

## Strathprints Institutional Repository

Jennings, C. and Mclean, I. (2008) *Political economics and normative analysis*. *New Political Economy*, 13 (1). pp. 61-76. ISSN 1356-3467

Strathprints is designed to allow users to access the research output of the University of Strathclyde. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. You may not engage in further distribution of the material for any profitmaking activities or any commercial gain. You may freely distribute both the url (<http://strathprints.strath.ac.uk/>) and the content of this paper for research or study, educational, or not-for-profit purposes without prior permission or charge.

Any correspondence concerning this service should be sent to Strathprints administrator: <mailto:strathprints@strath.ac.uk>



Jennings, C. and Mclean, I. (2008) Political economics and normative analysis. *New Political Economy*, 13 (1). pp. 61-76. ISSN 1356-3467

<http://strathprints.strath.ac.uk/7279/>

This is an author-produced version of a paper published in *New Political Economy*, 13 (1). pp. 61-76. ISSN 1356-3467. This version has been peer-reviewed, but does not include the final publisher proof corrections, published layout, or pagination.

Strathprints is designed to allow users to access the research output of the University of Strathclyde. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. You may not engage in further distribution of the material for any profitmaking activities or any commercial gain. You may freely distribute both the url (<http://eprints.cdlr.strath.ac.uk>) and the content of this paper for research or study, educational, or not-for-profit purposes without prior permission or charge. You may freely distribute the url (<http://eprints.cdlr.strath.ac.uk>) of the Strathprints website.

Any correspondence concerning this service should be sent to The Strathprints Administrator: [eprints@cis.strath.ac.uk](mailto:eprints@cis.strath.ac.uk)

# STRATHCLYDE

DISCUSSION PAPERS IN ECONOMICS



POLITICAL ECONOMICS AND NORMATIVE ANALYSIS.

BY

COLIN JENNINGS & IAIN MCLEAN

No. 08-02

DEPARTMENT OF ECONOMICS  
UNIVERSITY OF STRATHCLYDE  
GLASGOW

# Political economics and normative analysis<sup>1</sup>

Colin Jennings (University of Strathclyde)

Iain McLean (Nuffield College, University of Oxford)

## Abstract

The approaches and opinions of economists often dominate public policy discussion. Economists have gained this privileged position partly (or perhaps mainly) because of the obvious relevance of their subject matter, but also because of the unified methodology (neo-classical economics) that the vast majority of modern economists bring to their analysis of policy problems and proposed solutions. The idea of Pareto efficiency and its potential trade-off with equity is a central idea that is understood by all economists and this common language provides the economics profession with a powerful voice in public affairs. The purpose of this paper is to review and reflect upon the way in which economists find themselves analysing and providing suggestions for social improvements and how this role has changed over roughly the last 60 years.

We focus on the fundamental split in the *public economics* tradition between those that adhere to *public finance* and those that adhere to *public choice*. A pure public finance perspective views failures in society as failures of the market. The solutions are technical, as might be enacted by a benevolent dictator. The pure public choice view accepts (sometimes grudgingly) that markets may fail, but so, it insists, does politics. This signals institutional reforms to constrain the potential for political failure. Certain policy recommendations may be viewed as compatible with both traditions, but other policy proposals will be the opposite of that proposed within the other tradition.

In recent years a *political economics* synthesis emerged. This accepts that institutions are very important and governments require constraints, but that some degree of benevolence on the part of policy makers should not be assumed non-existent. The implications for public policy from this approach are, however, much less clear and perhaps more piecemeal.

We also discuss analyses of systematic failure, not so much on the part of markets or politicians, but by voters. Most clearly this could lead to populism and relaxing the idea that voters necessarily choose their interests. The implications for public policy are addressed. Throughout the paper we will relate the discussion to the experience of UK government policy-making.

The approaches and opinions of economists often dominate public policy discussion. Economists have gained this privileged position partly (or perhaps mainly) because of the obvious relevance of their subject matter, but also because of the unified methodology (neo-classical economics) that the vast majority of modern economists bring to their analysis of policy problems and proposed solutions. The idea of Pareto efficiency and its potential trade-off with equity is a central idea that is understood by all economists and this common language provides the economics profession with a

---

<sup>1</sup> This paper is published in the March, 2008 edition of *New Political Economy*

powerful voice in public affairs.<sup>1</sup> The purpose of this paper is to review and reflect upon the way in which economists find themselves analysing and providing suggestions for social improvements and how this role has changed over roughly the last 60 years.

We focus on the fundamental split in the *public economics* tradition between those that adhere to *public finance* and those that adhere to *public choice*. A pure public finance perspective views failures in society as failures of the market. The solutions are technical, as might be enacted by a benevolent dictator. The pure public choice view accepts (sometimes grudgingly) that markets may fail, but so, it insists, does politics. This signals institutional reforms to constrain the potential for political failure. Certain policy recommendations may be viewed as compatible with both traditions, but other policy proposals will be the opposite of that proposed within the other tradition.

In recent years a *political economics* synthesis emerged. This accepts that institutions are very important and governments require constraints, but that some degree of benevolence on the part of policy makers should not be assumed non-existent. The implications for public policy from this approach are, however, much less clear and perhaps more piecemeal.

We also discuss analyses of systematic failure, not so much on the part of markets or politicians, but by voters. Most clearly this could lead to populism and relaxing the idea that voters necessarily choose their interests. The implications for public policy are addressed. Throughout the paper we will relate the discussion to the experience of UK government policy-making.

