Political Process and the Formation of Economic Policy

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Introduction

Various episodes of *Yes Minister* and *Yes Prime Minister* may have inured us to the machinations of the Permanent Secretary in Her Majesty's Government, but a deeper message lies within the economics of public choice and bureaucracy. The process of government has profound effects on the kinds of economic policies that emerge from democratic governments and how they are implemented.

Political decision making in the economic sphere involves a balancing of views of different interests to find some common denominator. The final decision in a given case is likely to be influenced by those who bear the costs and those who share the benefits of the policy decision. This article suggests that the transaction costs involved in the political process itself are also important.

Public choice economics has focused attention on many parts of the political process such as the role of constitutions, the use of rules, the earning of economic rents, principal-agency relationships and capture of independent government-owned organisations by interest groups. The meeting place where these issues are resolved is known in public choice circles as the `political market'. The political market can be seen as the collective expression of individual and group preferences through an aggregate decision-making process, the governmental polity.[1] Less attention has been paid to the economics of political processes that are used to formulate economic policy. `Transaction cost' economics, a branch of the `new institutional economics', has some potential in this regard which is discussed in this article.

Working from the writings of Buchanan, Williamson, and North, it is possible to construct a transaction cost model of the political decision process and its effects on the formation of economic policy. The model sees politicians and interest groups resolving their differences by adopting policy measures that suit both parties. Politicians favour policies which extend the life of the party[ies] in power while interest groups favour policies which deliver benefits to them now and in the future. Interest groups are powerful precisely because they can influence voting patterns and party finances. Major transaction costs arise from the difficulties and uncertainties of maintaining control of the process over time.

In the first part of the article I review recent literature in this area, and follow that with a discussion of some of the implications for public policy analysis.

Transaction cost economics

Transaction cost economics derives from the work of Ronald Coase who first posited that when it is costless to transact, the efficient competitive solution of neoclassical

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[1] See D.B.Johnson (1991), *Public Choice: An Introduction to the New Political Economy*, Bristlecone Books, California.

economics obtains[2]. It does so because the competitive structure of efficient markets leads the parties to arrive costlessly at the solution which maximises aggregate income regardless of the institutional arrangements. But with information deficiencies and imperfections in input and product markets further *transaction* costs are incurred by the firm in the conduct of its business. It is no longer costless to transact and the institutional arrangements have a bearing on the outcome as the base line is no longer the neoclassical solution.

As a result, proponents of the institutional approach therefore focus on alternative governance structures in firms and ask what are the *net gains* after costs of information gathering and maintaining contracts have been taken into account[3]. The focus is on organisational alternatives rather than the marginal conditions. The marginal conditions are seen as some `ideal' benchmark which can never be achieved in the real world.

This approach is the basis of Oliver Williamson's analysis of hierarchical organisations and the economics of vertical and horizontal integration[4]. It stresses the role of a number of transaction costs that prevent the pure model of competition working in an imperfect world. In particular, costs of maintaining and policing contractual obligations and asset specificity are the determinants of the final outcome.

Government policy formation

Can this reasoning be applied to government policy-making and organisation? Douglass North, Murray Horn and Avinash Dixit are among those who have applied transaction cost economics to political decision making in the realm of economic policy[5]. There is a new recognition of the role of governance structures in policy making institutions. In turn, these constructs enable policy formation and implementation to be identified separately from the political process of which they are part.

The study of alternative institutional arrangements started with the work of Coase. He observed that the conventional approach in welfare economics was to consider an

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[2] R. H. Coase (1960), The Problem of Social Cost, *Journal of Law and Economics 3,* 1-44.

[3] This follows D.C. North (1990a), *Institutions, Institutional Change and Economic Performance,* Cambridge.

[4] The most recent statement is that of Oliver Williamson (2000), The New Institutional Economics: Taking Stock/Looking Ahead, Invited Paper presented to Annual Conference of the Australian Agricultural and Resource Economics Society, Sydney, January 23-25.

