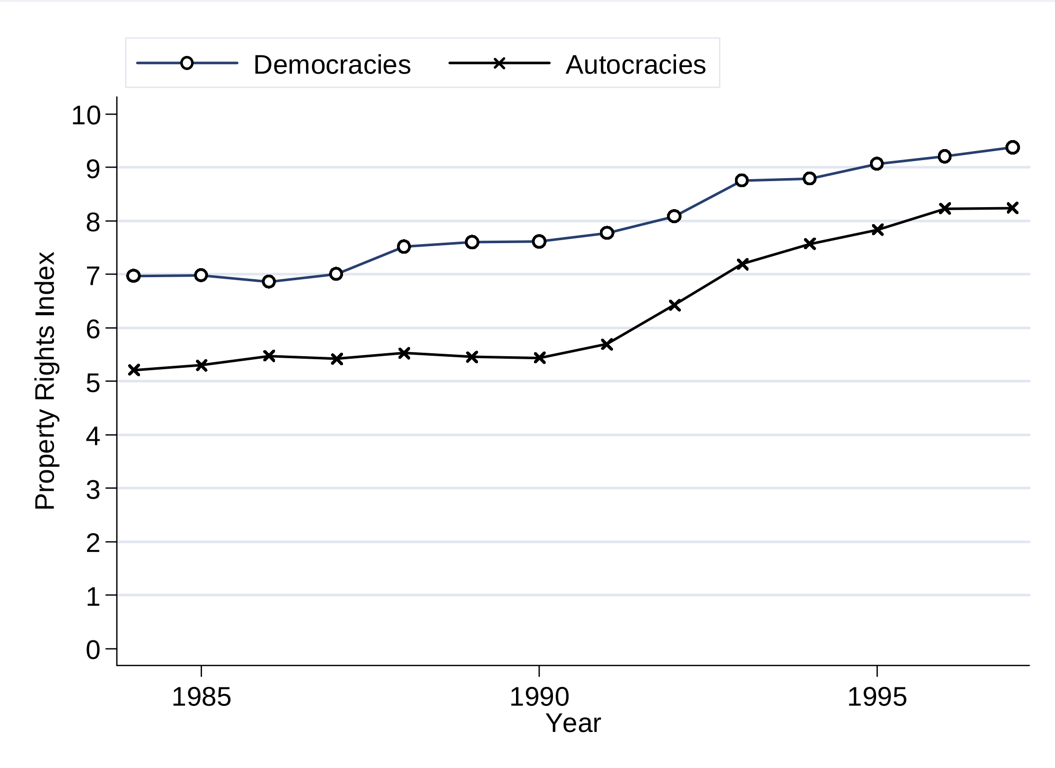

Figure 1.9: Property rights for democracies and autocracies
Source: International Country Risk Guide (http://www.countrydata.com/datasets/) and POLITY IV
Notes: Property Rights Index (variable "risk of expropriation" in the dataset) ranges in values 0-10 with higher values indicating *more* secure property rights. The simple average for each group of countries is calculated. A country in a given year is classified as a democracy if POLITY2 variable is greater than zero, and as an autocracy if POLITY2 variable is zero or negative. Note that a country that is a democracy in some year can be an autocracy in another year. The International Country Risk Guide dataset covers years 1982-1997 though figures for years 1982 and 1983 are dropped because about half of democracies are missing for these two years.

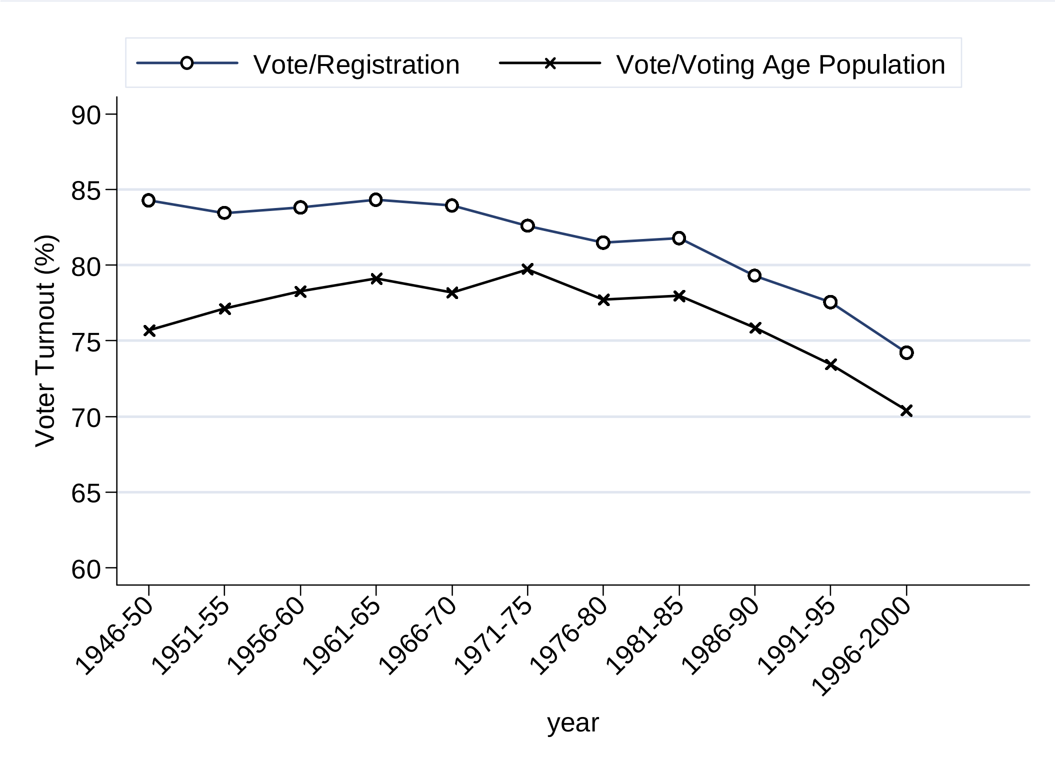

Figure 1.10: National Election Turnout in high-income OECD countries, 1946-2000

Source: International Institute for Democracy and Electoral Assistance (IDEA) (www.idea.int/vt)