## **Public finance and public choice**

### **The public finance approach and normative analysis**

The normative basis conventionally used in Economics is Pareto efficiency which is, in turn, embedded within the maximisation of a social welfare function. Pareto efficiency in its narrowest form states that those changes, and *only* those changes, which make at least one person better off while making nobody worse off should be

made. This would seem to be highly restrictive. However, the possibility of compensating losers from the gains accruing to the winners greatly expands the set of possible policy initiatives to include all those that maximise social surplus. At the core of this approach lie the two theorems of welfare economics:

- Every competitive economy is Pareto efficient
- Every Pareto efficient resource allocation can be attained through a competitive market mechanism, with the appropriate initial redistributions<sup>2</sup>

At one level the first theorem is often considered a statement of the genius of free market institutions as originally posited by Adam Smith. The second theorem could be viewed as a device that binds economists together regardless of their political views. Whatever the societal preference for distributive justice, society can have what it wants (determined by the specification of a social welfare function) at no cost in terms of efficiency. Indeed, the economist may argue that such an ethical choice requires the expertise of the moral philosopher and the economist can concentrate on the first theorem – that is achieving efficient outcomes. In theory, issues of efficiency and distribution can be separated.

Public finance emerges from the recognition that the conditions required for the two theorems to hold are not possible. Market failures are widespread caused by non-excludability, non-rivalry, imperfect competition and problems of information (both lack of information and its asymmetry). In addition, lump-sum taxes are infeasible. As such, redistribution requires distortionary taxation so that efficiency and distribution can no longer be completely separated. The failure of the two theorems creates much work for the policy expert. Policies to improve efficiency must be devised and redistribution must now take account of efficiency losses.<sup>3</sup> This approach is classically seen in the work of Pigou, where it was famously challenged by Coase. It also thrives in the fiscal federalism literature; see for example Oates.<sup>4</sup> Pure public finance proceeds in an institutional vacuum. The government is a benevolent dictator and will implement best policy. Citizens are depicted as passive and this follows naturally from the assumption of a benevolent dictator. The dictator will not be influenced by interest groups or the opportunity of personal gain, so citizens presumably see no case for becoming politically active. The policy expert is

triumphant as they inform the benevolent dictator of the best means to provide for efficiency, redistribution and macroeconomic stability (the traditional tri-partite roles for public finance as defined by Musgrave).<sup>5</sup> We will not attempt to discuss the multitude of areas in which advice is proffered, but will make reference to specific examples later in the paper. It suffices to say that the twin goals of achieving allocative efficiency with due regard for equality provides the template to which virtually all academic economic advice refers.

Designing policies to achieve these objectives is in itself an exceptionally complex task, for example consider the difficulties involved in designing preference revelation mechanisms for provision of public goods or the problems posed by the theory of second-best.<sup>6</sup> For this reason the public finance economist may, with some justification, argue that this provides a challenging enough problem without having to worry about political institutions. Furthermore, is it not a sensible division of labour that economists concern themselves with efficiency and leave the concern regarding institutions to the political scientist? Indeed it could be argued that by fulfilling their role, public finance economists have greatly assisted the political scientist by providing a picture of an optimal world which institutions should aim to provide, but direct engagement in institutional design is not their concern. This is certainly not a view that would be shared by adherents of the public choice approach.

### **The public choice approach and normative analysis**

Clearly the public finance approach is not realistic. It is free of institutions and is really an exercise in social engineering where the task is the technical one of devising policies to achieve maximum social surplus. There will be differences of opinion over the distribution of income, but assuming this is the only dimension of political disagreement and preferences are single-peaked the view of the median voter will win. But how this uniquely selected level of redistribution is achieved is once again a job for the expert in devising optimal tax regimes. The idea here is that redistribution will occur until the marginal social benefit of increased equality equals the marginal social cost of increased distortionary taxation.

James Buchanan's early work on positive public choice launched attacks on two fronts. One strand attacked the focus on social choice emerging after the publication

of Arrow.<sup>7</sup> The debate surrounding Arrow's theorem that a rational social ordering will always violate at least one desirable property seemed beside the point to Buchanan. For him, the idea of an organic society democratically ranking social outcomes was misguided. Social choice rests on a category mistake. Societies do not choose, people do.

The second strand of Buchanan's attack concerned the idea of motivational non-neutrality as practised in public finance – where participants in the market are modelled as self-interested, but the dictator is wholly altruistic.<sup>8</sup> Public choice argues that the various political actors (politicians, voters, interest groups and bureaucrats) should also be modelled as self-interested and the consequences of such an assumption explored in greater depth. This provides the subject matter for the positive strand of public choice. The idea of an unconstrained, revenue-maximising Leviathan is provided by Brennan and Buchanan.<sup>9</sup> Brennan and Buchanan set up an environment which they admit is unrealistic, but crucially, is at least as realistic as the environment inhabited by public finance. In this world, even democracies can basically be viewed as dictatorships as elections may do little to hold government to account. Here government is modelled as a self-interested Leviathan (motivated as self-interested just as economists generally model individuals in a market setting) and thus the model of monopolistic behaviour serves as a useful benchmark for how we should expect Leviathan to behave. Just as a monopolist will seek to maximise profits, Leviathan will seek to maximise tax revenues for personal gain and just like a monopolist the Leviathan would prefer to price discriminate in terms of tax rates if possible.

