Economic Approaches to Political Institutions

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1 Introduction

Political institutions play a key role in shaping economic policies. Economists now have theoretical approaches to explain this and empirical evidence support it. Political institutions are those things that affect the rules of the game in which politics is played. For the most part "institutions" is taken to mean formal rules as embodied in constitutions, and other forms of legislation. However, it may also refer to norms and informal rules.

Two basic categories of political institutions are electoral rules and forms of government. The former refers to features such as district magnitudes and electoral formulas that translate votes into seats. It also refers to the rules for selecting candidates and for governing their tenure in office. The latter category refers to such as whether the systems is presidential or parliamentary, how decision making powers are divided between central and local governments, or the executive and legislature, and whether citizens have a direct say in policy making via referenda.

Our aim in this article is to sketch an intellectual framework that is useful in shaping discussions about how political institutions may shape policy outcomes. To breathe life in the discussion, we do this by way of specific examples, referring to recent research on the topic – we do not attempt to provide a comprehensive overview of theoretical modeling or empirical knowledge. In each case, the example illustrates the potential for theoretical frameworks to shape thinking on the topic backed up with empirical analysis.

When political scientists debate democratic institutions, they frequently use two metrics for their performance – *accountability* and *representativeness*. The former refers to the way in which political institutions make politicians (and to some degree bureaucrats) answerable for their actions. The second refers to whether the policies and/or policy makers fairly reflect the population as a whole.

Translated into the language of economics, these two performance dimensions correspond well to two main conflicts of interest that arise in representative democracies – those between politicians and citizens and those between groups of citizens with competing economic interests. The problem of accountability deals predominantly with the former and representativeness with the latter. As normative criteria, the welfare underpinnings of these metrics are somewhat vague, but they do provide a useful way of thinking about the positive effects of political institutions.

Economic models for studying accountability are mostly based on some form of *agency* approach. Such models assume that there exist problems of hidden actions (moral hazard) and hidden types (adverse selection) in politics. Politicians typically have career concerns which lead them to seek re-election. Voters decide whether or not to re-elect based on the record of politicians. To make the problem interesting, there has to be some conflict of interest between politicians and voters. The simplest (and most widely used model) supposes that this is due to opportunities for rent seeking (or effort avoidance) among politicians. The question is then how much of this conflict of interest rubs off onto policy choice in equilibrium, i.e., when voters and politicians are behaving rationally and optimally. There is now a large body of literature using such models. Political institutions can affect policy in such models in three main ways – affecting the information that voters have to assess politician performance, directly affecting incentives of politicians to extract rents and affecting the kinds of people of who are selected for public office. (See Besley (2006) for a broad survey of agency models and their uses.)

Economic models for studying representativeness rely on some kind or another of a *spatial* framework. These models envisage citizens being located at different points in the space according to their underlying economics interests (such as their age or ability) and their social interests (such as ethnicity). The classic Downsian model of political competition falls in this class and many subsequent developments have built on its insights. More recent work has tried to make the framework more tractable by supposing that voting is probabilistic – there is a random elements in the ballots cast by voters and politicians can therefore not be exactly sure how policies translate into voting outcomes. In standard models, competition is directly over policies without regard to who is being asked to carry these policies out. More recent approaches have looked at the problem of picking policymakers to deliver these policies. This is particularly important when modeling the credibility of policies being offered. (See Persson and Tabellini (2000) for a broad survey of spatial models of policymaking and their uses.).

In this essay, we will illustrate the main themes of the recent literature by focusing on four examples of how political institutions shape policy. Two of these examples deal with electoral rules, two with forms of government, broadly defined. Two of the examples are motivated mainly from cross-country empirical applications, while the other two are motivated more from studies of within-country variation. (Persson and Tabellini (2003) discuss empirical work on cross-country studies of political institutions, while Besley and Case (2003) discuss within-country studies for the US). Thus, Sections 2-6 discuss, in turn, the policy consequences of adopting proportional or plurality elections, the effects of parliamentary or presidential forms of government, the consequences of term limits for elected politicians, and the impact of direct or representative democracy. Section 7 concludes.