[5] Main references are North, D.C. (1990b), A Transaction Cost Theory of Politics, *Journal of Theoretical Politics 2*, 355-67: Horn, M. (1995), *The Political Economy of Public Administration,* New York, Cambridge University Press; and Dixit, A. K. (1996), *The Making of Economic Policy: A Transaction-Cost Politics Perspective,* MIT Press, Cambridge, Massachusetts.

ideal economic system and then prescribe what is necessary to achieve the ideal. The recognition of the importance of transaction costs transferred analytic interest to alternate systems of governance, whether private or public. Public policy involves a choice between alternative social institutions, which are created by law or are dependent on it. Without knowledge of what could be achieved under alternative institutional arrangements, it is impossible to choose wisely among them[6].

This approach is consistent with classical economics where the primary objective of political economy was to contrast alternative political and frameworks in order that choice among these institutional arrangements might be better informed[7]. The economist following the Pigouvian approach in the analysis of market failure problems is likely to prescribe government action where none is warranted because the method has an implicit bias toward interventionist solutions[8].

The US economist Pasour reasons that the Pigouvian approach is flawed precisely because it ignores transaction costs. If one explores many actual exchange situations it is soon found that they are characterised by imperfect markets, deficiencies of information and unequal bargaining power. As Avinash Dixit puts it: `As a crude but effective caricature, one can say that normative policy analysis began by supposing that the policy was made by an omnipotent (having infinite power), omniscient (infinite knowledge), and benevolent dictator. The work on second best removed the omnipotence. That on information removed the omniscience. However, the assumptions of benevolence and dictatorship have remained unaffected by all these improvements in our understanding of the limits on instruments and information....In reality, a policy proposal is merely the beginning of a process that is *political* at every stage - not merely the process of legislation, but also the implementation, including the choice or formation of an administrative agency and the subsequent operation of this agency' *(italics in original).*

Dixit's approach

Dixit develops an organisational approach as promoted by the likes of Buchanan, North[9], and Williamson[10]. In terms of the political process, Dixit puts it: `the standard

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[6] As stated in Coase, R. H. (1988), *The Firm, The Market and the Law*, Chicago, The University of Chicago Press.

[7] This is set out in Buchanan, J.M. (1989), *Explorations into Constitutional Economics*, R.D.Tollison and V.J.Vanberg (eds), College Station, Texas A & M University Press.

[8] Pasour, E.C. (1993), Economics and the Public Policy Process: What Can Economists Do?, *New Zealand Economic Papers 27,* 1-17.

[9] According to Williamson (1999, p.309), North suggests that the efficiency of politics is to be judged by examining how closely an actual political market `approximates a zero transaction cost result'.

[10] Williamson (1999) does not offer an analysis, to my knowledge, of the economic-political system. He appears to be diverted by the possibly more interesting question, to him, of whether private bureaucracies replicate the attributes of public bureaucracies: `The discrete structural atributes that define and distinguish the public

normative approach to policy analysis views this whole process as a social-welfare-maximising black box, exactly as the neoclassical theory of production and supply viewed the firm as a profit-maximising black box.....Economists studying business and industrial organisation have long recognised the inadequacy of the neoclassical view of the firm and developed richer paradigms and models based on the concepts of various transaction costs'. Dixit therefore suggests that a better model of the policy forming process should be based on an analysis of the relevant transaction costs.

Dixit asks what organisational forms will overcome the monopoly of information held by bureaucrats, the opportunistic behaviour of civil servants, the problem of divided principals, and government-owned asset specificity? He clearly derives his approach from the writings of Oliver Williamson and Douglass North. Dixit identifies transaction costs involved in overcoming the asymmetric distribution of information between parties (signaling and screening costs, costs of monitoring and incentives, auditing costs and costs of misrepresentation), costs involved in managing agents (monitoring, incentives, and contractual obligations), costs of agents responding to multiple principals (coordination of policies, playing off one principal against another) and costs related to asset specificity (irreversible investments and lack of durability).