The value of institutional constraints upon such a Leviathan has provided the normative core of Public Choice just as Paretianism and social welfare has provided the normative core of public finance. As with Rawls' veil of ignorance, Buchanan and Tullock analyse how citizens might choose a set of institutions under a veil of uncertainty regarding their future positions in such a society.<sup>10</sup> In such a constitutional setting citizens will realise that sometimes they will win politically and sometimes lose and thus will design institutions to sufficiently constrain government and prevent extreme outcomes. The constitution will design electoral rules, post-electoral institutions, the degree of decentralization and stipulate constitutional rights



(to protect minorities from the potential electoral ‘tyranny of the majority’) backed by an independent judiciary. The spirit and intent of the US Constitution and its various checks and balances is often held as an ideal set of institutions. The policies that emerge from the political process may not be so different from those that would be proposed by public finance economists as before, but now the scope of government activity has been restricted. To this extent the difference between public finance and public choice is not so much on policy content but on just how much policy there should be. However, it is also possible (indeed more likely) that the policies that do emerge would be very different from those proposed by public finance economists and it is in this that a further striking difference in the two approaches exists. Public choice in its purest form may view policy advice as largely pointless. Policy will emerge as the equilibrium of ‘in-period’ political play between the various political actors in a society and this may be unresponsive to ‘good’ advice. The best/only thing that can be done is to influence policy via a common agreement at a constitutional stage to introduce institutional reform which implements procedural rules and substantive constraints.

Many public choice scholars would not take as extreme a line and would argue that policy proposals may have significant influence on the policy process. However, it may also be the case that policy proposals differ in the two schools of thought due to different views on human nature. One area may be the extent of using market forces for the provision of government services. For instance, if public finance economists extend public motivation beyond the dictator to public sector workers in general, then public finance economists may argue against the use of market forces in public provision on efficiency grounds. Another difference may emerge from the constitutional perspective itself. In addition to the sorts of constitutional proposals mentioned above, Brennan and Buchanan also make a radical proposal for a fiscal constitution. These fiscal constraints may be complementary or a substitute for non-fiscal constraints depending on specific circumstances. Of greatest relevance for this paper on policy advice, the fiscal constitution proposed by Brennan and Buchanan would actually recommend specific rules for tax rates. Therefore, they simultaneously provide policy recommendation as part of their constitutional recommendations. Or put differently, they take an area, taxation, conventionally viewed as a policy instrument under the control of government and implicitly open to in-period policy

advice and instead fix it as part of a set of constitutional rules, thus not leaving it open to policy advice. Further, these recommendations with regard to taxation may be the opposite of those proposed in the optimal taxation literature. Allowing Leviathan to use taxes causing least distortion is equivalent to helping a monopolist to price discriminate. They have access to taxes that are too good at raising income. As such, uniform taxation or even rules such that taxation should be focussed on goods with the most elastic demand would greatly restrict Leviathan's tax-raising power. The more distortionary the tax base the better it is for tying the grabbing hand.

Clearly if elections are more powerful and/or non-fiscal rules are substitutes for fiscal rules then Brennan and Buchanan's controversial approach to taxation could be relaxed. Nonetheless, such a view could not have emerged from the public finance perspective but follows naturally once self-interest on the part of politicians is assumed. Constitutions are important, as Hume had argued, to protect us from knaves.<sup>11</sup> So the shift in the normative public choice perspective is from in-period policy advice to higher level advice on the rules of the political game and sometimes these rules will simultaneously embody policy content. Policy advice may be ignored by politicians as it may conflict with the self-interest of government. However, if institutions are well designed the agent (the government) will take actions that serve the principal (the electorate) if it leads to being re-elected and being re-elected is attractive for the politician. So policy advice is not irrelevant, but the adoption of such advice is dependent in turn on a 'good' set of institutions.

The public choice approach opened up a role for economists as advisors not just on policy initiatives, but also on the reform of the institutions within which such policy takes place. Public choice scholars have traditionally been very clear in the constitutional recommendations they make. In addition to the possibility of fiscal rules, we can also add inclusive voting rules (Buchanan & Tullock), decentralisation to promote yardstick competition (Brennan & Buchanan), constitutionally binding redistribution and macroeconomic stability and thus let in-period politics deal only with allocative efficiency (Mueller).<sup>12</sup> We will argue in the next section that modern political economics is more reluctant to make bold recommendations. However, we will also argue that this is now also true of the work by scholars identified more closely with the public choice tradition.

## **The political economics approach and normative analysis**

In the introductory chapter of their influential book, Persson & Tabellini argue for combining the best of three traditions: the theory of macroeconomic policy, public choice and formal political analysis.<sup>13</sup> Their deviation from public choice is methodological; they write ‘Researchers in this tradition were reluctant, however, to use formal game-theoretic tools or to impose strong notions of individual rationality. As a result, the initial work sometimes relied on weaker theoretical or microeconomics foundations.’

This is also the substance of the argument by Alesina, Persson and Tabellini in their debate with Blankart & Koester.<sup>14</sup> Alesina et al argue that Blankart & Koester’s attempt to make a clear differentiation of the two approaches is misguided and rather they regard political economics as evolving out of public choice (along with the theory of macroeconomic policy and formal political analysis). We largely agree with Alesina, Persson & Tabellini. However, we also believe that there is one area in which political economics does represent a fundamental shift from public choice. This comes through the willingness to include public motivation in political economics models. But, we also argue that a willingness to accept public motivation has also been a feature in the more recent work of scholars closely associated with public choice. In the third subsection, we also address the increasing attention being given to voter rationality.

