

Political Explanations of Inefficient Economic Policies -
An Overview of Some Theoretical and Empirical Literature

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1. BACKGROUND

Basic tradition of public economics: Govt policies aim to remedy market failures
Look for optimal policies, found by maximizing SWF subject to constraints

Reality of policymaking: Observed policies often appear to deviate from optima
First-generation explanation: “politics,” without explicit analysis of political process
Modern explanations: Explicit politico-economic models in rational actor framework

Each model is constructed ad hoc for a specific perceived inefficiency
Different models have different political settings, singly or in combinations
[1] electoral, [2] lobbying, [3] legislative and bureaucratic
Each makes prior assumptions about what policies are available
without explaining these choices by basic “contracting technologies”
Need an overview to see different models in common frameworks
Also need to relate theoretical and empirical literatures better

Here we attempt to organize inefficient outcomes around two “technological” issues
[1] enforcement and commitment problems for promises
of policies by governments / candidates, and of voting by citizens
[2] information and agency problems
between citizens and governments, politicians and bureaucrats ...

We try to ask whether the combination of problems is essentially political
or would it arise in non-political approaches to the same issues

We begin to relate theoretical and empirical work, but much remains to do
We raise many more questions than we answer

2. EXAMPLES

a. Tax and transfer policies

Personal and corporate income tax systems have complex provisions with loopholes and opportunities for evasion and arbitrage

Seemingly inefficient redistribution: Transfers via public works, price subsidies

Complex and costly bureaucratic rules

Cases/examples: J. Birnbaum and A. Murray, *Showdown at Gucci Gulch*

About U.S. income tax reform of 1986 – numerous special interests seemed likely to make result even worse, but were defeated by unlikely legislative coalition

Theoretical models:

[1] Information-based but without politics: First-best personalized lump-sum transfers not incentive-compatible. (Hammond)

[2] Information-based with politics: Coate-Morris.

[3] Credible commitment-based with politics: Acemoglu-Robinson etc.

Will discuss the last two in detail

b. International trade

In most cases, any trade restrictions at all are inefficient

Incidence of policies almost opposite to order of economic merit:

complex quotas by categories, and VERs, are chosen instead of tariffs

Export subsidies that worsen terms of trade (Strategic use of export subsidies is fine in theory but the economic benefits are rare and small in practice)

Cases/examples: J. Bovard, *The Fair Trade Fraud* tells how U.S. procedures are misused
But substantial liberalization has occurred under GATT/WTO for 50 years

Theoretical models: Lobbying by organized special interests; contributions. Older ad hoc influence-function models. Grossman-Helpman common agency model

c. Regulation

Capture; protection of inefficient incumbents

Excessively costly methods of intervention: mandates/requirements and allocations

Cases/examples:

[1] Ackerman and Hassler, *Clean Coal, Dirty Air*.

How and why coal-fired power stations were given costly mandate to install scrubbers instead of using much cheaper clean coal

[2] Traditional methods of spectrum allocation favor political supporters, incumbents

Some improvements in recent years - use of tradeable permits, auctions etc.

But these policies in practice differ significantly from their textbook forms

Theoretical frameworks:

[1] Older tradition of capture theory: Chicago-style models of political markets (supply of, and demand for, policies that favor different interests)

[2] Modern models of legislature and bureaucracy:

Bureaucrats' rents: Banerjee QJE 1997, Acemoglu-Verdier AER 2000

Delegation: Gilligan-Krehbiel JLEO 1987 etc.

3. DIMENSIONS OF CLASSIFICATION

A. STANDARD OF EFFICIENCY – OBJECTIVE FUNCTION

Questions -

[1] Whose preferences to allow when judging optimality or efficiency?

If a group does not organize for lobbying, is that voluntary choice justifying neglect of its welfare in efficiency judgment?

We generally favor the fully inclusive approach.

[2] Whether to respect individuals' feelings of envy etc. about others.

Individual papers usually make specific choices; any general principles for larger issue?

