

## CHAPTER ONE

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### What Is Political Economy?

Economists must not only know their economic models, but also understand politics, interests, conflicts, passions—the essence of collective life. For a brief period of time you could make changes by decree; but to let them persist, you have to build coalitions and bring people around.

You have to be a politician.

—Alejandro Foxley, *Chilean Minister of Finance*  
(quoted in Williamson and Haggard [1994])

#### 1.1. INTRODUCTION

How does politics affect economic outcomes? This question has been asked probably as long as people have been interested in economics itself. From Adam Smith's *Wealth of Nations* in 1776 (or perhaps the Physiocrats even earlier) until at least John Stuart Mill's *Principles of Political Economy* in 1848, what we now call "economics" was in fact generally referred to as "political economy."<sup>1</sup> This terminology in large part reflected the belief that economics was not really separable from politics. This was more than an administrative classification of disciplines; it arose from the widespread view that political factors are crucial in determining economic outcomes. Hence, as a discipline economics historically viewed political forces not only as influencing economic outcomes, but often as a determining influence.

With the division of economics and political science into distinct disciplines, economists abstracted from political and institutional factors. The desire for methodological progress and for a more rigorous basis for economic analysis were important motivations in this separation. The development of neoclassical economics stressed optimization by consumers and firms subject to well-defined constraints and a market environment,

<sup>1</sup> According to Groenewegen (1987), the term "political economy" for economics originated in France in the 17th century. He attributes the first use to Montchrétien in 1615. Sir James Steurt (1761) was the first English economist to put the term in the title of a book on economics, *An Inquiry into the Principles of Political Economy*.

deliberately downplaying more amorphous political factors. Those determinants of economic outcomes easily formalized in this choice-theoretic framework were stressed in the development of neoclassical economics; those not easily formalized were seen as largely the province of other disciplines.

Interest in the question of how politics affects economic outcomes may thus appear new to someone trained solely in modern neoclassical economics; in fact, it is not. One may want to keep the history of this interest in mind in assessing phrases such as “explosion of interest” or “recent flood of work” applied to current research in political economy. Nonetheless, looking at what has been happening in the past few years, such phrases are quite accurate. Of late, there really *has* been an explosion in the number of papers looking at the effect of politics on economic outcomes. Leading journals are filled with articles on the “political economy of” one economic phenomenon or another; specialty journals have been started; conferences on a specific economic issue typically have at least one paper on the politics of the issue, not to mention numerous conferences devoted solely to political economy. In short, it appears justified to speak of the “new political economy” as an important field of current research and to conclude that this is not simply a fad, but an area of analysis that is here to stay.<sup>2</sup> In short, political economy falls into that special class of things that seem quite old and musty and quite young and fresh at the same time.

The “new political economy” is not, however, just a resurrection of an earlier approach to economics. Though characterized by a strong interest in the question of how politics affects economic outcomes, the new political economy is defined more by its way of approaching this question. Specifically, it is defined in large part by its use of the formal and technical tools of modern economic analysis to look at the importance of politics for economics. Modern economic analysis is used not just in the formal sense of a mathematical approach; it is also conceptual, viewing political phenomena in terms of optimization, incentives, constraints, *et cetera*. Hence, what really distinguishes the new political economy is not so much the volume, but the sort of research being done.<sup>3</sup>

Formal technique sometimes clouds, rather than enhances, our understanding of phenomena, and sometimes seems to be used as a substitute for insights into the phenomenon being studied. The relative newness of political economy in its current form may make this problem more acute. It has led some people to the perception, incorrect in my opinion, that the

<sup>2</sup> One should, however, note that when asked to assess the significance of the French Revolution, Chinese Premier Chou En-Lai is said to have replied, “It is too soon to tell.”

<sup>3</sup> For example, Alt and Shepsle (1990) defined political economy as the study of rational decisions in the context of political and economic institutions, stressing explicit microfoundations based on rational actors.

new political economy is simply a not very insightful formalization of the obvious. Recent research has also been criticized as being too broad, seen as trying to cover everything, with widely differing degrees of success.

Both the strengths and the weaknesses of the new political economy suggest the need for a more organized treatment. In this book, I not only survey recent work on political economy in macroeconomics, but also attempt to organize the work. As such, the approach is somewhere between a textbook and a monograph. It is meant not only to summarize, organize, and critique the existing literature, attempting to guide the reader through the wilderness, but also, like a monograph, to present a very specific view of the field. I argue that heterogeneity and conflict of interests are essential to political economy and should be the organizing principles of the field. However, whether or not a reader finds himself in agreement with this point of view, he should find an organized treatment of the field very useful. Those readers who do agree with the central role of conflict of interests may thereby gain not only an understanding of different parts of the field, but also a better sense of how they fit together.

