

Political Economy and Institutional Choice

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1. The present state and the limits

Political Economy or Public Choice distinguishes sharply between positive and normative aspects. This also applies to the analysis of institutions. The main characteristics of the Political Economy approach with respect to positive and normative aspects of institutions are discussed in turn.

1. The working of institutions: positive analysis

The main emphasis of modern political economy lies in the explanation of how social institutions function. Political institutions are generally taken to be democracies. Accordingly, the behaviour of voters and of politicians in and out of power has been extensively analyzed. Three models of government may be distinguished: one in which the politicians in power are completely subservient to the voters who decide by the simple majority rule (median voter models); one in which (usually two) parties have to continually act in such a way that they receive as many votes as possible (models of party competition), and one in which the government may pursue ideologically oriented policies, but has to receive a sufficient number of votes at discontinuous elections (politico-economic models). Such models have been subjected to empirical tests, and it has been shown that when they are applied under the appropriate institutional conditions, they perform well. In comparison, there have been few studies of the working of authoritarian or dictatorial political institutions.

Administrative institutions have been analyzed in the context of the economic theory of bureaucracy. Much knowledge has been gained about the internal workings of hierarchically organized institutions. Outside behaviour has mostly been modelled in terms of budget maximization, but it has proved difficult to integrate public bureaucracies in a macro-model of politico-economic interdependence.

Another institution which has received much attention within Political Economy are interest groups. It has been shown under which conditions they arise and are able to overcome the public good or free-riding effects involved. A result of great importance is that suppliers of goods and factors of production (i.e. both producers and workers) find it easier to establish strong pressure groups while consumers and tax payers are only weakly or not at all organized. As a consequence, their interests tend to be disregarded in an economic policy process which strongly relies on bargaining between established groups.

There are two theoretical bases to the modern political economist's approach to institutions:

(1) The *model of human behaviour* is used in which individuals are taken to pursue their own interests, subject to constraints imposed by income and time. Preferences are strictly separated from, and independent of, constraints. Changes in behaviour are attributed to changes in constraints; i.e. the law of relative price effect (the relatively more costly good or activity is substituted by a less costly good or activity) is built upon.

(2) *Institutions* are looked at in a *comparative way*. The 'Nirwana' approach is rejected as misleading; the task is to relate to each other imperfect institutions as they can be observed in reality. Pareto-optimality exercises in the general or partial equilibrium framework are regarded with suspicion because they tend to concentrate on a comparison between the existing state and a thus defined 'optimum' instead of between actual institutions among which a choice may be taken.

2. Proposals for policy: normative analysis

The transformation of the findings reached by positive analysis into suggestions for policy application has been undertaken along two lines:

(1) The alternatives open to choice are evaluated using a social welfare function. However, it has been exactly Public Choice, or more precisely Social Choice analysis, which has shown that an aggregation of individual preferences to a social welfare function, or even to a social choice function, is generally impossible provided 'reasonable' conditions are to be fulfilled. The search for the circumstances under which this procedure is acceptable has resulted in a dead end at least

from the point of view of institutional choice. While an institution producing a Pareto-superior outcome is preferred by all individuals concerned (and therefore no voting paradox arises) this is definitely not so if aspects of distribution are taken into account (as well as strategic behaviour). As distributional issues are ever present, and are of often overwhelming importance in social life, there is no hope of deriving normative conclusions from the positive analysis by using a social welfare function.

(2) Information based on the positive analysis is offered to the individuals who are therewith better equipped to take decisions which conform to their own preferences. Under the appropriate institutional conditions for the expression of the preferences by voting (which are in principle met in a democracy) the politicoeconomic interaction leads to results which conform to individual preferences as well as possible. This second procedure is vastly superior to what orthodox economists normally do, namely to simply state that this or that *should* be done because it is 'rational from the economic point of view'. Such statements are not only inconsistent with the individualistic basis of economics but have also little, if any, effect in the politico-economic process.