## **Positive political economics and normative analysis**

A key problem with the public choice emphasis on constitutional reform is how would a constitutional convention be created? Solving the institutional principal-agent problem, with regards to political rules and the internal incentive structure of public bodies is the major task, but advice on institutions will not be sought if current arrangements are satisfactory for the government or powerful interest groups. So why, for instance, would a dictatorship ever initiate a convention on constitutional reform which would ultimately reduce its power? Such a move from dictatorship to well-designed democratic institutions should lead to an improvement in both efficiency and equity. Where a self-interested dictator rules over a passive citizenry,

the tax rate is set at a level that maximises revenue to the dictator but not social surplus and transfers are made not to achieve some ethical objective, but rather to enrich the dictator.<sup>15</sup> Clearly a movement towards greater efficiency (lower taxes) is not in the interests of the dictator as it reduces revenue. The situation can only change if citizens are active rather than passive. Active citizens can force change through the threat of revolt and change may either arise by rewarding citizens with a larger slice of the pie or institutional reform (for example extension of the franchise).

This process of institutional change takes us a long way from the idealised environment of a constitutional convention of experts selecting a socially optimal set of institutions. Instead, democracy develops as a sequence of compromises between the ruler and the ruled and these institutions are likely to result in policies that will still greatly trouble academic advisors. In particular, there may be a concern that government remains too powerful with too great an opportunity to be corrupt. Policies may be geared too much towards satisfying powerful interest groups rather than towards the public interest. The existence of compromise institutions leaves substantial room for policy and institutional advice. Whether a self-interested government would wish to listen to such advice is questionable, unless it would lead to clear electoral advantages which would compensate for lost revenue (either through reduced corruption or support from interest groups). This, in turn, depends on the existence of powerful political competition.

So institutions do not tend to have been created in some ideal setting, but rather they have evolved. These institutions may be efficient or inefficient, where we define efficiency in the standard Paretian sense. More precisely, we can split institutional inefficiency in to two types: the productive inefficiency of government institutions (which would include corruption) and where redistribution occurs it may occur inefficiently in that it happens at a higher cost than would seem to be necessary.

Inefficient institutions create a paradox at the heart of public choice analysis. If there are policies or institutional arrangements that would increase social surplus, then why would the government not wish to implement them and become better off in the process? This is essentially a rephrasing of the Coase Theorem – if there are gains in social surplus why do the relevant agents not find a way of dividing up the gains to leave all parties better off?<sup>16</sup> The problem is that such moves would not be rational

for the government if it led to a change in political equilibrium that resulted in their loss of power or income. So inefficient policies and institutional arrangements may continue because no clear way of separating efficiency and distribution can be found. It is not possible to compensate the losers of political change, because the winners will have no *ex post* incentive to do so – there is a time-inconsistency problem.

So, for example, efficient policies that would enrich a certain group of citizens could, in theory, be implemented with a promise that they would compensate the political leaders out of their increased wealth at a later stage. However, the political leaders will anticipate that the group instead of compensating them *ex post*, will use their increased wealth to try and take power themselves or extract further favourable policies. For example, increasing public sector efficiency today could be made worthwhile with the promise of *ex post* rewards but future taxpayers may not agree. Anticipation of this may destroy the incentive to increase efficiency today.

Similarly, Acemoglu and Robinson argue that in areas such as trade policy, agricultural support and labour markets transfers continue to be made inefficiently because the beneficiaries of these understand that efficient transfers in the form of cash transfers may reduce the future numbers in the interest group and thus lead to the cancellation of all transfers by future taxpayers.<sup>17</sup>

Perhaps the most famous example of time-inconsistency is in macroeconomics as analysed by Kydland and Prescott.<sup>18</sup> The government announces a low inflation target, but for electoral reasons expands the money supply at a later date. But since agents in the economy rationally know that the government, which faces an election every four or five years, cannot credibly commit to low inflation, they will not believe the inflation target in the first place and by expecting higher inflation will demand higher wages and the policy is ineffective. The solution to this problem is to remove control of the money supply from the government, but then why would any self-interested politician agree to rules over discretion? We will return to this issue later.

The problem of commitment is a severe problem in a democracy. Any academic policy advisor is required to think not just about social welfare, but whether the policy

advice is time-consistent. It could be argued that theorising about ideal constitutional rules, without identifying a solution to time-inconsistency and/or identifying how such a constitutional convention could come about is interesting but ultimately irrelevant.

If the focus on commitment and the naivety of theorizing about ideally created constitutions is an implicit attack on traditional public choice, a more explicit attack is provided by Besley & Coate.<sup>19</sup> Buchanan had argued that the public finance/welfare case for public intervention clearly fails to take account of the political process. In public finance theory, the introduction of a policy instrument (such as a tax or subsidy) would lead to socially optimal provision of, for example, externality producing goods. In reality, interest groups compete so that the level of actual provision may be socially inferior to that which would have existed in the free market. The pure public finance approach recommends too much intervention as it does not consider political market failures emerging from the political process.<sup>20</sup>

Besley & Coate take this point, but instead argue that there is an additional implication neglected by the public choice critique. The public choice critique ignores the spillover effects of introducing new policy instruments. So for example, socialising health care provision may lead elderly voters who normally vote for right parties to support left parties. This alters political coalitions and in turn has effects upon a host of other policy dimensions. All of these effects would need to be considered, many of which could have a positive effect upon social welfare. Indeed, they provide a model where the first best provision of a public good is zero, but due to its positive effect upon redistributive taxation it would be worth providing, they write that “the conservative bias of the public choice critique suggested by earlier work need not apply”. (p.255).