## 1.2. POLITICS AND ECONOMICS

What is the new political economy? A general definition is that it is the study of the interaction of politics and economics. Though such a vague definition may have the virtue of being all-inclusive, it gives no real sense of what is being studied. It is like describing the taste of French cooking by saying it results from the interaction of France and cooking. It is technically correct, but one misses the real flavor. Our first task, therefore, is to attempt to provide a definition that will indicate what makes a question one of political economy, and how political economy differs from “straight” economics or from other areas of economics concerned with policy choice. How, for example, is political economy different than the well-developed theories of public finance and public economics? How does it differ from the theory of public choice?

### *Some Preliminary Definitions*

A famous definition of economics is that of Lionel Robbins (1932, p. 16), “Economics is the science which studies human behavior as a relationship between ends and scarce means that have alternative uses.” If economics is the study of the optimal use of scarce resources, political economy begins with the political nature of decisionmaking and is concerned with how politics will affect economic choices in a society. Society should be defined broadly to include not only countries or other such jurisdictions, but also firms, social groups, or other organizations.

Obviously, we cannot go much further without being more precise about what we mean by the term “politics.” In the political science literature politics is defined as the study of *power* and *authority*, and the exercise of power and authority. Power, in turn, means the ability of an individual (or group) to achieve outcomes which reflect his objectives.<sup>4</sup> Similarly, authority “exists whenever one, several, or many people explicitly or tacitly permit someone else to make decisions for them in some category of acts” (Lindblom, [1977], pp. 17–18). Thus, for example, Lindblom defines politics as the struggle over authority. As he puts it (p. 119), “In an untidy process called politics, people who want authority struggle to get it while others try to control those who hold it.”

For our purposes, the most important part of these definitions is what is implicit and taken for granted. Questions of power and authority are relevant only when there is *heterogeneity of interests*, that is, a *conflict* of interests between economic actors in a society. How then does a society make collective policy decisions that affect it as a whole when individual members have conflicting interests? How do individuals, classes, or groups within a larger society gain power or authority to attempt to have the societal choice reflect their preferred course of action? Politics may be thought of generally as the study of mechanisms for making collective choices. Asking how power or authority are attained and exercised can be thought of as a specific form of the general question of what mechanisms are used to make collective decisions.<sup>5</sup>

With this as a basis, we can return to the question of what political economy studies. The view that economics is the study of the *optimal* use of scarce resources contains an implicit, but crucial, assumption when applied to policy choice, namely, that *once the optimal policy is found, it will be implemented*. The problem of policy choice is simply a technical or computational one. Once the optimal policy has been calculated, the policymaker then implements it, where *this* decision is taken as automatic. That is, since the policymaker is a social welfare maximizer, it is taken as given that once an optimal policy is derived, this is the policy that will be carried out. This identity of optimal and actually chosen action implies that a positive economics of policy choice follows almost immediately from the normative economics of policy choice. Note that the process of deciding *technically* what policy to adopt, the decision central to this approach, is very different from the process of deciding on policy which the definition of politics would suggest.

<sup>4</sup> For example, Weber (1947, p. 152) defined power as “the probability that an actor in a social relationship will be in a position to carry out his own will despite resistance, regardless of the basis on which this probability rests.”

<sup>5</sup> Keohane (1984, p. 21) writes, “wherever, in the economy, actors exert power over one another, the economy is political.”

Political economy thus begins with the observation that actual policies are often quite different from “optimal” policies, the latter defined as subject to technical and informational, but not political, constraints. **Political constraints** refer to the constraints due to conflict of interests and the need to make collective choices in the face of these conflicts. Positive political economy thus asks the question how political constraints may explain the choice of policies (and thus economic outcomes) that differ from optimal policies, and the outcomes those policies would imply. To put the same point another way, the mechanisms that societies use in choosing policies in the face of conflicts of interest will imply that the result will often be quite different than what a benign social planner would choose.<sup>6</sup> This positive view implies a normative approach as well: normative political economy would ask the question of how, given the existing political constraints, societies can be led to best achieve specific economic objectives. This includes not only how to “overcome” political constraints within the existing institutional framework, but also the design of political institutions to better achieve economic objectives.