Following a Williamson approach, Dixit takes the view that the election process creates a contract between the politicians (individuals or parties) or administrators (regulatory agencies etc), and the citizens (individuals or interest group organisations). The contract is a promise of a policy (or programme) in return for votes (or contributions). Unlike private contracts, such policy contracts are difficult to enforce[11].

First, political contracts are rarely between two clearly identifiable contractors; they have multiple parties (voters or lobbyists) on at least one side of the relationship. Second, their terms are generally much more vague (unspoken) than those of economic contracts. They leave much room for interpretation, and many loopholes for escape and opportunities to blame third parties or *force majeure* for failure to deliver. Thus a promise to cut taxes rarely specifies by how much, and can be rescinded when the budget situation turns out to be much worse than expected. In the electoral contract, the citizens have granted the elected representatives certain powers to collect taxes and make decisions on their behalf, the only safeguards in this process remains the free vote and, if this goes, abuse of power is likely to follow.

A Westminster approach

A similar approach has been put forward by ex New Zealand Treasury official, Murray Horn. He spells out some of the details of the exchange the two parties enter into[12]. His interpretation is also driven by bounded rationality, opportunism, agency

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bureau and are responsible for its powers and limitations thus need to be identified and explicated' (Williamson, op cit, p.307).

[11] Williamson (1999, p.310) summarises the Dixit viewpoint; `[he} works out of an incomplete contracting setup in which bounded rationality and opportunism are featured and holds that the object is `to understand how the combined economic-political system evolves mechanisms to cope with the variey of transaction costs that it must face' (Dixit 1996, p.xv)'.

[12] Horn does not specifically refer to the relationship as a contract, nor to incomplete contracts. He states (1995, p.13) that legislators and their constituencies engage in

theory and transaction costs in a parliamentary framework. He introduces some of the specifics of the political process and the accompanying transaction costs, including the cost of durability or lasting impacts. This is a wider definition of transaction costs than described by Dixit above.

Horn's transactions approach examines the relationship among three sets of actors with different roles and motivations. `Legislators' are the elected representatives who perform both legislative and executive functions. Legislation can only be enacted by an `enacting coalition' of individual legislators - that is, a group of legislators that is large enough to guarantee the passage of a bill into law. Constitutional differences between countries affect such groupings and the solutions they might seek. `Administrators' are appointed rather than elected. They answer to the legislature. Horn assumes that they do not bring policy preferences to their work! `Constituents' conveys the idea of particular groups in society that have a [vested] interest in the policy making process. Constituents enjoy the benefits - or suffer the costs - of legislation, offer support or opposition to legislators, and, ultimately, elect legislators to office. While these stereotypes tend to simplify the complexity of the political/administrative process in any one country, Horn maintains that they are sufficiently general to explain decisions legislators make about the organisation of public administration on a broad front.

The approach focuses on the difficulties political decision makers have in securing continued electoral support on a longer term basis. Legislators are regarded as self-seeking in their use of legislation to increase their net political support and lasting power. Their opportunities are limited by the transaction costs of achieving agreement on their proposals. These are the time and effort it takes to reach agreement on legislative refinements and any time and effort that affected private interests subsequently have to devote to participating in implementation and administration; political uncertainty that the legislation will last; uncertainty that the legislation will be administered as intended; and uncertainty about the distribution of private benefits and costs. If such relationships are regarded as the hazards of the `exchange' between the respective actors, then they are generically similar to Williamson's `far-sighted but incomplete contracting'.