On a more practical level (especially American) Public Choice practitioners do come forth with normative advice: almost without exception they are stern supporters of the use of prices compared to political or administrative decision making. Such a position must appear rather surprising to an outsider. It could have been expected that when someone puts in a lot of effort to study institutions such as governments and public bureaucracies he or she would be inclined to consider them favourably (to reduce the cognitive dissonance produced by the great effort put into the study of these deficient institutions). Most Public Choice scholars have reacted differently: they have revealed the shortcomings of collective institutions compared to the price system and have shown that many of the problems attributed to the market (in particular externalities and unjust income distribution) are not likely to be overcome in a satisfactory way by other decision making systems. Political and administrative institutions produce 'political' and 'administrative' failures which are often worse than 'market failures', and therefore often do not provide a preferable alternative.

3. *Towards new limits*

What has been said so far about modern political economy (see e.g. Mueller 1979, Buchanan and Tollison 1984) has been generally accepted (though not always put into practice) by scholars concerned with an analysis of institutions. It has, however, been completely disregarded in other (and often considered to be prestigious) fields of economics, above all in general equilibrium analysis or in neoclassical public economics which lack institutional content. Rather than expanding in greater length what is generally known among modern institutionalists, aspects will be discussed which are either *controversal* and/or *new*. The following section II deals with Institutional as Constitutional Choice while section III is concerned with the model of man used as a basis. In section IV empirical (experimental) analyses of human behaviour are critically analyzed from the point of view of the Public Choice approach to institutionalism. Concluding remarks are offered in section V.

II. *Institutional as Constitutional Choice*

Outcomes cannot be the subject of choice. Rather, outcomes emerge from the social interaction of individuals acting within institutional conditions. This is the essence of constitutional economics (see e.g. Buchanan 1977). Accordingly, outcomes can be influenced only by the choice of institutions. Institutions in the sense used here are *rules* according to which the current politico-economic process takes place. It is thus crucial to distinguish the level at which the institutions are chosen and set from the current politico-economic process in which one acts within given rules. As no rules exist at the pre-constitutional stage and as there is no possibility for forcing individuals, the choice of institutional rules has to be made unanimously, which means that everyone must expect to benefit from the rules. Consensus on rules is possible to reach because at the constitutional level the individuals act behind the veil of ignorance, i.e. no one knows in which position he or she will be at the postconstitutional stage.

The basic consensus in constitutional choice should be looked at as a logical, and not as a historical, characterization. While it is somewhat difficult to envisage for the choice of rules within nations, it is immediately applicable to institutions chosen at the international level. Such rules can only be arrived at by consensus as there is no world government which could force the individual nations to accept rules (Frey 1984).

In principle, constitutional economists such as Wicksell (1896) and Buchanan and Tullock (1962) demand unanimity, but for practical purposes they concede that rules may be established by a majority close to one hundred percent. A more satisfactory solution is, however, to keep strictly to the unanimity requirement but to acknowledge that a given rule's productivity depends on how inclusive the set of adherents is. If only a small share of individuals concerned participates, a rule tends to yield less collective benefits than if a larger share participates. To provide an example of institutions established between nations: if only a few nations accept humanitarian rules of warfare, these rules yield less beneficial results in case of war than if all nations join the humanitarian conventions.

The constitutional approach is incompatible with those institutional analyses in which *end states* or *outcomes* are the object of choice. This applies in particular to the studies in which the 'efficiency' (usually X-efficiency, but often simply cost comparisons) of alternative production arrangements are compared. Much effort has, for example, been devoted to the question whether private firms produce more efficiently or at a lower cost than public or cooperative firms. The constitutional Public Choice approach suggests that such studies overlook the crucial question: What *process* and what institutional *rules* have led to the choice of either the private, public or cooperative production arrangement? This focusses the attention away from a purely technical comparison of outputs and/or costs to the study of how well individual preferences have been represented when the decision about the mode of production was taken). Consider, for instance, waste disposal. Assume that in a particular town the public administration has decided of its own accord that this service will be undertaken by one of its branches and that no competition by private suppliers is admitted. In that case the mode of production has been decided according to the preferences of the public administrators (among whom the public employees' union has a large say) while the preferences of the consumers and the taxpayers have not been represented (at least not directly) and therefore tend to be disregarded. Not surprisingly then, the waste disposal service will not be produced X-efficiently or at a low cost. According to the preferences of the members of the public administration, however, the service may well be produced in the 'right' way, namely so as to yield them the highest possible net benefit. Following this view, it cannot therefore be surprising that an analysis provided by an economist, and leading to the conclusion that private production would be more 'efficient' and less costly than the existing public production will be rebutted or ignored by the decision makers in charge. The decision makers will be able to show that the economist considers part of the relevant