Notes: "Vote/Registration" is the ratio of the total number of votes cast to the number of registered voters. "Vote/Voting Age Population" is the ratio of the total number of votes cast to the population over the age of 18. The five-year period is chosen so that each country, except for Greece, Portugal, and Spain during their dictatorial rules (see below), held at least one election in each period, which avoids the composition bias. The five year average turnout for high-income OECD countries is calculated as follows. For each country and each five year period, the turnout (variables Vote/Registration or Vote/Voting Age Population in the IDEA dataset) for legislative elections is averaged. For countries whose form of government is presidential (e.g. the United States), the average turnout for presidential elections is calculated separately, and averaged with the legislative counterpart, in order to ensure that the same weight is given for each type of election. The simple average over countries is then calculated for each five year period. This makes sure that those countries that held more elections within each period than others are not over-represented. High-income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany (West Germany before 1990), Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States. There were no national elections in Spain for 1946-1976, Greece for 1965-1973, and Portugal for 1946-1974. The data on the number of registered voters (hence Vote/Registration) is not available for Greece for 1946-50 and the United States for 1946-63.

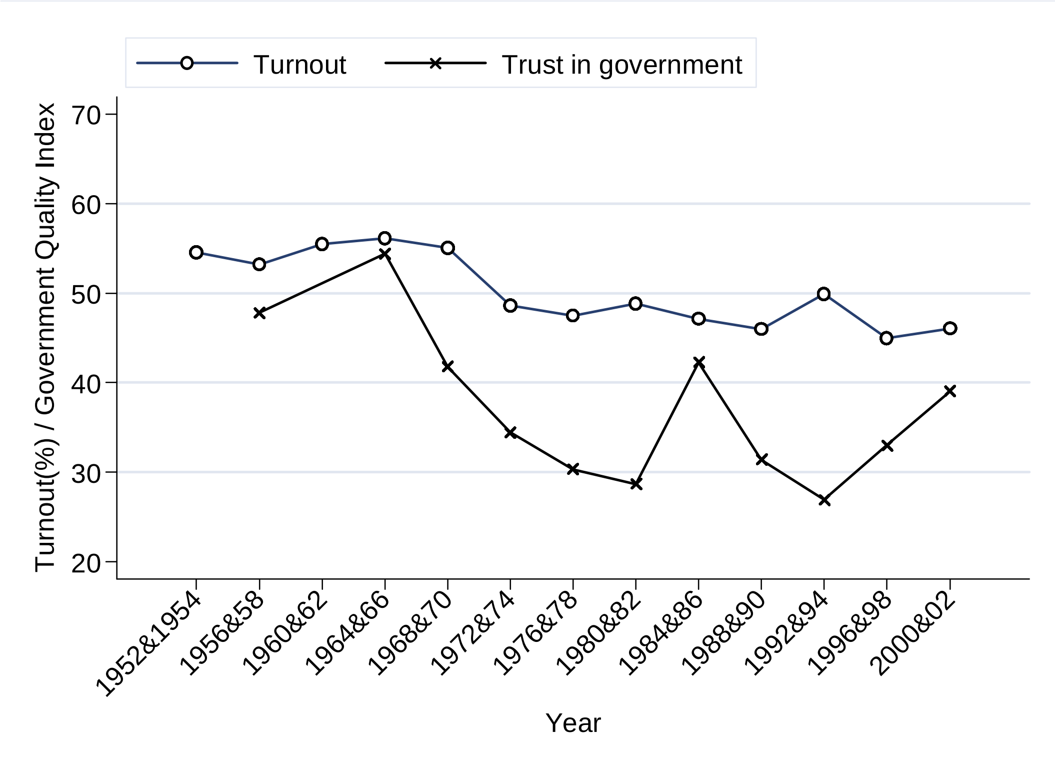

Figure 1.11: Trust in government and turnout (simple average across US states)

Sources: Trust in government is taken from NES (National Election Surveys); Turnout obtained from Michael McDonald for 1952-1998 and his website (elections.gmu.edu) for 2000-2002.

Notes: Turnout is the ratio of the total vote cast for the highest office to the voting age population. Shown in the figure is the simple average over each presidential year and its following mid-term election year with the same weight on each state. Trust in government (variable CF0656 in the NES dataset) is the aggregate index of survey responses to the following four questions: “How much of the time do you think you can trust the government in Washington to do what is right?”, “Would you say the government is pretty much run by a few big interests looking out for themselves or that it is run for the benefit of all the people?”, “Do you think that people in the government waste a lot of money we pay in taxes, waste some of it, or don't waste very much of it?”, and “Do you think that quite a few of the people running the government are crooked, not very many are, or do you think hardly any of them are crooked?” The survey was conducted each other year when national elections were held. The simple average across US states shown in the figure is calculated as follows: the simple average is taken across respondents in each state; then the simple average across states is calculated for each survey year; finally, each presidential election year figure is averaged with the figure for the following mid-term election year (except for 1958 where the survey in 1956 did not take place). For both turnout and trust in government, the states of Alaska and Hawaii and the District of Columbia are not included.