POLITICAL POWER AND ENDOGENOUS POLICY FORMATION

by

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OUTLINE

Part 1. Political Power and Economic Analysis

Chapter 1 Political Economy and Alternative Paradigms

This introductory chapter provides the motivation for the entire volume. A historical review of paradigms that have been advanced for political-economic analysis is presented. Many of these paradigms are generated from casual empiricism. It is argued that in much political-economic analysis, confusion exists about the roles of explanation and prescription. It is argued that a new perspective is needed whose focal point is the causal mechanisms underlying political power. To explain government behavior, such components must be an integral part of any framework that might be advanced for generating testable propositions as well as any framework that might be used for prescriptive purposes.

Six alternative paradigms of political economy are identified. Although the lines of demarcation among these paradigms are often blurry, the implicit power structure is distinct. The first paradigm is characterized as the Chicago School and has as its major architects George Stigler, Sam Peltzman, and Gary Becker. The second paradigm, rent seeking, originated with the work of Tullock and has been amplified by Krueger, Baghwati, Rausser, Brock, and Magee. The third paradigm emerges from the public choice literature and has as its contributors, Olson, Black, Riker, and Buchanan and Tullock. The fourth paradigm emanates from new institutional economics and its foundation has been clearly established by Coase, Williamson, and North. The fifth paradigm has been at the periphery of mainstream economics from the outset and has been defined as radical or Marxian political economy. Recently, Bowles and his colleagues have orchestrated a reconstruction of this paradigm. Finally, a social power and political bargaining paradigm has evolved from the original work of Nash, Harsanyi, and Zusman. From this paradigm a political governance structure can be derived which allows relative power to be measured and hypothesis tests to be conducted from real-world data rather than stylized facts.

Chapter 2 Axiomatic Bargaining Theory

A bargaining game among organized groups with conflicting interests is a way to explicitly model the process of accommodation among policymakers and interest groups. Under certain conditions, the equilibrium of a political-economic system with government intervention is identified with the solution of the corresponding bargaining model. These conditions are treated as axioms from which a unique solution can be derived. This solution is Nash’s axiomatic solution for a two-person bargaining problem. The Nash solution for fixed disagreement points is presented in this chapter.
Chapter 3  Nonaxiomatic Bargaining Theory

Additional subjects related to the formulation and solution of the axiomatic bargaining problem are discussed in this chapter. First, the Nash bargaining solution with endogenous disagreement payoffs is presented. Next, Harsanyi’s n-person generalization of Nash’s solution is explored. Harsanyi’s solution is useful for our class of problems because in most real-world political-economic situations there are more than two organized groups (including government) involved. Finally, Harsanyi’s model of the social power relationship is presented.

Part 2. Special-Interest Groups and Political-Economic Analysis

Chapter 4  Static Political-Economic Analysis

The political power of the organized interest group derives from its capacity to affect the well being of policymakers. The political power of organized interest groups is thus defined within the framework of a bargaining game and from which uncoordinated, but predictable, responses of unorganized interest groups are taken into account. The analysis induces a political governance structure whose maximization with respect to the policy instrument, given the prevailing economic structure, leads to a political-economic equilibrium. It is shown that the political governance structure is a weighted sum of the policymaker center(s) in organized interest groups’ policy objective function, where the weights are proportionate to the interest groups’ political power over the policymaking center.

Chapter 5  Normative Political-Economic Analysis

The normative properties of the resulting political-economic equilibrium are explored. The welfare implications are evaluated using the standard benefit-cost criterion. Despite the structure of the policy governance function, the resulting political-economic equilibrium is not necessarily efficient. The efficiency problem is investigated and efficiency conditions, stated in terms of the underlying economic and political power structures, are established. The analysis considers social gains and losses due to the choice of policy instruments and the attendant political-economic transaction costs.

Chapter 6  Dynamic Political-Economic Analysis

We explore several general features of political-economic dynamics. This exploration suggests that, as a result of systematic positive feedback loops, political-economic systems tend to gravitate toward particular equilibria sustained by politically powerful, status quo forces. To the extent that such equilibria are manifestly inefficient, reforms occur largely as a result of political crises involving major shifts in the underlying power structure. When the political power structure is fixed over time, the dynamic behavior of a political economy is exclusively determined by the economic structure. Accordingly, the analysis is carried out in the same fashion as the static political-economic analysis except for the economic structure which now contains various dynamic relations (e.g., differential and difference equations), while the participants’ policy-objective functions are expressed in terms of trajectories. Moreover, the political power structure exhibits certain dynamic behavioral regularities and thus can be endogenously determined.
Part 3. Ideology, Prescription, and Political Power Coefficients

Chapter 7  Political Power, Ideology, and Organizational Structures

In Part 2, the political power coefficients, or preference weights, are treated as parameters. After examining a multidimensional specification for political power, the role of ideology in policy formation is examined. Ideologies, consisting of beliefs concerning the functioning of the system, and ethical social values play a crucial role in the determination of political power coefficients. In particular, ideological commitments assist group leaders in controlling the proclivity of participants to free ride. Ideology, along with organizational structures, also affect interest groups’ policy objective functions and their relative political power. The relationship between the organization of interest groups and the government, on the one hand, and policy formation, on the other hand, is also explored.