### *Some Examples*

This definition of positive political economy may be better understood by reference to some examples of the questions it addresses. Some phenomena are so clearly in the realm of political economy that little discussion is required as to what are the political influences on the economic outcomes. For example, it is often argued that there is an opportunistic political business cycle, with pre-election economic policies and outcomes influenced by the desire of the incumbent to manipulate the economy in order to improve his re-election prospects. Or, even if incumbents do not, or simply cannot, manipulate the economy before an election, the fact of possible changes in the government after an election may have significant effects on policies and outcomes. If policies were made by an infinitely lived social welfare-maximizing planner who was sure to retain his job (it is, after all, hard to find replacements these days), there would be no effect on policies from the possibility that the policymaker will be replaced. We consider the myriad effects of this possibility in Chapter 7.

In other cases, the role of political constraints may be less in the foreground, but no less important. Consider an economy experiencing hyperinflation, where there is agreement that hyperinflation imposes very large costs on all members of society. The technical problem is how to

<sup>6</sup> The importance of conflict of interests is appreciated in some of the literature in public finance. Atkinson and Stiglitz (1980, p. 298), for example, write, “If everyone had identical tastes and endowments, then many public finance questions would lose their significance, and this is particularly true of the behavior of the state. If the interests of the members of society could be treated as those of a ‘representative’ individual, then the role of the state would be reduced to that of efficiently carrying out agreed decisions.”

reduce the inflation at the least possible cost. Experience of many countries which have suffered from hyperinflations indicates that a necessary component of inflation reduction is greatly reducing the government budget deficit. Having this information, a welfare-maximizing policymaker would cut the government budget deficit. What we observe in fact is that in many high-inflation economies, where it is agreed that deficit reduction is a necessary component of an inflation stabilization program, deficit reduction is long delayed while inflation accelerates. The positive political economy question is whether the political constraints on making budgetary decisions can explain this delay, and, furthermore, how the length of delay will reflect different political mechanisms for resolving budgetary conflicts. The normative political economy question is how to design policies or mechanisms for choosing policies which will hasten agreement on how to cut the budget deficit. This approach to the political economy of hyperinflation will be addressed in Chapter 10.

To take another example, consider the question of the transition of the formerly socialist countries of Central and Eastern Europe to market economies. Though it is generally agreed that economic efficiency and social welfare will be substantially higher once a market system of allocation is in place, the transition has been slow, far slower than observers expected at the outset on the basis of the technical constraints. Political opposition from groups that will be hurt in the transition and under the new regime has been a significant factor in determining the pace of reform. Hence, crucial to understanding transition policies and their outcomes are the conflicts between different interest groups in the economy. The relative performance of different transition economies reflects not only their differing economic characteristics, but differing political characteristics as well. We consider the political economy of large-scale economic reform and transition in Chapter 13.

### *Disciplines Compared*

Given the definition of new political economy, one may ask how it differs from the related fields of public economics (or public finance) and of public choice. Public economics is concerned generally with the economics of the public sector, meaning how economic decisions of the government affect economic actors. Positive public economics concerns the effects of tax and expenditure policies on individual and firm behavior. Although positive public economics broadly defined includes political theories of the state, the main focus is on the effect of tax and expenditure policies. To the extent that public economics addresses the question of how tax and expenditure policies are chosen, it is primarily from the perspective of neoclassical welfare economics, that is, taking the government's objective of welfare maximization as given and asking how tax and expenditure policies, rather than direct "command," may be used to achieve the objective of welfare maximization. This is the subject matter of normative

public economics. One area of normative public finance is the formulation of simple criteria for government decisionmaking, but this is not in terms of choosing the objective to be maximized, but of choosing criteria and methods to achieve the optimum.<sup>7</sup>

The question of how the objectives are chosen, that is, how collective choices are made, is the subject matter of public choice. That is, public choice is concerned largely with studying decisionmaking mechanisms *per se*, considering not only the positive and normative aspects of different ways of making collective choices, but also the question of how a society can choose over the set of possible choice mechanisms. Public choice differs from political science, in that it stresses the use of tools of economic analysis to study collective choices. As Mueller (1989, p. 1) concisely defines it, "Public choice can be defined as the economic study of nonmarket decision making, or simply the application of economics to political science." We consider the subject matter of public choice in a bit more detail in our treatment of decisionmaking mechanisms in Chapter 3 and again in Chapter 9 in the discussion of problems of collective action.