output, only, or counts elements as cost which according to the decision makers should be counted as benefits. This is, for example, the case for wages going to the members of the public firms. Provided the decision makers have not made a mistake, the production is efficient if their valuation is used. Even if they accepted the economist's efficiency study at face value (which they rarely do), the decision makers in charge would not switch to a private or cooperative mode of production because they would lose thereby.

The constitutional approach looks at where the whole decision process was one-sided. Public choice economists of this persuasion would suggest a change in the rules under which the decisions are taken. Above all, they would suggest that the consumers and the taxpayers have a (more direct) say in the decision process. If this is the case, their preferences would be taken into account with the result that more 'efficient' (now in the orthodox sense) outcomes will emerge.

The constitutional approach to institutional choice has so far been little appreciated and used. It is still a minority view even within political economy probably because it departs completely from established ways of thinking and requires a new view of the economy and society.

III. Economic man as a basis of analysis

The model of homo oeconomicus sketched above who systematically reacts to changes in relative prices is subject to *several limits* which so far have not received much attention in institutional economics. There are (at least) four major shortcomings:

(1) Everyday experience, as well as carefully designed experiments, show that people are willing to contribute to the financing of a public good much more than they are predicted to be by orthodox economic theory (e.g. McMillan 1979, Schneider and Pommerehne 1981). Indeed, individuals in many situations do not act as *free-riders*. One pair of researchers even suggests that free riding is produced by economic theory because economics students tend to free ride more than students from other fields (Marwell and Ames 1981). One important instance in which the economic model of man cannot explain behaviour is the fact that people do vote though the benefit-calculus suggest that they should not.

(2) People find it difficult to deal with *uncertainty*. Real life studies (Kunreuther et al. 1978) as well as a considerable number of experiments (Kahneman and Tversky 1979, Kahneman, Slovic and Tversky 1982) reveal e.g. that individuals treat small probabilities differently from large ones. A probability increase by a factor of 10, say from 0.07% to 0.7% is definitely not considered equivalent to an increase from 7% to 70%.

Economics rightly distinguishes between objective and subjective probabilities (though in empirical studies objective values are often taken for subjective ones, see e.g. Ehrlich [1973] for the analysis of crime). Objective probabilities are those obtaining 'in reality' while subjective probabilities are those perceived which depends on both the state of information and intelligence of the individual involved. It has been overlooked that there is a third category, namely the probability of being *personally* affected, which may differ greatly from the other probabilities. This 'personal' probability does not necessarily tend to approach the objective and the subjective probabilities. An example are the many young girls fully engaging in a ballet career and being convinced that they will become a primaballerina despite the fact that they are informed about the exceedingly small chance of getting so far. The explanation of such behaviour thus cannot lie in inadequate information, nor in inadequate intelligence.

By now a large number of anomalies of individual behaviour (mostly under uncertainty) have been shown to exist by experimental psychologists and (some) economists. Paradoxical counterevidence against the orthodox economic model of behaviour under uncertainty have already been produced by Allais (1953) and Ellsberg (1961). Well known are a number of irrationalities in individuals' behaviour which have reached the status of effects: the certainty effect, the sunk cost effect, the endowment and the framing effect. Much attention has also been given to the preference reversal phenomenon, while the choice heuristics of availability, representativeness, anchoring or adjustment have in comparison rather been neglected by economists. (For surveys see Slovic, Fischhoff and Lichtenstein 1977 and Payne 1982 from the psychological perspective, and Shapira 1986 and Machina 1987 from the economic point of view).