Chapter 8  Political Power, Influence, and Lobbying

Political power parameters are influenced by allocation of real resources and lobbying by interest groups. The structural determinants of lobbying are identified. The political power associated with the facility of each interest group depends on its allocation of labor resources. Lobbying absorbs labor resources and leads to redistributional gains but incurs a net social loss. The resulting social waste is shown to depend critically on the distribution of relative political power. An alternative formulation introduces asymmetric information and admits the possibility of social gains resulting from labor resource allocations to lobbying efforts. It is shown that the path of the political power structure depends critically upon whether lobbying is “information-revealing” or “information-concealing.”

Chapter 9  Political Power and Constitutional Prescription

The relationship between constitution rules and the political power parameters allow prescriptive analysis to be performed. The most important conditioning elements of the political power coefficients is the underlying collective choice rules or the constitutional space that sets boundaries on the policy formation process. Prescriptive selection across alternative constitutional rules entails evaluating their associated expected utility and their bargaining costs. Bargaining and organizing costs are specified to increase as the constitutional rules go from the sole decision-maker rule to a unanimity rule. Constitutional choices are determined by minimizing the expected transaction costs of implementation. A contract-theoretic approach is employed to explain the logic of the constitutional selection of alternative collective-choice rules.
Part 4. Conceptual Applications to Specific Case Studies

Chapter 10  The Political Economy of Commodity Market Intervention

While dynamic performance of commodity markets, at times, may be unsatisfactory, the corresponding market equilibria are, in principle, efficient. Hence, equilibrium-oriented government intervention is usually redistributive and is effected by politically powerful groups seeking transfers. The distributional and allocational implications of commodity market intervention are derived by examining tradeoffs among economic surpluses political-economic transaction costs and rent-seeking cost. The political power structure is analyzed and the roles of the economic and political power structures in determining chosen policy regimes and values of policy instruments are explored using a game-theoretic approach.

Chapter 11  The Political Economy of Public Research and Development

Private investment in R&D is often suboptimal because innovators are unable to fully appropriate the social benefits of their innovation. Public funding of R&D is designed to remedy this and other sources of market failure. The phenomenon is especially significant in agriculture which is the subject of the present study. Funding decisions are made within a political-bureaucratic hierarchy, and the political-economic equilibrium constitutes a solution to multilevel, nested bargaining games. The group configuration, the political power of the groups, and their policy objectives vary systematically across the political decision hierarchy (e.g., consumers’ interests are most pronounced at the national level). The welfare implications of the political-economic equilibrium are analyzed with the aim of deriving possible organizational and constitutional prescriptions.

Chapter 12  Political-Economic Analysis of Redistributive Policy and Public Good Policy

Chapters 11 and 12 treat commodity intervention policies and public research policies separately. For many governments throughout the world, however, these two sets of policies are jointly determined. These two types of policies are representative of a dichotomous treatment of economic policies. We analyze governments as jointly determining the two policies within a political-economic framework. We examine the effect that the joint determination of the two types of policies has upon the functional relationship between the policies, given the political power theory framework. It is shown that the joint determination of the two types of policy instruments can lead to results which are both puzzling and subject to misinterpretation if the joint determination of the policies is not explicitly recognized.

Chapter 13  Interest Groups, Coalition Breaking, and Productive Policies

In most political-economic models, the members of interest groups are presumed to be homogeneous, with no entry or exit from one interest group to another. The assumptions are implicitly imposed in all of the public-choice literature focusing on government failure and rent-seeking behavior. To the extent that heterogeneity exists among members of a particular interest group, however, it is possible, through creative mixes of policies or the introduction of new political technology, to split interest groups as well as to form new coalitions of interest groups.
Effectively, a potentially winning group may tax itself in order to mitigate the losses suffered by another group whose political strength lies in its ability to veto a move from the status quo. In a prescriptive sense, a political and economic robust mix of policies may manage special interests whose influence might otherwise obstruct the public interest.