Public choice and political economy as defined here are clearly closely related. Many treatments of the new political economy would not make a distinction between the fields, arguing that public choice is an integral part of the new political economy. There is much to this argument. First, both public choice and new political economy, namely, the study of the effects of political constraints on economic outcomes using specific analytical tools, are defined not so much by their subject matter as by their analytical and methodological approach. Second, since policy outcomes may depend on the intricacies of the decisionmaking process (consider, for example, the formulation of international trade policy), it may be unproductive to make a distinction between the fields in specific applications. Our distinction is meant more to highlight the subject matter of this book. Our interest is in the *effect* of politics on economic outcomes, not on politics *per se*. Though the stress is on using tools of economic analysis, the interest is not in choice mechanisms themselves. Moreover, there are already excellent textbook treatments of public choice and mathematical political science by practitioners, while there is no comprehensive textbook treatment of the effects of politics on macroeconomic outcomes in any generality.

### 1.3. TYPES OF HETEROGENEITY

What ties politics, public choice, and political economy together is the centrality of heterogeneity of interests. Were there no heterogeneity of preferences over outcomes, there would be no need for a mechanism to

<sup>7</sup> The subject matter of normative public finance will be touched on at many points in the book, especially in the discussion of public goods in Chapter 9.

aggregate individual preferences into a collective choice. Similarly, were there no conflicts of interests whatsoever, the choice of economic policy would be that of the social planner maximizing the utility of the representative individual. (Remember the quote from Atkinson and Stiglitz (1980) in footnote 6.) It is heterogeneity of interests that is the basis of the field of political economy.

At this point, one may argue that heterogeneity of interests is also central to much of economics. Markets are driven by heterogeneity as well, heterogeneity of tastes, of endowments, and of expectations. Why not therefore argue that heterogeneity is the basis not only of the field of political economy, but also of market economics itself? The argument on the importance of heterogeneity for political economy may be summarized in two propositions. First, heterogeneity or conflict of interests is necessary for there to be political constraints. Second, the effect of politics on economics follows from the mechanisms by which these conflicts are resolved. The first point is clear—heterogeneity is a *necessary* condition. It can be read as saying only that without heterogeneity, there would be nothing to study. It is the second which is really our focus, and, to my mind, defines political economy. Heterogeneity is also necessary for there to be markets, but heterogeneity of interests plays out quite differently when addressed through the market than through the political process. For example, the effect of heterogeneity of abilities on distribution of income mediated simply through the market will be quite different than the income distribution which would result when individuals can lobby for transfers, based on their endowed abilities. How much different will depend on the political mechanism by which tax-and-transfer policy is decided.<sup>8</sup> Moreover, there are numerous issues where individuals have a heterogeneity of interests where the market mechanism either cannot be used or simply is not used to determine outcomes, the political choice mechanism being used instead.

Given the necessity of conflict of interests for there to be a political economy problem, one is led to ask: what are important types of heterogeneity for political economy? There are many, which we find useful to separate into two basic classes, giving rise to two crucial types of conflict of interests. The first conflict reflects underlying heterogeneity of actors “coming into” the political arena, implying they have different policy preferences. There are a number of reasons. They may simply have different tastes over goods, broadly defined, or different relative factor endowments. They may find themselves in different situations not easily summarized in terms of tastes or endowments that lead them to prefer different policies. Or, they may just differ in how they think the world works, and hence what policies would best achieve a given aim. In short,

<sup>8</sup> Lindblom (1977) discusses at length the conceptual differences between markets and political institutions as allocation devices, and the implications of these differences.

individuals are heterogeneous in a number of dimensions, leading them to prefer different policies *ex ante*. We apply to this heterogeneity the general term **ex-ante heterogeneity**, which plays a crucial role in political economy.

There is another central type of heterogeneity. Even when political-economic actors have the same “primitives”—endowments, preferences, etc.—there will generally still be a conflict of interests. Actors may all equally value a good, but there is conflict if its distribution (if it is private) or the distribution of the costs of providing it (if it is public) is determined by a collective choice. Economic policies generally have distributional implications. Therefore, when a policy does (or *can*) have distributional consequences, self-interested “representative” agents will be in conflict over distribution. This includes the rents that office-holding may provide to those in office, whether these are pecuniary benefits or simply the “ego rents” associated with holding office. Since “distribution” can also refer to conflicts arising from *ex-ante* heterogeneity of factor endowments, we use the general term **ex-post heterogeneity** for this type of heterogeneity.