The elected/political appointees who are most likely to remain in power are those who are most successful in overcoming these transaction problems in the political process, such as those who are best able to reassure their supporters that the benefits of legislation will not be lost to administrators in implementation, or undone by subsequent legislatures. Successful implementation will depend on administrative agents who do not necessarily share the objectives of the enacting coalition and its constituents; these divergences create transaction costs to do with monitoring the performance of such agents and devising a system of rewards and sanctions that improve performance. There is no reference to asset specificity in this version of the model though government administrations are likely to depend on labour specificity in the administrative staff. Williamson[13] notes that asset specificity is negligible in most

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exchange. Legislators want electoral support and constituents want the private benefits - or to reduce the private costs - of legislation. Failure to deliver is measured at the voting booth and through other means of political support.

[13] Williamson (1999, p.322, 339)

public sector departments but human assets in many public bureaucracies involve considerable specificity (for example, nontransferable training and social conditioning).

Furthermore, the amount of net electoral support legislators receive from promoting a piece of legislation depends on the net flow of costs and benefits that private interests expect it to generate over time. Implementation bears on this calculus because private interests are sufficiently forward looking to anticipate how decisions on implementation will affect the flow of benefits and costs**.** Political support will cease unless they are well pleased (over time).

Horn's model supplements Dixit's model and brings back the broader concepts of public choice into main focus. The uncertainties identified by Dixit (information asymmetry, monitoring of agents and opportunism) create costs in the political process that have to be overcome if lasting control of the Treasury benches is to be achieved. The model posits that the endeavours of the legislators/politicians will continuously be directed to their own survival. This will be achieved by paying greater attention to the wishes of their supporters in a longer term framework. One term of office is never sufficient.

Now in a certain sense, these endeavours can be regarded as an optimal arrangement of the nation's affairs. The model posits that effective public administration requires that the transaction costs be minimised in determining and pursuing society's goals. There will be pressure from constituents to find least cost solutions to the problems of the day. There will be limits on the revenue and challenges from alternative expenditure items including government programmes. Debate and bargaining will tend toward least cost solutions.

Discussion

The insight from the transaction cost model of the political market is that it mimicks how policy decisions are reached in government polities rather better than previous constructions. Outcomes are based on the balancing of interests and the respective power bases of the participants. The balancing of interests extends to policy implementation and performance. Participants have a vested interest in who is to implement a policy and on what terms and will influence the political decision accordingly.

The model recognises that power is unequally distributed and that silent majorities tend to be forgotten. The balancing process assumes the interested participants can anticipate future benefits and costs that affect their welfare and that they will act in this light. The model assumes that self-interest is dominant to the national interest in most circumstances.

The model does not require any deep analysis of political motives but rather sets out a useful framework that explains the process in which economic policy is conceived and executed. It clearly posits that decision making has to be a political process subject to electoral demands and interest group pressure on the one hand, and national interest concerns contained in rational advice from civil servants (who may or may not be disinterested) on the other.

It can be utilised to examine the structure of government bureaucratic organisations. Oliver Williamson offers a detailed analysis of the US Department of State[14]. He asks: could the organisation of foreign affairs by the Department of State be replaced by a private bureau? Not surprisingly, perhaps, he comes to the conclusion that it cannot and that there are specific tasks for which a government bureau is more suited. These tasks include situations where hazards of probity (lack of honesty) are to be avoided and organisational matters such as dependence on labour asset specificity (social conditioning and reliance).

The model indicates that blackboard exercises involving producer and consumer surpluses are of limited use in policy making. The presence of transaction costs will suggest different solutions to a policy problem depending where they fall. The case for government intervention in the market failure case is not clearcut if the costs of intervention outweigh the possible benefits. There may be little or no relationship between the costs and benefits estimated by the outside observer and the evaluations that individuals place on alternatives in actual choice situations[15].

Another application is to ask whether the *policy advice function* in a government bureau could be contracted out? The Canadian department of agriculture, Agriculture Canada, explored this option and sponsored a study of a similar proposal in New Zealand[16]. While the study recognised that alternative sources of advice should be sought, for informational reasons, it came to the conclusion that confidentiality and probity concerns made the function more suitable for a public bureau.