(3) The behaviour of individuals is shaped by the *cognitive processes* surrounding choice, and is certainly not only determined by end state utility as suggested by orthodox economics. This has been pointed out by such insightful welfare economists as Sen (1979, 1982) and

also stands behind Simon's (1957) satisficing model of behaviour. The critique often advanced against Simon that it is just utility maximization subject to an additional constraint, is a typical example of an argument by orthodox economists who are incapable or unwilling to see this point.

(4) Individuals are (partly) able to *construct the kind of person* they had been in the past and, more importantly, will be in the future. In this sense, preferences are not given but can be shaped by the person concerned. One possibility is to use selfcommitment, a procedure discussed e.g. by Elster (1979), Hirschman (1982), Schelling (1980) and Thaler (1980).

The limitations and shortcomings of the orthodox homo oeconomicus do make a difference for human behaviour. They are relevant for economics because they generally carry over to the *aggregate*, i.e. to the level in which economists are interested in (see, more extensively, Frey and Eichenberger 1988). It cannot be assumed that the anomalies are randomly distributed among individuals so that they wash out when a group of people is considered. Neither may it be assumed that competitive markets eliminate these kinds of irrational behaviour. Rather, it has been shown (e.g. Russel and Thaler 1985, Shiller 1984, Thaler 1987a, 1987b) that even in financial markets – i.e. in markets where competition is assumed to be nearest to the competitive ideal anomalies exist which are inconsistent with rational behaviour. It may even be shown that there are conditions under which anomalies among individuals are strengthened by the process of aggregation. A case in point is the fiscal intervention of governments which tends to punish successful individuals and firms by (high) taxation, and support unsuccessful individuals and firms by the solidarity principle, or because they have the stronger political arguments. If individuals and firms prone to anomalies or irrational behaviour have a higher probability of being poor and making losses, and the rational ones of being successful – which is, of course, the assumption of the survival of the fittest in the market (Alchian 1950, Friedman 1953) – then this governmental intervention blocks and counteracts the elimination process: The effects produced by the anomalous actors are strengthened, those by rational actors are weakened.

It follows that these anomalies and the other developments mentioned are important for institutional choice analysis. To name just one major consequence: the expected utility maximization model, which according to the von Neumann/Morgenstern axioms is equiva-

lent to the definition of rational choice under uncertainty, and which is a standard model in public microeconomics such as optimal taxation (see e.g. Sandmo 1976) or optimal public pricing (see e.g. Bös 1987), can no longer serve as a general model of behaviour. Empirical research has well established that individuals consistently and significantly violate expected utility maximization (for a wealth of evidence, see Schoemaker 1980, 1982). It follows that an institutional choice analysis which endeavours to improve our understanding of the real world and wants to make worthwhile suggestions for social improvement has to make a strong effort to introduce a better model of human behaviour.

In principle there are two ways to cope with this challenge. The first is to completely reject the economic model of behaviour and to seek refuge in some other approach. To take this course would be unwise for at least three reasons: (i) The economic model of behaviour has served well in many areas of application within and beyond the market. The 'economic approach to social problems' as championed by Becker (1976) – of which political economy or Public Choice is a special variant – has been able to throw light on many aspects of social life which have so far been neglected. (ii) These contributions based on the 'rational choice' approach have found considerable attention and acceptance in other social sciences, especially in political science (see e.g. Riker and Ordeshook 1973) and to a lesser extent also in sociology (see e.g. Opp 1979, Lindenberg 1983, Voss 1985) as well as in history (e.g. North and Thomas 1973). (iii) In psychology – the science which is most intimately concerned with individuals – the economic model of behavior is in the process of being taken seriously (see e.g. Stroebe and Frey 1980) because it goes beyond a person's cognition of a situation, his or her motivational state and (unexplained) drives and also takes into account that behaviour is limited by a set of restrictions.