These two concepts of heterogeneity will appear in various forms throughout the book. One should note that these are not by any means mutually exclusive. In discussions of supply of a public good, for example, there may be conflict over the importance of the public good relative to other expenditures, reflecting *ex-ante* heterogeneity, as well as conflict over who should bear the cost of supplying the public good, which is *ex-post* heterogeneity. To take another example, conflict over the size of income assistance programs in the budget combines distribution of a private good whose burden may be seen as a public good, not to mention the ideological conflict over the proper role of the state in providing income transfers.

We end this section with two notes on the relevance of our argument that heterogeneity of interests is central to political economy. First, *ex-post* heterogeneity is important not only in questions of income redistribution, but also in understanding the political aspects of some “representative” agent problems, problems where it might initially appear that heterogeneity plays no substantial role. Specifically, consider imperfect credibility of policy due to the possibility of time inconsistency, which is the subject of Chapter 4. Time inconsistency is said to arise if the optimal policy chosen at  $t_1$  for date  $t_1$  differs from the optimal policy for  $t_1$  which was chosen at  $t_0 < t_1$ , even though technology, preferences, and information are the same at the two dates. Time inconsistency refers to more than a policymaker announcing a policy for  $t_1$  at  $t_0$  and then enacting a different policy at  $t_1$  if it suits his own interests. Time inconsistency is especially interesting because it can arise even when the planner is maximizing the welfare of a representative individual. Hence, heterogeneity would appear to play no role. We will argue in Chapter 4 that this is not correct. In models where the government is maximizing the welfare of a representative individual, time inconsistency arises only when there is an important

*ex-post* heterogeneity. That is, in such models all individuals may be identical *ex ante*, but are not identical *ex post*. In fact, we shall argue that *ex-post* heterogeneity is key to the possibility of time inconsistency in the presence of a “benevolent” government.<sup>9</sup>

Second, the reader may still feel uncomfortable with the argument that the distinction between political and nonpolitical problems turns on the heterogeneity of interests and how they are handled. We had indicated above that markets are also driven by heterogeneity, but that the effects of heterogeneity are quite different when mediated in the market than when addressed by a political process or social planner. What about the study of social welfare maximization with heterogeneous individuals? This is the topic of multiple-agent welfare economics, where *ex-ante* or *ex-post* heterogeneity of actors is central to the analysis of optimal policy choice. How does it differ from political economy? Though heterogeneity is central to both areas, there is a key difference. Welfare economics takes as given the multi-agent objective function, which weights the importance of heterogeneous agents for social welfare. That is, the “say” that different actors have in determining the policy outcome is taken as exogenous, the focus of analysis being the calculation of optimal policy given the objective function. In contrast, in political economy, a main focus is often the endogenous determination of the objective that is to be implicitly maximized. The weights in the implied objective function are not exogenous; they are determined by the political process and in turn determine the economic outcome. In the next section we make this distinction clearer by comparing fields and their approach to heterogeneity through a specific example.

#### 1.4. AN ILLUSTRATION OF APPROACHES

The points of the previous two sections, both on the role of heterogeneity and conflict of interests and on the comparison of disciplines, may be better understood by considering a specific economic problem and asking two questions. First, how might heterogeneity of interests manifest in a specific example and what issues does it raise? Second, how can we better characterize and understand the differences between the disciplines discussed in Section 1.2 by how their focus differs with respect to this problem? Hence, in this section, we consider a basic dynamic optimization problem in economics, namely, the choice between consumption today and consumption tomorrow, and ask what issues it raises with respect to multi-agent welfare economics, public finance, public choice, and political

<sup>9</sup>An alternative view of time inconsistency is that it reflects the decisionmaker having different preferences over time, a sort of *ex-ante* heterogeneity. This approach will also be considered in Chapter 4.

economy. The example will also make clear the centrality of heterogeneity to questions of politics and political economy.

### *The Optimal Saving Problem*

Ricardo Smith must decide on how much of his income to consume today and how much to save, that is, accumulate as capital, which produces income next period. He has a two-period horizon, so his decision on how much to save is how much to consume tomorrow. Given his preferences over consumption today and consumption tomorrow, as represented by his utility function, standard maximization techniques, in this case, simple calculus, will allow him to choose saving optimally.