**Chapter 14  Political-Economic Analysis of Land Reform**

As suggested by political-economic dynamics, land reform is preceded by major power shift involving the ascent of reform-minded political groups. The organization, motivation, and power bases of groups constituting the political-economy of land reform are examined. Land reform consists of major changes in the structure of property rights in land and stringent restriction of tenurial contracts. The efficiency of a land-reform program depends on both legislation and implementation, the latter generally the responsibility of local bureaucrats. The ensuing political-economic equilibrium is, consequently, reconceived as a solution to a two-level, nested bargaining game. Land reform is essentially redistributive, inducing major changes in the contractual equilibrium. The shift in the equilibrium resource allocation, though hindered by observability problems, is assessed and evaluated.

**Chapter 15  Political-Economic Analysis of Water Resource Systems**

This case study explores the performance of a political economy of natural resource management involving choice among alternative trajectories. The political group configuration consists of two policymaking centers: a central water-supply project (CWP), and a governmental fiscal authority; it also includes $n$ water districts, each acting as an organized interest group whose policy objective is the maximization of the district’s net incomes. To retain simplicity, the analysis focuses on steady states in the water-resource system. Each organized interest group regards the state of water resource systems as a collective good/bad. It is found that due to the narrow rationality of water districts, the political-economic equilibrium is inefficient. Politically set water prices are too low and water utilization quotas are too liberal, so that either an excessive amount of land is lost through water logging or groundwater aquifers are overutilized.

**Chapter 16  Political-Economic Analysis of Trade Liberalization**

Despite the espoused benefits of free trade, trade protection exists in most, if not all, countries of the world. In an attempt to explain these policies, numerous political-economic models of rent seeking have been introduced. Liberalization is shown to harm some groups and, if these groups are sufficiently powerful, they can block moves from the status quo. From a positive, political-economic perspective, an understanding of Pareto-fulfilling compensation forms the basis for assessing the likelihood of reform taking place. Given that losers from a policy change can delay, restrict, or even block the change, the Pareto-fulfilling compensation represents a real barrier for the trade reform process. In this case study, we show that, if the principles provided by the constitution are reflected in an institutional structure that promotes resource mobility or asset diversification, an interest group structure will emerge that has little, if any, incentive to acquire political power and exercise influence.

**Chapter 17  Political-Economic Analysis in Transition Economies**
We build a bargaining-theoretic model of an important dilemma inherent in any major political-economic transition process. While swiftly removing the old order is a necessary condition for a successful transition, it also leads to widespread social disruption that may threaten the viability of the reform process. This issue lies at the heart of much of the “big-bang/gradualism” debate in the literature. We argue that this dichotomy is overly simplistic. In particular, the debate, as it has been framed, has failed to capture the significance of interest group competition. Interest group competition matters precisely because the political environment during a transition is fluid and malleable and is thus open to manipulation by interests seeking to mold post-transition governance structures to best serve themselves. As different economic and political structures will give rise to different incentives within these interest groups, one might expect that transition strategies will differ across societies. We show this is the case with two interesting examples. First, we consider how transition strategies differ in open and closed economies. We are able to derive a number of strong results, the most striking of which identifies conditions under which closed economies outperform open economies in terms of social welfare. Our second set of experiments examines Krueger’s (1993) “vicious and virtuous circles” theory of policy reform. We identify conditions under which societies with political systems that reward rent-seeking behavior enjoy higher social welfare than societies with political systems that reward productive behavior.

Part 5. Political Power Econometrics

Chapter 18  Political Econometrics

To be validated, a theory must successfully pass stringent qualification tests in which the behavioral implications of the theory are compared to actual observations on the selection and setting of the policy instruments. The key concepts of the political-economic theory advanced in this volume are not directly observable (strength of power and the cost of power functions), and thus refutability of the theory requires creative empirical formulations. Solutions to the nonobservability of a number of crucial variables are presented, identification rules are derived, and prediction validation tests are developed.

Chapter 19  The Political Econometrics of the Israeli Dairy Industry

The econometric estimation of the political power structure are determined for the Israeli dairy program over the period of the 1960s and 1970s. Governmental intervention in the Israeli dairy market include import quotas, farm prices for raw milk, and consumer retail prices. Moreover, differential subsidy support across various dairy products is also recognized in the constructed econometric model.

Chapter 20  The Political Econometrics of the U.S. Wheat Industry

The political governance structure representing the relative power of consumers, taxpayers, producers who participate in the policy programs, and producers who choose not to participate is specified. Historical observations on the four policy instruments of the US wheat program (target prices, support prices, diversion requirement, and diversion payments), along with the empirically estimated economic structure are used in a revealed preference methodology to input the power of
various interest groups. Based on the estimated political governance structure, flexible policy rules tied to market conditions are shown to improve economic welfare. Specifically, it is shown that flexible policy rules out perform historic policy instrument settings (determined once every four years) across a wide spectrum of economic conditions.