This leaves the second approach to overcome the shortcomings mentioned: to improve the existing economic model of behaviour. Such an attempt may concentrate on a more satisfactory treatment of either (i) the constraints with which an individual is faced (for such an effort see Frey and Foppa 1986), or (ii) the preferences of the individuals. In the context of dealing with the anomalies of individual behaviour observed, a reformulation of the underlying preference structure has been undertaken by various authors (e.g. Loomes and Sugden 1987, Encarnación 1987, Machina 1987). A less formal course is to endeavour to give more content to individual preferences by empirical research. The following section discusses at somewhat greater length efforts to capture the notion of fairness among individuals.

IV. Human behaviour and institutional choice

1. Experimental research on fairness

Over the past few years, important experimental results concerning human behaviour relevant to economists have been gained (see e.g. the surveys by Plott 1979, Smith 1982, Binmore 1987). In particular *empirical* notions of fairness of individuals acting in the economic sphere have been analyzed in a joint work by psychologists and economists (Kahneman, Knetsch and Thaler 1986, 1987).

By way of a telephone survey of a representative sample of persons living in two Canadian cities, the following scenario was read to the participants:

"A hardware store has been selling snow shovels for \$ 15. The morning after a large snowstorm, the store raises the price to \$ 20."

82% of the participants (N=107), rated this action as "unfair", and only 18% considered it to be "acceptable" to take advantage of the short-run increase in demand due to a blizzard. The same question (translated into German) was put in the summer of 1987 to a representative sample of 400 persons living in Zurich and Berlin in a written survey by the present author in collaboration with Beat Gygi and Werner W. Pommerehne. It turned out that 81% of those living in Berlin, and 84% of those living in Zurich, overall 83% of all respondents (N=155) considered the rise in price to be unfair. Thus, virtually the same evaluation was found despite the difference of continent and time.

Several other scenarios also suggest that to raise prices because of an increase in demand is considered unfair, while it is found acceptable to raise prices because of cost increases. This result conflicts with orthodox economic theory which treats opportunity cost exactly the same as any other cost. The authors then draw conclusions about the role of prices for the allocation of resources, or as a *decision rule*, from the point of view of fairness and the implied reactions of consumers and producers.

2. Critique and empirical results

From the point of view of the political economy of institutional choice the fairness experiments alluded to have shortcomings in two respects:

(1) The scenarios do not use a *comparative perspective*. In the example here given, the participants had to state whether they find the use of the price system fair or not. They did not have the possibility to express whether they find the use of prices to ration demand more or less fair than an allocation by a traditional method such as 'first come, first served', an allocation by the public administration, or the use of a random mechanism.

In the written survey undertaken for Zurich and Berlin, the fairness of the price system was analyzed when the respondents were explicitly confronted with other allocation mechanisms. The excess demand situation was characterized in the following way²:

"On a popular sightseeing spot which can only be reached on foot there is a water source. The water is filled into bottles and sold to thirsty hikers for the price of SFr. 1.— (DM 1.—) per bottle. The daily production and thus the inventory per day amounts to 100 bottles. On an especially hot day 200 hikers would like to buy a bottle.

Please indicate *how fair* you consider the following methods for allocating the bottles to the hikers:

- (a) A price increase to Fr. 2.— (DM 2.—) per bottle?
- (b) Selling the bottle for Fr. 1.— (DM 1.—) according to the principle 'first come, first served'?
- (c) Selling the bottle for Fr. 1.— (DM 1.—) according to a random mechanism (e.g. to all persons whose surnames start with A to P)?
- (d) The commune buys all the water for the price of Fr. 1.— (DM 1.—) per bottle and distributes according to its own principles?

The answers (N=293) given were:

Decision making system	evaluation	
	'fair'	'unfair'
(a) Price	27%	73%
(b) Tradition	76%	24%
(c) Random	14%	86%
(d) Administration	43%	57%

As expected, the price system is considered to be somewhat less unfair namely by 'only' 73% of the respondents – than if the price system is evaluated in isolation (where 83% found it to be unfair). There is a clear ranking of the decision making mechanism: tradition, i.e. an allocation according to the principle of 'first come, first served' is by far considered to be the fairest; more than three-quarters of the respondents find it to be fair. More than 40% of the respondents find an allocation undertaken by the public administration – or more precisely, the commune – to be fair. This is a quite sizeable proportion in view of the fact that many economists proclaim government allocations to be badly made (or to be inefficient). A solution of the excess demand situation by a rise in price is taken to be much less fair; almost three-quarters reject it as being unfair.