However, in the process of weakening the public choice critique we are left with a much less clear view of normative intervention than was the case with either the public finance or public choice approaches. So a trade-off occurs between *getting things right* and the ability to make normative recommendations.

A crude description of the difference between public finance and public choice is that the former finds big government more acceptable. The former focussed on the failure of markets and the latter focussed on the danger of putting too much faith in government to solve these failures. Political economics as a synthesis would seem to be more at home with both points of view and to that extent is harder to attach a particular political preference to. More focus is given to positive analysis and empirical work on the effects of institutions with much less emphasis on prescriptive analysis. Often in the public choice literature institutional innovations that would reduce the size of the state would be explicitly or implicitly recommended. Modern political economics tends to stress trade-offs without stating explicit preferences. So for example Persson and Tabellini's focus on the trade-off between the leanness of majority rule but at the expense of more narrowly focussed policies versus the bloatedness of PR but with the benefit of more generally focussed policies.<sup>21</sup>

All the examples provided here are either ambiguous with regard to what is 'best' or take a very sceptical view as to the possibility of achieving 'best'. However, as mentioned above this work could simply be viewed as an evolution of public choice where much closer attention is paid to modelling and statistical techniques. The application of these techniques creates scepticism with regard to the confidence of normative public choice. Nonetheless, the underlying assumptions of agent motivation are not different in the work we have discussed so far. A large volume of work in political economics is happy to relax the self-interest assumption.

### **Restoring public motivation and normative analysis**

Social progress in the public choice approach will not emerge from the altruism of politicians, but rather the creation of good institutions which align the self interest of political agents with the electorate. Constitutional moments may occur which allow for institutional innovation on the part of the advisor. The public choice approach emerged as the antithesis of the public finance approach and we now argue that a dialectic has led to a synthesis of the two approaches emerging in recent years. In this synthesis institutions are certainly viewed as important, but not all politicians are bad. We label this approach the political economics synthesis.

What has caused this synthesis? Modern economics has become more open minded with regard to the contents of a utility function. Human beings are seemingly much less self-interested than *homo economicus* can account for and as a result economists are less inclined to assume pure self-interest in their models.<sup>22</sup>

This general development in economics has been reflected more specifically within the political economics literature. An ambivalence regarding the motives of politicians is reflected in the literature on *political agency*.<sup>23</sup> This work applies models of asymmetric information where political types (either 'good' or 'bad') exist and the task for the voter is to identify which of these the incumbent government is and vote accordingly. The problem is that the bad politician will sometimes have the incentive to mimic the action of a good politician. This in turn creates two conflicting benefits of elections. On the one hand, if a bad politician behaves well to get re-elected this is a positive *discipline* effect. On the other hand, if they do so there is a higher probability that the government will be of lower quality after this election, this is called the *selection* effect.

The optimum lies between allowing too much freedom for politicians who may turn out to be corrupt and binding the hands of government that may have been benevolent. As an example, forcing inefficient taxation constitutionally as a means of reducing tax-raising power would not be a sensible idea if politicians are likely to be bad. Therefore, political economics, unlike the other two traditions, does not provide clear implications on policy/institutional initiatives. Public finance prescribes optimal first order institutions. Normative public choice claims that such institutions are unachievable and settles for second-order institutions such as constitutional rules.

Besley and Smart discuss various restraints upon Leviathan and show how institutional recommendations are strongly affected by the likelihood of politicians turning out to be good or publicly motivated.<sup>24</sup> They analyse the case for inefficient taxation, limiting the power to tax, increasing fiscal transparency and yardstick competition. Allowing for different political types has a major impact on institutional design. Crucially, creating rules for inefficient taxation and yardstick competition only works if there are a relatively high proportion of good politicians. If this is the case, the improved selection effect compensates for the reduced discipline. Bad



incumbents find it less attractive to mimic good politicians as the potential gains are so limited, so they extract surplus today instead and accept losing the election. This will be welfare increasing if the bad incumbent is likely to be replaced by a good politician. This finding is, of course, ironic as these constitutional devices were recommended for an environment in which all politicians were assumed to be bad. The implication for normative analysis and constitutional design, in common with the previous subsection, is ambiguous.

This ambiguity is not applicable only to political economics. It has been happening within traditional public choice circles as well. An aspect of this can be traced to the public choice focus on the 'paradox of voting'. Since the likelihood of determining the outcome of elections is effectively zero there would appear to be very little *instrumental* benefit from voting. So if there is any cost to voting, the benefit that drives people to incur this cost must be a direct or *expressive* benefit. What precisely this expressive benefit is lies open to debate, but one possibility is that it may be ethical. It is easier to think morally when one does not have to pay the cost of a decision and this is the effect that being non-decisive when voting creates.<sup>25</sup>

A variation on this argument has been made by Brennan and Hamlin (1999) where they construct an argument for representative democracy as a first-best arrangement for political decision-making rather than a second best one (second best because it saves on the transaction costs of direct democracy). Their argument is that we may possess moral dispositions which seek out politicians who are moral when we vote expressively. This would lead to a morally superior parliament than one that would have been selected randomly. Beyond this argument though, the scope for normative recommendation in the book by Brennan and Hamlin is greatly reduced compared to that contained in Brennan and Buchanan.<sup>26</sup>