Now, suppose that instead of a two-period horizon, Smith has an infinite horizon. In each period he faces the same decision problem, with the value of saving at any date  $t$  depending on the value he assigns to consumption at  $t + 1$  (and the return to capital), which in turn depends on the value of consumption at  $t + 2$ , *et cetera*. His choice problem can be seen as choosing a sequence of optimal consumption levels, one for each date  $t$ ; though conceptually identical to the two-period problem, the infinite horizon makes this problem technically more difficult. The key point to note is that the “decision problem” is a technical one, that is, how to find an optimal consumption sequence over an infinite horizon, given his preferences. For example, under some fairly unrestrictive conditions, dynamic programming may be used. (An exposition of the method of dynamic programming applied to the optimal saving problem is presented in Chapter 2.)

In an economy composed of a number of identical individuals, the choice problem of a social planner maximizing the utility of a representative individual would be identical, and the same techniques may be used to solve for the consumption sequence that maximizes social welfare. The social planner’s problem with a representative agent represents the baseline case in standard welfare economics. The emphasis in welfare economics is on identifying what is the optimal policy, *given* the welfare function to be maximized subject to constraints. Hence, as above, the “decision process” refers only to the *technical* process of solving a set of equations. This may be mathematically difficult (for example, in some dynamic optimization problems), but there is *no* political problem arising from a conflict of objectives.

### *Ex-Ante Heterogeneity*

To introduce *ex-ante* heterogeneity and conflict of interests, suppose that Smith is part of a group that makes collective consumption decisions, where there are several types of individuals in the group with different consumption preferences. For example, the Smith family (all with identical

preferences) each summer rents a two-family house together with the family of Robinson Malthus, whose vacation preferences are the same within the family, but differ from those of the Smiths. Hence, a decision must be made on what sort of house to rent. To simplify the exposition, let us begin with a very simple set-up. Suppose there are enough resources left over from previous years for two summers' worth of vacations, and the decision is simply how much to spend on this year's vacation and how much to save and spend on next year's vacation. Suppose there are only two types of individuals in the group—the Smiths prefer a fancier, more expensive house this summer, while the Malthus family prefers a less expensive house this summer, allowing more resources to be saved for next summer. These differences in preferences could be represented by different utility attached to the current summer's consumption, or, in a many-period framework, by a different discount factor  $\beta$  relating the utility of current and future consumption.

Standard welfare economics handles the case of many agents with different preferences by considering a social planner maximizing a weighted sum of individual utilities (a social welfare function), where the weight on each type is *exogenously* given, say  $\alpha$  to the preferences of the Smithians,  $1 - \alpha$  to the preferences of the Malthusians.<sup>10</sup> A level of current consumption will result from this maximization problem, where it will reflect the value of  $\alpha$ . As in the representative agent problem, the planner's decision problem refers to the problem of technically deriving the optimum for any value of  $\alpha$ . If  $\alpha$  is high, so that the Smithians' utility is more heavily weighted in the social welfare function, the chosen saving rate ("chosen" in the normative, and, therefore, implemented in the positive sense as well) will be closer to their preferred policy, that is, lower. The planner's solution will be **Pareto efficient**, in that neither type of individual could be made better off without the other being made worse off. A typical problem in multi-agent welfare economics would be to ask how the chosen optimum would be affected by an exogenous change in the weights, that is, to derive the **contract curve**, the set of such Pareto-efficient points.

### *Ex-Post Heterogeneity*

The concept of *ex-post* heterogeneity may be easily represented in this example as well. Suppose that both families have exactly the same preferences for what type of house to rent this summer, and hence the same preferences over current and future consumption. However, each family would like to have the nicer half, or perhaps the larger half of the house for itself. That is, they value current consumption equally and care about the distribution of consumption benefits. We could represent this as a problem in welfare economics in which the two types of individuals have

<sup>10</sup> The temptation to call the social planner Summers is almost irresistible.

the same utility function and discount rate, but can be assigned different levels of current consumption. The planner's problem can be represented as choosing a level and distribution of current consumption to maximize discounted utility over the two summers. If the distribution of consumption between the Smith and Malthus families could be represented as a continuous variable (let us say, square feet of house space!), standard calculus techniques could be used to find the planner's optimum. As before, the planner's problem is a technical one, finding the optimal consumption vector for given  $\alpha$ , with different values of  $\alpha$  corresponding to different consumption allocations. The higher  $\alpha$  is, the more house space the planner would assign to the Smith family.