The ranking of the decision making systems according to the population's evaluation of fairness is

the fairest:	tradition
2nd fairest:	administration
3rd fairest:	price
least fair:	random

(2) The scenarios by Kahneman, Knetsch and Thaler asked the participants to evaluate *outcomes* and not *rules*. The specific conditions of a choice at the constitutional level do not appear in this setting, because: (i) the scenario is constructed as a once and for all situations instead of a repetitive one, and (ii) the evaluation had to be given under a condition of certainty instead of behind the veil of ignorance.

In the survey of Zurich and Berlin, a question has been addressed to the respondents in order to test whether the evaluation of the price system differs according to whether the underlying situation is

taken to be expected (i.e. normal and repetitive) or unexpected. It may be hypothesized that when an excess demand situation is a normal and expected occurrence, the rise in price is considered more in terms of a *rule* than if the underlying situation is an unexpected, unique occurrence.

The difference between the two situations was directly addressed when it was asked:

"How is your evaluation when the especially hot day occurred completely unexpectedly?"

Do you find the rise in price to Fr. 2.– (DM 2.–) per bottle more acceptable, equally acceptable, or less acceptable?"

The answers were:

more acceptable	8%
less acceptable	64%
(equally acceptable)	28%

The evaluation of the respondents is very clear: the price system is taken by almost two thirds (64%) of the respondents to be fairer in an expected, normal situation – i.e. as a decision making *rule* – than it is as a pure rationing device in an unexpected, once and for all situation. It follows that the strongly negative evaluation of a rise in price as found in the study by Kahneman, Knetsch and Thaler (and replicated by us) is due to the fact that the respondents reject pricing as a device for rationing a *fixed* supply in a unique situation. On the other hand, in a situation in which prices work as an allocation system (and where it also serves to increase supply) it is regarded more favourably.

The discussion of these surveys on fairness intended to show that the fascinating research on the limits of the orthodox economic model of human behaviour can be expanded in order to make them directly relevant for the choice of rules in institutional economics. It need not be stressed that surveys are not the only way to gain such information, another useful way are, of course, real-life situations such as, e.g., referenda.

V. Concluding remarks

The purpose of this paper has been to show that political economy may make a distinctive contribution to modern institutional economics. While the positive Public Choice analysis has been generally accepted and has been increasingly used, the policy conclusions have been rather neglected. The constitutional approach concentrating on how the rules are chosen which then determine the outcomes presents an important avenue consistent with the individualistic basis of modern economics. It has been argued that the underlying model of human behaviour as it is now commonly used has serious shortcomings and must be further developed. So far neglected aspects of human behaviour can be made directly useful for institutional choice by stressing the comparative and the rules aspects.

Summary

The political economy (or Public Choice) approach to modern institutional analysis is based on the economic model of human behaviour and on the comparative approach. Compared to the positive analysis which has been generally accepted by now, the policy consequences have been neglected: The constitutional approach concentrates on the individuals' choice of rules which then determines the outcome. The existing economic model of man is deficient in various respects and must be further developed. Survey results on the individuals' evaluation of fairness under various conditions are discussed in order to show the relevance of normative views for the choice of rules.

Notes:

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¹ Efficiency and cost studies comparing different modes of production are thus by no means unnecessary. They are crucial in order to see what effects are

produced by different institutional conditions. What is argued here is that constitutional choice goes one step further: it does not stop with the technical efficiency comparison but asks how the underlying institutional conditions have come about.

² It turned out that the following excess demand situation referring to water was considered to be very similar to the one referring to snow shovels. The situation was changed because most inhabitants of Berlin are never confronted with the need to shovel snow as the overwhelming majority lives in large multi-family houses where snow shovelling is the duty of the caretaker.

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