B. STANDARD OF EFFICIENCY – CONSTRAINTS

Question – which constraints are truly inviolable (implying a lower evaluation standard) and which ones to regard as removable, so failure to remove them is an inefficiency?

i. **First-best** – only resource and technology constraints

ii. **Second-best** – constrained by some unavoidable distortion

or restriction on available instruments justified by information or commitment considerations

Related to Williamson's remediability, or interim efficiency in contracting literature

Special questions in political economy -

- (1) Which institutions to take as given / fixed, which ones to regard as open to reform?
Reform of policies within an institutional framework vs. reform of institution
- (2) Is inefficiency in organizations and procedures of bureaucracy
an inherently *political* explanation? Two considerations:
James Q. Wilson – public bureaucracies have special features: Multiple issues without
scalar outcome measures; multiple principals.
Prendergast – bureaucracies used for allocating goods where markets don't work;
so inefficiency is inherent feature of the problem, not a political failure
- (3) Constitutions and institutions deal with many different issues (economies of scope?)
Should efficiency be judged by average outcome, or for each separately?

iii. Second-best constrained also by some ad hoc restrictions on available instruments

This is common in many models, which include only certain kinds of taxes, subsidies
or other policies, and even special functional forms such as a linear tax;
and allow only specific legislative / bureaucratic institutions, procedures
Then it is not clear whether the outcome being inefficient is a consequence of these
ad hoc restrictions, or an essential feature of the situation

C. NATURE OF EXPLANATION

i. Counterarguments denying basic claim of inefficient outcomes

Assertions or arguments that everything is actually optimal

These are usually explicit or implicit appeal to Coase Theorem

Examples - Stigler, Wittman

Weaker version - Everything tends toward efficiency,

or at least comparative statics work in the right direction

Examples - Becker, Peltzman

General idea: If losing interests fail to mount sufficient opposition, this is

prima facie evidence that their losses cannot have been large enough.

But this ignores game-theoretic aspects: the winning side may have strategically

raised the campaigning or lobbying costs of the losing side

(parallels from industrial organization).

But the losing side should have anticipated this ...

Rebuttals of these “denials” are explanations of failure of Coase Theorem in politics

Can group these under two major but interconnected themes

ii. Enforcement and commitment problems

Political promises are not formally justiciable contracts

Governments / candidates may renege on their policy promises

Citizens may renege on their promised votes

without facing any contractual penalties enforceable by third parties

Political enforcement mechanisms (elections) are imperfect

Highly imperfect but useful analogy with problem of equity owners' control over board/CEO

Efficient bargains may not be subgame perfect (Acemoglu, Robinson etc)

Equilibria under self-enforcement constraints typically inefficient

iii. Agency and information problems

Information asymmetries causes of inefficiencies in usual way

But how does this arise specifically in political processes?

Incentives and rent-sharing methods in electoral or lobbying contexts

may have special limitations, e.g. Ferejohn 86 (bounded compensation space),

Bureaucracies have multi-task, multi-level, and multi-principal problems

Special combinations of adverse selection and moral hazard (Coate and Morris 1995)

Will discuss one prominent example of each of these in some detail;

then a small sample of literature to see how they fit into these categories.

4. COMMITMENT EXPLANATION – ACEMOGLU-ROBINSON, APSR 2001

Setup: Two sectors of production (e.g. farming, manufacturing), Two periods

Farmers are politically decisive in Period 1

New entrants choose sector based on expected incomes (including transfers)

(Only new entrants make this choice; others are locked in)

Manufacturing is more productive in Period 2

If sufficient new entrants join manufacturing sector, political power shifts to that sector and the newly decisive group makes second-period policy

Efficient redistribution in this setup is one that does not distort new entrants' choice of sector;
e.g., cash transfer to those who were initially in farm sector

Inefficient redistribution induces new entrants to join less productive sector;
e.g., general price subsidies in agriculture

To prevent loss of political power, incumbent farmers choose inefficient policy in Period 1

If the (potentially) newly-powerful sector could commit to Period 2 policy of making an efficient transfer to farmers, then the inefficiency could be avoided

Powell (APSR 2004) shows that this is a fairly general property of a class of dynamic games

When [1] Current decision-makers cannot commit to lock in future policies of redistribution etc.