### *Political Economy*

By this point, the reader may be a bit amused by this example. The two sorts of conflict of interests between the Smith and Malthus families are easily recognizable, but the social planner is not. Who is this social planner who is making collective consumption decisions for the Smiths and Malthus's? What relation does the social planner's problem with an exogenous weight  $\alpha$  on Smithian consumption have to the problem the two families face—resolving the conflict over collective consumption when they have different preferences? The short answer is very little if any. This is not because the multi-agent welfare economics problem is poorly formed, but because it misses key issues we associate with conflicts of interest. How in fact are conflicts of interest resolved? What implications does the need to resolve conflicts (and the way they are resolved) have for economic outcomes? Deriving the optimal policy once society has chosen how to weight the preferences of different groups does not treat these problems.

In the case of two families with different preferences trying to plan a joint vacation, we may think of various ways in which they try to resolve their conflicts. Coming to a joint decision is usually not too difficult, but the problem they face is a political one in microcosm. When we consider not two individuals or families, but an economy as a whole making collective choices on saving and investment, the political problem of resolving conflicts of interests is not so simple, and the economic implications of how the conflicts are resolved are far larger. To continue with our comparison of different disciplines by considering a specific economic problem, the reader should continue thinking of the consumption versus saving problem, but now in an economy composed of many, heterogeneous individuals.

Political economy starts with the problem of choice in a society with heterogeneous agents, but with a very different focus than multi-agent welfare economics. The focus is on the process by which it is decided what policy to adopt, and, more specifically, on what policy choice will emerge from a specific political process. The issue is not the *technical* problem of

the implication of different weights, but the *political* problem of how the weights are chosen (representing the question of how conflicts of interests are resolved) and its economic implications. In the consumption versus saving problem with either *ex-ante* heterogeneity (difference in how present and future are weighted) or *ex-post* heterogeneity (the incentive to increase one's share of current consumption at the expense of others), the focus is on the implications for capital accumulation of the society's current aggregate consumption being politically determined. This means both how the political mechanism determines the  $\alpha$  in a political-economic equilibrium and how this decision in turn affects capital accumulation and welfare. Heterogeneity of interests is crucial for the problem to be of any political interest. If all individuals had the same discount factor and there was no possibility for consumption to differ across individuals, societal and individual variables would be identical, no matter what the collective choice mechanism, and there would be no political problem.

The idea that the political process may *bias* the result away from a socially preferred solution has at least two aspects to it. First, society as a whole may have preferences over efficient outcomes, but the outcome emerging from the political process, even if Pareto-efficient, may be different from what society finds optimal. For example, given their preferences over income distribution in the society as a whole, individuals may find the political-economic equilibrium far from optimal, even if both exercise of political power and redistribution absorb no economic resources. Second, and more important, the political process by which economic policy is chosen will generally absorb resources in one way or another, leading to an economically inefficient outcome. The most interesting economic implications of heterogeneity and conflict of interests stem not from determining which point on the contract curve is chosen. They stem from the fact that the political process implies the economy is "off the contract curve," that is, in an equilibrium that is economically inefficient, often markedly inefficient.

### *Public Economics and Public Choice*

The optimal saving problem may also be used to sharpen the distinction between political economy (as defined here), on the one hand, and public finance and public choice on the other. Consider first a public finance perspective. In the multi-agent welfare economics problem, the social planner was modeled as choosing consumption levels directly. Alternatively, one may think of a "decentralized" problem, in which the planner does not choose quantities directly; instead, the optimal allocation is achieved via a price system, in which individuals choose their desired levels of consumption and saving on the basis of market prices. The problem is

transformed from finding optimal quantities to finding prices that support these quantities. This too is a “technical” problem in the sense set out above. A major question in normative public finance is the derivation of optimal tax and public pricing structures given technological and informational constraints.<sup>11</sup> Positive public finance forms the basis of the normative analysis, where the objective function is taken as given. A public finance “solution” to the multiple-agent decentralized growth problem is a set of tax rates, one on each type of agent at each point of time, that supports the chosen consumption allocation, which itself is derived from the given  $\alpha$ .

In contrast, in a political economy model of determination of tax rates, conflict over whose preferences will be reflected in aggregate policy may induce a conflict over tax rates. For example, different preferences over current versus future consumption will induce different preferences over consumption taxes. Conflict over tax policy may also reflect *ex-post* heterogeneity, as individuals use the tax system to try to redistribute resources towards themselves. In both types of cases, conflict over tax structure can lead to grossly inefficient outcomes. Positive public finance forms the basis not of a normative analysis as discussed in the previous paragraph, but of calculating the economic consequences of choosing any particular tax policy, corresponding, for example, to different values of  $\alpha$ . The focus would be on what resolution of this conflict of interests is implied by the political mechanism, and, on the basis of positive public finance, the implications for economic magnitudes.