2 Proportional or Majoritarian Elections

Political scientists often describe a key trade-off in electoral systems: electoral formulas based on plurality rule promote accountability at the expense of representativeness, while formulas based on Proportional Representation (PR) errs on the other side of the trade-off. Recent theoretical work by economists has analyzed the consequences for governments spending of having legislative seats awarded by plurality rules rather than proportional representation (PR) – an issue closely related to representativeness. The key idea is relatively straightforward (see Persson and Tabellini (1999), Lizzeri and Persico (2001), Milesi-Feretti, Perotti, and Rostagno (2002)). If candidates with the highest vote shares win every seat at stake in a district – rather than seats in proportion to their vote shares – it becomes more attractive to target spending to small and geographically concentrated groups of voters. (The same will hold true if each district has small magnitude, i.e., represents a small share of the electorate.) This tilts equilibrium policy towards spending programs with benefits targeted to particular geographical groups, not the electorate at large, and (perhaps) towards higher overall spending.

Empirical work has sought to evaluate these predictions using cross-national data. Long term inertia in the broad features of electoral systems makes it necessary to rely on the cross-sectional variation in the data, which – together with the non-random selection of electoral systems – raises a number of statistical issues. These issues are tackled by a variety of methods in Person and Tabellini (2003, 2004), who classify actual electoral systems according to their electoral formula (classifying by district magnitude gives similar results) and approximate geographically non-targeted spending by welfare-state programs, such as pensions and unemployment insurance. Their results indicate that a reform from an all-PR to an all-plurality-rule system would cut welfare spending by about 2% of GDP in the long run. Such an electoral reform would cut overall government spending by a whopping 5% of GDP.

The underlying theory works off the incentives of politicians and takes party structure as given. Yet, it is a well document fact that PR promotes a more fractionalized party system than plurality rule (see e.g., Lijphart (1990)). Austen- Smith (2000) studies a model where redistributive tax policy is set in post-election bargaining, assuming that the number of parties is, exogenously, higher under PR than plurality rule. He shows that this produces higher taxes and spending under PR. Bawn and Rosenbluth (2005) and Persson, Roland and Tabellini (2005) obtain a similar prediction but endogenize the number of parties. In their models of parliamentary democracy, they how that coalition governments spend more than single-party governments under each electoral rule. We should still observe higher spending in PR systems, but this is an indirect effect of a larger number of parties increasing the incidence of coalition government. Persson, Roland and Tabellini (2005) derive an empirical way of discriminating between indirect effect and the direct effect via the incentives of politicians. Using panel data for parliamentary democracies since 1960, they find that the higher overall spending observed under PR is entirely due to its more fractionalized party systems and hence more frequent coalition governments compared to plurality rule.

A second body of theory relates to the accountability of politicians under alternative electoral systems. The key idea here is that extraction of rents – or, more generally, corruption – is better deterred if chances of re-election for individual lawmakers (or parties) may respond more forcefully to their performance (see Myerson (1993), and Persson and Tabellini (2000)). Large district magnitude achieves this by allowing easier entry and a larger number of candidates than small districts. Personal ballots impose individual accountability and stronger incentives than party-list ballots, which impose only collective accountability. In other words, systems where a larger number of lawmakers are elected in each district, and systems where they are elected on personal rather than party-list ballots, are both expected to reduce rent extraction by politicians. Empirically, Persson and Tabellini (2003) find quite sizeable effects in the hypothesized direction on different perception indexes of corruption, or on inefficiency in the delivery of government services.

3 Presidential or Parliamentary Governments

How well voters can hold politicians accountable also depends on the form of government. This insight goes far back in political writing. For example, James Madison insightfully discussed various aspects of the separation of powers in his contributions to the Federalist papers. Economists have recently produced modern versions of the argument as to how separation of powers across political offices may serve to limit conflicts of interest between voters and their elected representatives. Extending the agency model of Ferejohn (1986), Persson, Roland, and Tabellini (1997) show that separating the proposal powers over taxes and spending creates a conflict between politicians that enable voters to better discipline their power to extract rents when in office.

This approach is extended to include issues of representativeness by Persson, Roland and Tabellini (2000), who analyze how different forms of government shape fiscal policy by embedding different forms of legislative bargaining in spatial voting models. They assume that presidential systems have a more extensive separation of powers across legislators than parliamentary systems. On the other hand, as in Huber (1996) and Diermeier and Feddersen (1998), parliamentary systems make the government subject to a confidence requirement of the legislature. whereas a presidential system does not (the president is directly elected). These two institutional features shape the legislative bargaining, such that legislative majorities in presidential systems become less stable than in parliamentary regimes. If majorities re-form, issue by issue, different minorities are pitted against each other for different issues on the legislative agenda. As a result, broad spending programs suffer at the expense of targeted spending. Moreover, the lack of a stable legislative majority means that there is no well-defined residual claimant on government revenue. This reduces the incentives to boost overall taxation and spending. Overall, we should thus expect presidential regimes to be associated with lower total spending and smaller broad (non-targeted) spending programs than parliamentary regimes.