[2] Current decisions affect identity or preferences of future decision-makers

This dynamic commitment problem leads to the inefficient use of (current) power

Failure of “political Coase theorem”

5. INFORMATION / AGENCY EXPLANATIONS – COATE-MORRIS JPE 1995

Setup: [1] Public project has sure benefit to a special interest, may also benefit rest of society

Citizens less informed ex ante about project than political decision-maker

Ex post flow of benefit to citizens does not fully reveal whether project was ex ante efficient (i.e., ex post outcome is stochastic)

[2] Heterogeneous politician types, differ in degree of bias in favor of special interest

Citizen does not directly observe politician type

[3] So voters have two types of uncertainty

Policy uncertainty: about social desirability of project

Politician uncertainty: about type of politician

Timing: Incumbent politician observes quality of project and decides

(a) whether to adopt project; and (b) level of cash transfer to special interest

Citizens observe incumbent's actions.

If project was adopted, citizens observe realized benefits from project

Election in which incumbent faces a challenger of stochastic quality;

Voters have noisy signal about challenger type

Winner of election decides on (nonnegative) transfer to special interest

Citizens are better off with positive cash transfers to the special interest than with zero cash transfer together with ex ante bad project

A “good” politician would always choose zero transfers and only adopt ex ante good projects
So choosing positive cash transfer reveals negative information about incumbent politician
Citizens can’t commit not to use information about policy choice against the incumbent,
So “bad” politician has reputational incentive to avoid cash transfer, and instead favor
special interest by adopting project even though bad
Possible equilibrium: inefficient redistribution

NB: Need both types of uncertainty to get inefficient equilibrium

Without policy uncertainty, politician can’t use project to disguise type
(So explanation won’t work for policies that can never be efficient,
e.g. many forms of trade restrictions.)

Without politician uncertainty, voters can choose optimal strategies
(re-election probability function of politician type and observed policy)
to give the politician the right incentive to avoid inefficient outcome

6. EXAMPLES OF PAPERS WITH MIXTURES OF THESE CONSIDERATIONS

A. OLSON, APSR 1993

This paper introduces the famous distinction between stationary and roving bandits. Both types want to maximize what they can extract from the economy but the former has long horizon and therefore “cultivates” the economy with policies that promote growth; latter uses “slash-and-burn” methods. Olson says that even a stationary bandit will not promote full efficiency: his optimal tax rate is $< 100\%$ so he does not internalize full marginal benefit.

This sounds like commitment explanation. If the bandit could strike enforceable deal with citizens and rivals, everyone would favor efficient policies. But the model has informational component. Without information asymmetry, stationary bandit has no need to use distorting taxation.

B. GROSSMAN-HELPMAN, AER 1994

Common agency model. Organized lobbies are principals; they offer the ruler payment schedules as functions of policies. Model has complete information, so not clear why game has principal-agent structure with non-cooperative equilibrium concept. Answer presumably has to do with enforcement / commitment aspects. In fact, two-stage subgame-perfect Nash equilibrium of this common agency model is efficient for the players active in the game, but not for whole society. Also ad hoc restrictions on available set of policy instruments (tariffs in original G-H; variants in subsequent literature).