Le Grand distinguishes politicians as being knights or knaves, and citizens as being pawns (passive) or queens (agents). With this framework he argues that post-1945 government policy proceeded as if it were an interaction of knights and pawns. This, of course, is also the public finance approach. Le Grand identifies the Thatcher years in the UK as signalling a switch to the idea of knaves interacting with queens. Thus, we see moves towards privatisation, reduced taxation and eventually the introduction

of market forces in the provision of public services. This was clearly influenced by public choice reasoning.<sup>27</sup>

Since the change of UK government in 1997, there seems to be a greater tension as to whether politicians should be viewed as exhibiting knight or knave characteristics and whether voters should be viewed as pawns or agents. For example, The Bank of England was made independent and this could be interpreted as a view of politicians as essentially knavish in that they could not be trusted with monetary policy.

However, surely it would take a knight to implement such an institutional change and have the courage to bind their own hands? An alternative interpretation is also available. This could simply have been the action of a knavish politician who wants to be re-elected. The Labour party realising that they lose elections due to a lack of trust in their economic competence take this measure and adopt other rules (such as the Golden Rule that over the economic cycle governments should borrow only to invest and not to fund current spending) to establish a good reputation. Whether Gordon Brown was a knight or a knave, the interests of vote-seeking politicians had become aligned with an institutional innovation that was in the voters' interests.

The Labour government has continued (although with considerable internal party dissent) with the use of market forces in the provision of public services. To that extent, the public choice perspective is winning through. But running contrary to this point is the increased size of the state under the Labour government and this trust in the ability of government to intervene and solve for market failures is much more in line with a public finance view. The presence of both a trust in the role of government, but an awareness of the importance of incentives is characteristic of the more complicated motivational landscape as discussed above.

### **Uninformed voting, populism and normative analysis**

Much of what has been said is based on the assumption that if citizens do get to make choices that they are well-informed. This assumption has been given considerable attention recently. This goes back to the problem of 'rational ignorance' as recognised by Downs.<sup>28</sup> Citizens may not understand the policies being proposed, have no economic incentive to become informed (due to the probability of determining the outcome of elections being effectively zero) and thus choose irrationally. Non-

benevolent politicians may feel no great incentive to attempt to correct for this ignorance and provide the policies that the people want regardless of their implication for social welfare.

The possibility that the electorate will not choose policies that are in their own interests is very damaging for academic policy advice as good policy is no longer necessarily a vote-winner. The 'Chicago' school would argue that this argument is overly pessimistic.<sup>29</sup> They would argue that rational ignorance would imply random selection rather than consistently irrational choice and furthermore rational people learn from mistakes and will not continue to support 'bad' policy. Furthermore, democratic political competition and a free press will provide information on policy choices and the behaviour of incumbent politicians thus limiting their ability to be corrupt. So, voters may not be completely ignorant and combined with vibrant political competition this may ensure that voters are more likely to vote their interests than not and if this is the case good policy advice will be a vote winner.

Voters are rarely confronted with a political choice in which they determine the outcome. So voters may vote against policy initiatives on highly questionable equity grounds without due consideration of efficiency gains, for example tuition fees for higher education and the use of market forces in the provision of public services. Voters may expressively attach themselves against tuition fees or market forces on strictly equity grounds. However, this can blind them to arguments that these stances are either not equitable (particularly relevant to opposing tuition fees) or that the voter should weigh up the potential efficiency gains versus equity implications. These considerations may not enter the voting calculus for the very nature of electoral decision-making is to render voters non-decisive with regard to the outcome; this in turn creates a disincentive to become properly informed about the issues. Voters may also weigh too heavily nationalistic concerns that may lead them to favour protectionist policies that are not in their instrumental interests. Voters may choose more myopically than they would choose instrumentally and this has created difficulties for green taxation for example. In September 2000, direct action by farmers and hauliers in protest against fuel taxes led the UK government to abandon the main form of environmental taxation to that date – namely the fuel duty escalator. Public opinion sided with the protesters.<sup>30</sup> Not until the Pre-Budget Report 2006 did

the UK government gingerly return to the subject of raising environmental taxes, beginning with air passenger duty, which polling had shown to be popular.<sup>31</sup>

Combining this idea with the possibility that politicians may be benevolent or vote maximisers sets up a contrast between actions that would be taken by statesmen versus actions that would be taken by populists. Agency models are relevant here, except that now it would be the good politician who finds that they need to mimic a populist in order to be re-elected. However, it is also good politicians who have the incentive to work harder to inform the public regarding the quality of their policy proposals.<sup>32</sup>

In such a model of politics economic advisors may find themselves in direct conflict with political advisors. The battle between the statesman and the populist is hardly new but is likely to be more intense at times when left and right have largely converged thus creating a more vigorous competition for votes. A central conflict in politics is then between those politicians who wish to listen more to the economic advisor (and risk losing elections) and those that listen more to their political advisor (and risk implementing poor economic policies). The example of UK environmental taxes is again relevant. Chancellor Brown may be fairly accused of having listened to political advisers in 2000 over fuel tax. It is characteristic of his way of working that, when he wishes to prepare public opinion, or give a boost to a trend which is already going in a direction he supports, he commissions an independent or 'independent' review of a policy area by some weighty figure. Such a review was the Stern Review of the economics of climate change, published in November 2005.<sup>33</sup> Sir Nicholas Stern was, at the time of the report, the Head of the UK Government Economic Service. But he was not a conventional government economist. Chancellor Brown recruited him from his previous position as chief economist at the World Bank, and since his report he has returned to academe.