Persson and Tabellini (2003, 2004) confront these predictions by data, where real-world forms of government are classified as parliamentary or presidential, depending on whether the executive is or isn't subject to the continual confidence of the legislature. For broad welfare state programs, they find the hypothesized result only among long established democracies, among which presidential regimes spend less, by about 2% of GDP. For overall spending the results are very robust across samples and in line with the basic hypothesis. Whether the results are obtained by OLS, instrumental variables or matching methods, the finding is that presidential regimes have smaller governments by at least 5 % of GDP – again, a large number.

4 Term Limits or Not

Political accountability is achieved in part by re-election chances responding to performance while in office. This resembles the kind of contractual relations that arise in a market context and provide workers with incentives. However, the relationships between politicians and voters are not contractual – they resemble something closer to a fiduciary relationship. While political parties may have a role in disciplining politicians, the ultimate sanction is electoral: poorly performing incumbents are removed from office by the voters.

The frequency of re-election and the number of terms that a politician can serve become important institutional choices in shaping electoral accountability. The agency model of politics referred to above provides a tool to approach these issues. The theory suggests two ways of thinking about term limits: incentive effects and selection effects. Incentive effects arise because politicians who face a shorter time horizon are less obliged to please voters. Whether this increases or reduces the quality of policy is moot. On the one hand, politicians may have less incentive to please voters and hence may follow their private agendas. But politicians may also be tempted to pander to voters, in the process eschewing hard decisions that may impose short run costs in exchange for long-run benefits. This latter effect can lead term-limited politicians to “do the right thing”. Either way, if electoral incentives matter, we should expect term-limits to shape political decisions. Terms limits will also induce a selection effect. Politicians have to be elected to lame-duck terms. Rational voters should anticipate this when deciding whether to (re)elect them, which will make politicians elected to lame-duck terms “better than average”. Such positive selection may counteract any adverse incentive effect.

U.S. states provide a natural experiment for looking at the impact of term limits, because Governors are subject to such limits in around half the states. This allows two kinds of comparisons: across time of governors who are up against a terms limit vs. their first non-term limited period in office, and across states of term-limited and non-term limited governors.

Besley and Case (1995) identify the effect of a term limit from the difference between first and second terms in office for incumbents facing term limits. Controlling for state fixed effects and year effects, and using annual data from the 48 continental U.S. states from 1950-86, they find that a variety of policy measures are affected by term limits. Specifically, state taxes and spending are higher in the second term when term limits bind in states that have them. Such limits tend to induce a fiscal cycle with states having lower taxes and spending in the first gubernatorial term compared to the second. More recently, List and Sturm (2006) have applied these ideas to environmental policies at the U.S. state level and also find evidence of a term-limit effect. They observe that the way in which environmental interests are represented in policy may depend on whether the Governor is in his last term in office.

Term limits have also been advocated as solutions to institutional distortions in legislatures. A good example is the committee system in the U.S. Congress, which puts a premium on seniority of politicians and may therefore induce voters to have an unwarranted demand for re-electing their Congressman with a resulting diminution in accountability (see Dick and Lott (1993) for development of this argument).

A host of studies look for effects of announced retirements on voting behavior in Congress. On the whole, it has been difficult to find evidence of a last-period effects. For example, Lott and Bronars (1993) analyze Congressional voting data from 1975-90, and find no significant change in voting patterns in a representative’s last term in office. McArthur and Marks (1988) look at Congressional behavior in a lame-duck session of Congress: in post-election sessions, members who have not been reelected are at times called upon to vote on legislation before the swearing in of the new Congress. They find that lame-duck representatives were significantly more likely in 1982 to vote against automobile domestic content legislation than were returning members.

5 Direct or Representative Democracy

Whether polities should use some element of direct democracy as part of their political institutions is widely debated. The two most famous examples are U.S. States and Swiss Cantons that both display considerable variation in their reliance on initiatives and referenda. From a theoretical point of view, issues of accountability and representation are important in thinking through these issues.

