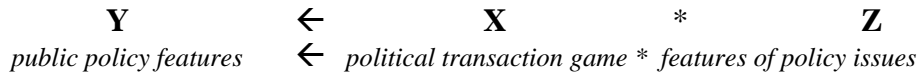
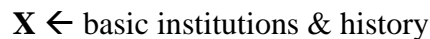


A Transaction-Cost Politics Framework: Some Basic Notes¹

Public policies can be seen as the outcome of an inter-temporal political-transaction game among political actors (see Figure 1):



Where the features of the political-transaction game X also depend on basic institutions & history:



I. Some features of the political transaction game (X): cooperative or non-cooperative? (Figure 2)

- Political actors need to make collective and individual decisions or policy actions.
- Commonality: Actors have a common interest in having policies that respond to economic or technological shocks—all else equal, everybody would like some flexibility.
- At any point in time, the status quo policies generate relative winners and losers.
- Conflict and Bargaining: Actors have heterogeneous preferences over the **distributive** effects of policies and policy changes (reforms).
- Changes in the rules of the game and random shocks shift the relative power of the players.
- If political actors have long horizons and are patient enough, they can sustain *first-best* cooperative policies in an infinitely-repeated game.² But if their time horizons are short and/or they are impatient, full cooperation is not sustainable.
 - Under **full cooperation**, players prefer flexible policies that adapt to economic shocks. But note that “political agreements” need not always be “economically efficient”.
 - **Without cooperation**, we either get (i) very inflexible or **rigid** policy rules, or (ii) very **volatile** and perhaps partisan policies.
 - The choice between inflexible/rigid or volatile/partisan policymaking depends on the weight of economic or political “**shocks**” relative to the “**distributional conflict**” over the payoffs of the policy or reform.
 - If the **distributional conflict is more (less)** important than the impact of an economic shock, **rigid (volatile)** rules and policies will be chosen.

II. The determinants of political cooperation

Ceteris paribus the **political cooperation** necessary to implement efficient/desirable public policies is more likely if:

- (1) The short-run payoffs from non-cooperation are lower than long-run payoff from cooperation.
- (2) The number of political actors is small (i.e., few veto players).
- (3) Those actors have strong intertemporal linkages (repeated and frequent interactions).
- (4) Policy and political moves are widely observable (deviations and “cheating” are verifiable).

¹ Based on Dixit, Avinash K. *The Making of Economic Policy: A Transaction-Cost Politics Perspective*. MIT Press, 1996, ch. 2., and Spiller, Stein, and Tommasi, “Political Institutions, Policymaking Processes, and Policy Outcomes: An intertemporal transactions framework”, IADB, 2003.

² This is the so called “folk theorem” in game theory.

- (5) Good delegation mechanisms are available (to reduce time inconsistency problems).
- (6) Good enforcement mechanisms, such as a strong court or judiciary to arbitrate disputes are available (contracts are enforceable).
- (7) The key political exchanges take place in arenas where properties (2)-(6) are satisfied (institutionalized policy arenas vs. secretive bargaining).

This list is somewhat similar to the “veto players model” from Tsebelis (2002), and the distinction between “separation of powers and separation of purpose” from Cox and McCubbins (2001).

Some of these things are hard to measure and observe, but some proxies for the factors affecting intertemporal cooperation are:

- Number of key political actors (proxy for the number of veto players)
- Degree of judiciary independence (proxy for the availability of an enforcement mechanism)
- Political stability—number of regime changes in last decades, century, etc. (proxy for regime duration and the discount rates of political actors).
- Political realizations: which party is in power, divided or unified government, is the governing coalition stable? (proxy for policy preferences of actors and policy change feasibility).
- Civil service independence—proxy for professional bureaucracy.

III. The political game also varies according to the specific nature of each policy issue (Z)

- Number and cohesiveness of the relevant political actors
- Degree of irreversibility of the assets involved in the policy (asset specificity)
- Intertemporal pattern of payoffs (up front costs, delayed benefits, etc.)
- Duration of the policy “exchanges”/ contracts / transactions involved (the longer and more frequent, the better)
- Ease of performance measurement (how easy is to notice whether someone defects?)
- Shock observability (how easy is to distinguish between exogenous shocks and “bad”/endogenous choices?)
- Degree to which policy benefits broad vs. narrow interests (diffuse costs, concentrated benefits, etc.)

IV. The political transaction game (X) and the nature of policies (Z) combine to yield “outer features of public policies” (Y)

- We want to focus on whether policies are predictable and adaptable to changing economic or political circumstances.
- We do not need to focus so much on whether policies are first best efficient, as to whether they are flexible and predictable enough to be considered *second-best*.
- Different policy domains—trade, fiscal, social, etc.—(Y) may have different “outer features” even within the same given institutional setup (X) because of their different features as a policy issue (Z) per se, or because of the different political realizations at a given point in time.