The Stern Report is weighty political economics. It identifies global warming as a global public bad. But then (as Stern and Brown are well aware) there is a global n-player prisoners' dilemma among the governments and peoples of the world. If a government can free-ride on others' efforts to curb global warming, it will, as in the short term defection strictly dominates cooperation. However, in the UK the

opposition Liberal Democratic, Conservative, and (of course) Green parties have already committed themselves to supporting collective action against global warming. Conservative leader David Cameron took a much mocked trip (by air) to northern Norway to see the glaciers there receding.<sup>34</sup> This was part of his repositioning the party, by cheap talk gestures, away from (what was perceived as) the hard right positions associated with Margaret Thatcher and closer to the median voter. By the time the Stern Report was published, therefore, Brown had ample cover to do what he believed to be economically right.

The prescriptive implications of this neglected political dilemma are not clear. If politicians are responsive to voting then it is acting as a constraint on government activity and so may be effective in rooting out corruption. But it may result in policies that are ultimately not in the interests of the voter. This would point towards a greater role for paternalism at the expense of allowing decisions to be made through elections. If this is considered too risky then it could be that populism is the price that has to be paid to avoid further constitutional constraints on government action. Nonetheless, policy or institutional initiatives that improve the information available to voters would clearly be efficient. Further, it calls into question the wisdom of calls for compulsory voting. Perhaps a relatively small, but well-informed turnout is better if there is a tendency towards populism on the part of politicians. However, this would have to be weighed against the potential informational role that electoral participation in itself creates.

## **Concluding Comments**

The paper has traced a dialectic within Public Economics. The optimistic view of government intervention devised in the public finance tradition was met with the pessimistic view contained within the public choice approach. Public choice has both been challenged and has itself evolved in more recent times such that a new synthetic paradigm has emerged in the form of Political Economics. It challenges public choice in its more technical methodology, its increased focus on positive, rather than normative, analysis of institutions and in its willingness to allow for the existence of publicly motivated politicians. A trade-off involved in these developments is that the scope for making proposals for policy and institutional reforms appears to be

considerably less clear than was the case in the public finance and public choice traditions. Finally, we identify a further area of focus that has been receiving increasing attention in recent times. This is the idea that, in addition, to the possibility of markets and politicians failing, voters might also fail to vote their interests and thus provide for another source of failure. This serves to further deepen the difficulty of making clear normative prescriptions in political economics.

## **Strathclyde Discussion Papers 2008 Series**

08-01 Nikos Pappas

Can Migrants save Greece from Ageing? A Computable General Equilibrium Approach Using G-AMOS.

---

<sup>1</sup> See Iain McLean & Colin Jennings (eds), *Applying the Dismal Science: When economists give advice to government* (Palgrave MacMillan, 2006).

<sup>2</sup> Joseph Stiglitz, *Economics of the Public Sector* (Norton, 2000), p.60.

<sup>3</sup> One famous implication regarding commodity taxation is the Ramsey Rule that goods most inelastic in demand should be taxed most heavily as this creates the least distortion. See Christopher Heady, 'Optimal taxation as a guide to tax policy: A survey', *Fiscal Studies*, Vol.14, No.1 (1993), pp. 15-41 for a review of the literature on optimal taxation. We will refer to this rule in the next section.

<sup>4</sup> Arthur Pigou, *The Economics of Welfare* (Macmillan, 1932); Ronald Coase, 'The problem of social cost', *Journal of Law and Economics*, Vol. 3, No.1 (1960), pp.1-44; Wallace E. Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich, 1972).

<sup>5</sup> Richard Musgrave, *The Theory of Public Finance* (McGraw-Hill, 1959).

<sup>6</sup> See chapters 8 and 9 in Yew-Kwang Ng, *Welfare Economics: Towards a More Complete Analysis* (Palgrave MacMillan, 2004) for a discussion of both issues.

<sup>7</sup> James Buchanan, 'Individual Choice in Voting and the Market', *Journal of Political Economy*, Vol. 62, No. 4 (1954), pp. 334-343; Kenneth Arrow, *Social Choice and Individual Values* (John Wiley & Sons, 1951).

<sup>8</sup> James Buchanan, 'The Pure Theory of Public Finance: A Suggested Approach', *Journal of Political Economy*, Vol. 57, No.6 (1949), pp.496-505.

<sup>9</sup> Geoffrey Brennan & James Buchanan, *The Power to Tax* (Cambridge University Press, 1980).

<sup>10</sup> James Buchanan & Gordon Tullock, *The Calculus of Consent* (University of Michigan Press, 1962).

<sup>11</sup> David Hume, 'Of the Independency of Parliament', in Knud Haakonssen (ed), *Political Essays* (Cambridge University Press 1994), p. 24: 'It is, therefore, a just *political* maxim, *that every man must be supposed a knave*: Though at the same time, it appears somewhat strange, that a maxim should be true in politics, which is false in fact.' Originally published in 1741.

<sup>12</sup> Dennis Mueller, *Constitutional democracy* (Oxford University Press, 1996).

<sup>13</sup> Torsten Persson & Guido Tabellini, *Political Economics: Explaining Economic Policy* (The MIT Press, 2000).