C. BECKER-MULLIGAN, JLE 2003

They assume that the degree of inefficiency (dead-weight loss) of a policy

affects how hard its proponents and opponents fight for and against it

Efficient policies generate more support from those favored by the policy,

but that may lead to higher government spending and taxation

Taxpayers recognize this, and may therefore be willing to support inefficient subsidies

because they limit the political pressure from beneficiaries

This has commitment aspect – if the beneficiaries could commit not to lobby harder

for expansion of more efficient programs, taxpayers be more willing to accept these

Model has many ad hoc aspects, but authors have supporting regression estimates

D. PARENTE-PRESCOTT, *Barriers to Riches*, 2000

Political process favors incumbents who benefit from current technologies

This creates barriers to technological innovation

Overcoming these barriers is possible but costly

New technology has to be sufficiently better; so some inefficient lock-in

New entrants cannot commit to make future transfers to those who would lose

by giving up their current protected positions

But don't systematically examine the reason for this, and the question

why it is more serious in some countries / political environments than in others

Explanations like "in a democracy, explicit transfers are politically unpopular"

E. ACKERMAN-HASSLER, *Clean Coal, Dirty Air*, 1981

Context: 1970s policies to reduce SO₂ emissions from coal-fired power stations in U.S.

Efficient solution: set emission caps and let polluters achieve these at least cost,
which would mean using low-sulfur clean coal from western states

Actual policy: mandate requiring costly installation of scrubbers in smokestacks

Reason proffered: Coalition of producers of high-sulfur coal in the eastern states
and environmentalists who wanted caps tight enough to bind in western states

Begs question of why better solutions were not feasible; vague explanations in terms of
coalition-building, limits of congressional attention etc.

Other case studies of regulatory policy follow similar approach:

[1] transportation (Morrison et al, JLE 1999, Winston Fiscal Studies 2000)

water (Timmins NTJ 2002)

These emphasize the role of interest groups, but don't go to fundamental determinants

[2] U.S. savings and loan crisis (Romer and Weingast 1991, Kroszner and Strahan 1996)

These describe some informational and agency considerations that
led to delayed and costly resolution of the problem

[3] Trade adjustment (Hufbauer et al 1986)

Describe how these policies did not in fact promote adjustment;
inflicted large costs on consumers

Highlight the role of special interests in the formulation of policy,
but not coherent analysis of why some political bargains were possible and others not

7. RECAPITULATION, COMMENTS

Identifying some gaps in the literature

These should be viewed as opportunities for future research

Question common to all scientific theories – What and how far down to endogenize
Political economy literature has improved substantially over the last 30 years
but still leaves opportunities for improvement.

A. CASUAL APPEAL TO PLAUSIBLE EXPLANATIONS

Without analysis of why better bargains not feasible

So tantamount to assuming the explanation

Models of elections and explanations for diffuse/unorganized special interests:

Individual voters / potential lobbyists don't have the incentives to acquire information

But why don't parties disseminate information to acquire / maintain reputation,
or political entrepreneurs acquire the information and campaign on its basis?

On the other hand, Wittman assumes such a process works perfectly

Need better-founded analysis of the middle range

what is feasible under what circumstances, in what kinds of political systems etc.

B. UNEVEN MIXTURE OF RIGOROUS AND AD HOC ASSUMPTIONS

Detailed specification of rational choice and equilibrium in some dimensions,
combined with ad hoc assumptions on others or dismissal of other problems
e.g. Earliest political economy literature had “rational economics, ad hoc politics”
Modeling is much better now, but even in the best of them, for example
Grossman-Helpman have sophisticated game or contributions between organized groups
and politicians, but do not explain which groups organize successfully,
in fact have a model with complete information so agency not really needed
May be unavoidable interim research strategy but need improvement

C. A SEPARATE MODEL FOR EACH QUESTION?

Many theoretical models set out to explain one particular situation or observation
and make just the right set of assumptions that will yield that result
Models should be judged by stricter criterion - what else can this model explain?
Related question: need model of multi-issue aspect of constitutions and institutions
Examine and explain the reasons – political economies of scope

D. CONNECTION BETWEEN THEORY AND EMPIRICAL WORK

Theoretical models usually produce at most casual evidence in support
Fails to examine what alternative hypotheses could yield the same result
Empirical work generates hypotheses from at most casual theorizing
Often constitutes an estimate of inefficiency and not test of hypothesis concerning
the political source of inefficiency – fails to distinguish between alternatives