From a public choice perspective, the interesting question is the implications for equilibrium  $\alpha$  of different choice mechanisms, more specifically, the formal analysis of how collective choice mechanisms translate into specific policy choices. Relative to the political economy focus in this book, there is far more stress on the positive and normative workings of these mechanisms, far less on the economic consequences. For example, in an economy with many different interests to be weighted in a social welfare function, how will the weights differ under simple majority voting versus more complicated voting procedures? Or, if the weights are chosen in a representative democracy, where the elected representatives then bargain over them, how will a change in election procedures in the first stage, or rules of agenda in the second, affect the equilibrium weights that emerge from this process? In the theory of public choice, the economic implications in terms of an aggregate path of saving are a decidedly secondary consideration (though more important in applied public choice). In fact, the economic application is often not relevant in the analysis of the implication of voting rules, and the analysis often abstracts away from it.

<sup>11</sup> In the next chapter we solve a simple, but important public pricing problem under asymmetric information.

## 1.5. PLAN OF THE BOOK

The book is divided into four parts. The first part of the book, comprising this chapter and the following two, are meant to set the stage for the study of political economy. The next chapter is meant to familiarize readers with a number of useful economic models. Some models and techniques are, however, introduced in chapters as they are used. Chapter 3 concentrates on the subject of “politics” *per se*, concentrating on mechanisms for making collective choices.

In Part II, we investigate the problem of time inconsistency, representing a crucial distortion away from the first-best optimum that can arise even when policy is chosen by a social welfare maximizer with an infinite horizon. Chapter 4 introduces the problem and presents two widely studied models, as well as discussing intuitively why problems of time inconsistency arise. A key argument in the chapter is that time inconsistency reflects heterogeneity of interests and would be absent if such heterogeneity were absent. This view, consistent with the approach of the book, differs from the standard view of time inconsistency. Chapters 5 and 6 consider “solutions” to the problem of time inconsistency. In Chapter 5, we concentrate on how the policymaking environment can make policy credible, that is, how institutions or the creation of external circumstances (broadly defined) can lead to the expectation that announced policies will be carried out. Put simply, we consider mechanisms by which a policymaker can commit himself to a desired policy. In Chapter 6, we consider commitment through repeated interactions, so that policy choice can be made credible. We concentrate on investing policy with credibility by the policymaker building a reputation, that is, by engendering the expectation that certain policies will be followed in the future on the basis of actions that have been observed in the past. These chapters, especially Chapter 6, present much of the game-theoretic basis for analysis so widely used in the new political economy and that will be used repeatedly in the book.

In Part III, we address phenomena of heterogeneity and conflicting interests directly. In Chapter 7, we consider the crucial role in the political economy of macroeconomics of elections, and more generally, expectations of possible changes in policymakers. This includes numerous models of the political business cycle (including a detailed empirical assessment), models of interactions of the executive and the legislature (including discussion of non-American phenomena, such as coalition governments and endogenous timing of elections) and various aspects of “tying the hands” of successor governments. In Chapter 8, we consider numerous aspects of redistribution of income and wealth, including using transfers to court voters, pork-barrel politics, rent-seeking, intergenerational and cross-jurisdictional redistribution. Chapter 9 covers many aspects of public goods, not only the classical theory, but also collective action, clubs, and dynamic models of the supply

of public goods. Several of these models form the basis of studying the effects of the political nature of decisionmaking on macroeconomic aspects. Chapter 10 is important both in its own right and as a bridge between Part II and Part IV on applications. We consider four general classes of models in which heterogeneity and conflict of interests lead to the nonadoption or the delayed adoption of socially beneficial policies. We also consider the role of crisis in enabling the adoption of such policies.

Part IV presents applications of the models of earlier chapters to specific areas. Chapter 11 covers the political economy of factor accumulation and growth, including models of redistributive pressures, market imperfections, and the link between political institutions and growth. Given its prominence in the literature, there is also a detailed discussion of empirical determinants of growth. Chapter 12 covers a wide range of political economy issues connected with macroeconomics of the open economy, including exchange rate arrangements, currency crises, international policy cooperation, capital controls, sovereign debt, and foreign aid. Chapter 13 presents a more applied approach to the political economy of large-scale economic reform and transition, with special emphasis on the transition from socialism and central planning to markets. This includes the political economy of labor reallocation, privatization, and price liberalization. Chapter 14 covers a number of topics on the political economy of the size of government (specifically, growth of government) as well as recent work on the size and number of nations.