Some commentators (for example, Denzau, Mackay and Weaver (1981)) emphasize the role of initiatives in reducing rent-seeking by government and hence enhancing accountability in the political process. This underpins a number of studies investigating whether jurisdictions that permit initiatives have smaller governments. For example, Matsusaka (1995) regresses government expenditures and revenues on a number of control variables for a panel of 49 U.S. states (Alaska excluded) sampled over a 30-year period at five year intervals from 1960 to 1990. He includes year effects, but not state fixed effects, since the presence of initiatives is largely fixed within states over time. His main finding is a strong negative effect on expenditures of access to the initiative. Matsusaka(1995) also finds some evidence that the effect is strongest where the signature requirement on expenditures is low. Similarly, Pommerehne (1990) shows that Swiss cantons using the initiative have smaller state governments.

Others emphasize the fact that initiatives can change the representation of policy preferences. A large body of empirical evidence from political science supports the lack of congruence of policy and voter preferences on a variety of issues (see Besley and Coate (2000) for references).

Gerber (1999) considers how, given a set of policy preferences in a legislature, the availability of the initiative could change equilibrium policy. Moreover, the legislature may make such a change preemptively, if legislators anticipate the possibility of an initiative at some later date. Hence, the possibility of initiatives forces greater agreement between voter preferences and policy outcomes, assuming that representatives elected to the legislature have views that are out of step with the citizens as large. Similar conclusions follow from the theoretical analysis of Besley and Coate (2000) but for quite different reasons. They develop a model in which initiatives affect electoral outcomes. They argue initiatives have an impact via *issue unbundling*. In general elections, many issues are decided at once, which may result in non-salient issues being distorted away from the preference of a majority. Initiatives allow such issues to be unbundled from other issues in the election. Besley and Coate show that this can change the probability distribution of a range of policy outcomes and the composition of candidates who are chosen to run. Both of these theoretical approaches, as well as many popular discussions of initiatives, imply that citizens' initiatives are a device for bringing policy into line with public opinion.

One strand of empirical literature on initiatives has used data from US states to test whether public opinion and policy outcomes are closer together in initiative states. For example, Lascher, Hagen and Rochlin (1996) and Camobreco (1998) investigate whether the link between aggregate measures of policy outcomes and public opinion is closer when states allow citizens' initiatives. They find no significant effect. With respect to specific policy issues, Gerber (1999) uses cross-sectional state variation from the 1990s and compares stances on an array of policies. She finds significant differences (at the 10 percent level) for personal income taxes (initiative states lower); highway, natural resources and hospital spending (initiative states higher in all cases); and the implementation of "three strikes" legislation (initiative states lower). Gerber looks in greater detail at the death penalty and parental consent laws for abortion, using public opinion data to estimate median voter preferences. With cross-sectional data for 1990, she runs a logistic regression that interacts whether a state has an initiative with public opinion, and finds that states with initiatives mirror public opinion on abortion and the death penalty more closely even though these policies are not directly determined via initiatives

6 Final Remarks

The examples discussed above illustrate how knowledge in the field has benefitted from research targeted towards understanding specific issues, even though they can be nested in broader debates about accountability and representation. Theoretical and empirical research on the boundary between economics and political science has uncovered systematic relationships between political institutions and policy outcomes and is currently being extended to new domains of economic policymaking.

One challenge for the future is to study what determines changes in institutions over time. It is evident that studying how political institutions work, the focus of the discussion here, is a necessary part of research on institutional change. From a theoretical point of view, it is important to understand whose interests are served by particular institutional arrangements and how policies change as a consequence of them. For practical purposes, this will likely be a piecemeal agenda dealing with specific constitutional arrangements rather than examining constitution design from the ground up. This is why the kind of "nuts and bolts" issues illustrated in our four examples provide the basis for further progress in the field.

Much of the empirical research, so far, has adopted a relatively simple approach, where political institutions are taken as given and the hypothesized institutional impact is the same across political, social and economic conditions. As is well known from the microeconometric treatment literature, this can easily lead to biased estimates. Current research has started to address non-random selection of political institutions as well as the likely existence of heterogenous treatment effects, where the effect of a specific institutional reform depends on social and historical preconditions. Measurement and econometric testing of these complex issues would benefit greatly from new theoretical research on the endogeneity and conditional effects of institutional reform.

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