V. Assessing the “outer features” of public policy: 5 dimensions

1. Stability vs. volatility

- Are policies sustained or reversed over time?
- Do policies have time to work?

- Do intertemporal agreements allow for the preservation of policies beyond a particular officeholder or coalition?
- Analogy: Cox & McCubbins (2001) “resoluteness”

2. Adaptability or flexibility vs. rigidity

- Are policies responsive to changes in the environment or in the information available?
- Is there political cooperation to facilitate policy changes, or political actors embed rigidities to prevent future reversals?
- Does the prevention of political opportunism lead to incapacity to adjust to changing circumstances?
- Analogy: Cox & McCubbins (2001) “decisiveness”

3. Coordination / coherence

- Is there a lack of coordination/cooperation among actors leading to inconsistent or incoherent policies?
- Analogy: Cox & McCubbins “balkanization”

4. Investment-related qualities / capacities

Many political actions have investment-like properties: upfront costs and long-term benefits—and we know that poorly enforced property-rights lead to underinvestment (*tragedy of the commons*). These investments are also affected by:

- Are agents experienced / well qualified?
- Do legislators have policy expertise?
- Do sub-national governments invest in improving their capabilities?
- What is the quality of the policy outcomes?

5. Public vs. private-regardedness

- Do policies resemble public goods?
- Do policies improve allocative efficiency?
- Do policies promote the general welfare, or funnel private benefits to individuals, groups, regions, or factions? (ie, pork-barrel projects, subsidies, tax loopholes)

Can you think of alternative dimensions?

VI. The logic – or how do I use this framework?

1. Think about any policy you are interested in and try to answer the questions above. This will be your dependent variable.
2. Go back and see if the political transaction game (X) determined by the institutions, political realizations, and specific policy features (Z) can explain your answers about (Y).
3. Go further back and see if the history and more basic institutions (like the Constitution) also help you explain the whole enchilada.
4. Write a nice paper entitled: “The political economy of *whatever* policy: A political transaction-cost perspective”.
5. Have fun!

"FIGURE 3"
The Framework

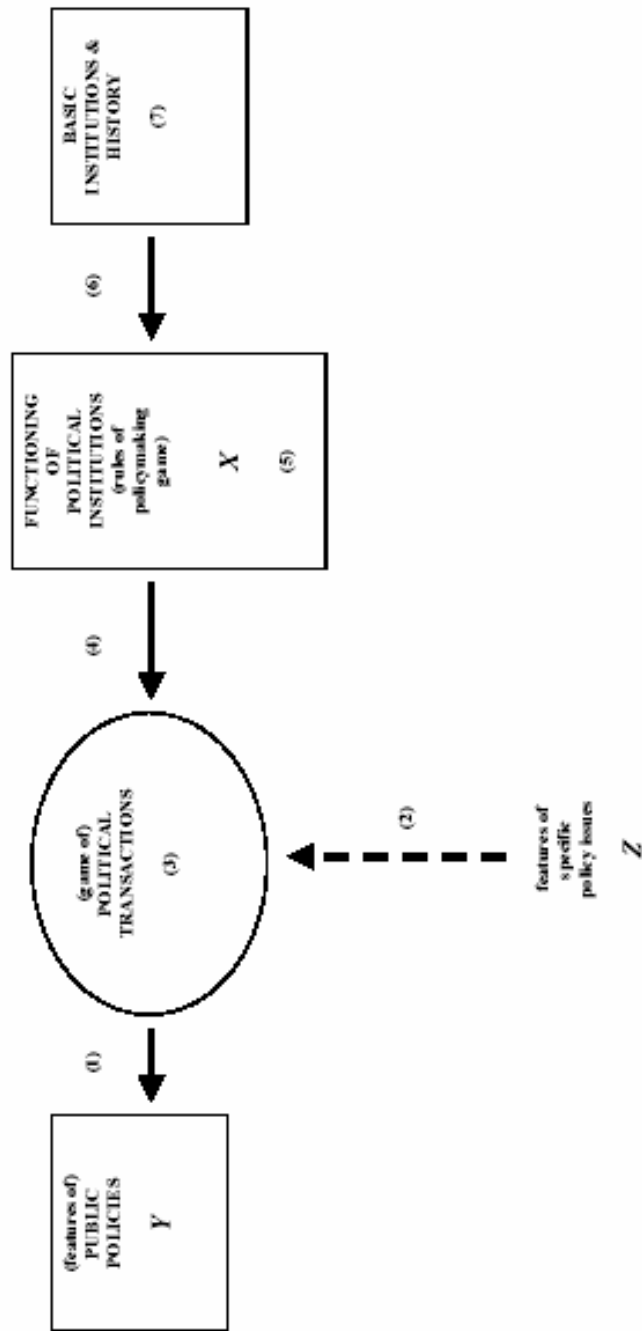


Figure 1.

Figure 2.