More widely, the international flavour of the analysis overcomes the dominance of US writing on the subject dependent as it is on interpretations of the US constitution[17]. Murray Horn, in particular, while drinking at the fountain at Harvard, has incorporated the Westminster tradition into his version of the model and broadened its application to include state-owned profit-making organisations as well as government-financed bureaus.

While there is still an emphasis on democratic governmental decision making, particularly with regard to maintaining electoral support, the focus on institutional economics broadens the application to non-democratic regimes and offers a fruitful

[14] See Williamson, O.E. (1999), Public and Private Bureaucracies: A Transaction Cost Economics Perspective, *Journal of Law, Economics, and Organisation 15*, 306-42.
[15] A case where such costs exceed benefits [soil erosion] is discussed by E.C. Pasour (1993), Economics and the Public Policy Process, *New Zealand Economic Papers 27,* 1-17.
[16] See Storey, G.G. (1996), Investigation on the Implications of Government Reform in New Zealand for Obtaining Economic and Policy Analysis for the Agri-food Sector, Department of Agricultural Economics, University of Saskatchewan , for Agriculture Canada.
[17] For a comparison of Westminster with the US parliamentary system, see Weaver, R.K. and Rockman, B.A. (1993), *Do Institutions Matter? Government Capabilities in the United States and Abroad,* The Brookings Institution, Washington.

avenue of further research[18]. It also provides an entry point to the analysis of malfeasance and corruption in government administrations[19]

Another application is in the distribution and administration of foreign aid. Many IMF and World Bank programmes are focused on particular national policy programmes or projects which depend on local initiatives and execution[20]. The strengths and weaknesses of national administrations very soon come to the fore when visiting economists seek answers to poor response rates to massive aid packages. Institutional economics offers useful guidance to those seeking reform in E. Europe[21].

A powerful analysis of EU milk policy in this tradition has been published by FAO[22]. In this study, Roland Williams, an ex-official of the Milk Marketing Board, shows how the details of the policy emanated from the terms of the Treaties establishing the European Community. The Treaties provide the *constitution* of the Union for making individual acts of *common* policy, but the individual constitutions of the member states (in all their diversity) provide for the implementation of policy where governments and agencies are dependent on the traditions of past policies and national legislation[23]. Williams suggests that little can be changed in the way of `policy' without first changing the constitutional arrangements which allowed them to develop as they have in the first place[24]. He explicitly rejects `a marginalist approach in which judgement is passed on the system in relation to what the writer *believes* would be the oucome of a free-market situation'.(*italics in original).*

I have argued elsewhere for a more realistic policy-making framework as a guide to better policy making[25]. National and international advisors in ministries would benefit from a better understanding of the institutional background. University training could benefit from the teaching of more institutional economics and its practical applications. More university people could with advantage work in the civil service. General economists could re-assess their welfare models and voluminous writings in the professional literature and pay greater regard to the conditions under which their policy recommendations will have to operate. The world of Pigou would then find its proper place.

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[18] I have discussed this elsewhere, see Johnson, R.W.M. (1990), The Role of Political and Economic Institutions in Rural Strategy Formulation and Implementation (http://WBLN0018.worldbank.org/trade/decagridoc.nsf/referencedocuments).
[19] Johnson (1999, *op. cit.*)
[20] Johnson (1999, *op. cit.*)
[21] See Williamson, O.E. (1995), The Institutions and Governance of Economic Development and Reform, *Proceedings of the World Bank Annual Conference on Development Economics 1994*, Washington, 171-197.
[22] Williams, R. (1997), *The Political Economy of the Common Market in Milk and Dairy Products in the European Union,* FAO Economic and Social Development Paper 142, FAO, Rome.
[23] See Williams (1997), p.7.
[24] Williams, *op.cit.,* p.107.
[25] See Johnson, R.W.M. (1994), The National Interest, Westminster and Public Choice, *Australian Journal of Agricultural Economics 38,* 1-30.