<sup>14</sup> Charles Blankart & Gerrit Koester, 'Political Economics versus Public Choice', *Kyklos*, Vol. 59, No. 2 (2006), pp.171-200; Alberto Alesina, Torsten Persson & Guido Tabellini, 'Reply to Blankart and Koester's Political Economics versus Public Choice', *Kyklos*, Vol. 59, No. 2 (2006), pp. 201-08.

<sup>15</sup> See Mancur Olson, *Power and Prosperity: outgrowing communist and capitalist dictatorships* (Basic Books, 2000).

<sup>16</sup> See Daron Acemoglu, 'Why Not a Political Coase Theorem? Social Conflict Commitment and Politics', *Journal of Comparative Economics*, Vol. 31, No. 4 (2003), pp.620-52.

<sup>17</sup> Daron Acemoglu & James Robinson, 'Inefficient Redistribution', *American Political Science Review*, Vol. 95, No. 3 (2001), pp. 649-61. The cost of inefficient redistribution is amplified by the inclusion of any rent-seeking costs and a moral judgement that transfers to some of these groups are not deserved. An alternative explanation of inefficient policies is that voters *systematically* misunderstand economics in various ways, e.g., by wrongly believing that protection is better for the economy than free trade. Bryan Caplan, *The Myth of the Rational Voter: why democracies choose bad policies* (Princeton University Press, 2007).



- 
- <sup>18</sup> Finn Kydland & Edward Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy*, Vol. 85, No. 3 (1977), pp. 473-490.
- <sup>19</sup> Timothy Besley & Stephen Coate, 'On the public choice critique of welfare economics', *Public Choice*, Vol. 114, No. 3 (2003), pp. 253-73.
- <sup>20</sup> James Buchanan, 'Politics, policy and the Pigouvian margins', *Economica*, Vol 29, No. 113 (1962), pp.17-28.
- <sup>21</sup> Torsten Persson & Guido Tabellini, *The Economic Effects of Constitutions* (The MIT Press, 2003).
- <sup>22</sup> See Joseph Henrich, Robert Boyd, Samuel Bowles, Colin Camerer, Ernst Fehr & Herbert Gintis (eds), *Foundations of Human Sociality* (Oxford University Press, 2004) for a comprehensive survey.
- <sup>23</sup> See Stephen Coate & Stephen Morris, 'On the Form of Transfers to Special Interests', *Journal of Political Economy*, Vol. 103, No. 6 (1995), pp.1210-1235; Timothy Besley & Robin Burgess, 'The Political Economy of Government Responsiveness: Theory and Evidence from India', *Quarterly Journal of Economics*, Vol. 117, No. 4 (2002), pp. 1415-52; Timothy Besley, *Principled Agents: The Political Economy of Good Government*, (Oxford University Press, 2006).
- <sup>24</sup> Timothy Besley & Michael Smart, 'Fiscal restraints and voter welfare', *Journal of Public Economics*, Vol. 91, No. 3-4 (2007), pp. 775-73.
- <sup>25</sup> See Robert Goodin & Kevin Roberts, 'The ethical voter', *American Political Science Review*, Vol. 69, No. 3 (1975), pp. 926-28.
- <sup>26</sup> Geoffrey Brennan & Alan Hamlin, 'On political representation', *British Journal of Political Science*, Vol. 29, No. 1 (1999), pp. 109-27; Geoffrey Brennan and Alan Hamlin, *Democratic Devices and Desires* (Cambridge University Press, 2000).
- <sup>27</sup> Julian Le Grand, *Motivation, Agency, and Public Policy* (Oxford University Press, 2003).
- <sup>28</sup> Anthony Downs, *An economic theory of democracy* (Harper Row, 1957).
- <sup>29</sup> See Donald Wittman, *The Myth of Democratic Failure: Why Political Institutions are Efficient* (University of Chicago Press, 1995).
- <sup>30</sup> <http://www.ipsos-mori.com/mrr/2000/c001110.shtml>
- <sup>31</sup> <http://www.ipsos-mori.com/polls/2006/pdf/aet-report.pdf>
- <sup>32</sup> A series of papers have analyzed the problem of pandering/populism in the context of political agency models, see Bandice Canes-Wrone, Michael Herron and Kenneth Shotts, 'Leadership and pandering: A theory of executive policymaking', *American Journal of Political Science*, Vol. 45, No.3 (2001), pp. 532-50; Stephen Morris, 'Political Correctness', *Journal of Political Economy*, Vol. 109, No.2 (2001), pp. 231-267; Eric Maskin & Jean Tirole, 'The politician and the judge: Accountability in government', *American Economic Review*, Vol. 94, No.4 (2004), pp. 1034-54. In these models voters are not viewed as rationally ignorant, but rather that they are misinformed as to best policy at a particular point in time. However, this avoids the problem of trying to explain why voters may consistently and persistently choose bad policies. Bryan Caplan, *The myth of the rational voter: Why democracies choose bad policies* (Princeton University Press, 2000) discusses this issue in depth.
- <sup>33</sup> [http://www.hmtreasury.gov.uk/independent\\_reviews/stern\\_review\\_economics\\_climate\\_change/stern\\_review\\_report.cfm](http://www.hmtreasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm)
- <sup>34</sup> [http://news.bbc.co.uk/1/hi/uk\\_politics/4925444.stm](http://news.bbc.co.uk/1/hi/uk_politics/4925444.stm); Iain McLean, 'Climate change and UK politics, from Brynle Williams to Sir Nicholas Stern', paper for ECPR Conference, Pisa, September 2007.