The New Political Economy*

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1 Introduction

It is a great honour to give this year's Keynes lecture. I have chosen as my subject the New Political Economy, a body of research and thinking that has flourished in the past fifteen years or so at the interface between economics and politics. At the margin the New Political Economy reverses the split that occurred between the disciplines of economics and political science at the end of the nineteenth century.

The aim of the New Political Economy is to understand important issues that arise in the policy sphere.[1] It is not, as is occasionally hinted, an effort by economists to colonize political science. Rather, the main concern is to extend the competence of economists to analyze issues that require some facility with economic and political decision making.

This lecture is not in any sense a survey of the field. It is a highly selective and personal view of the motivation behind the field and some of the key themes that link the literature. Thus, it represents a manifesto presented in the hope that somebody who encounters these ideas for the first time here might be tempted to delve further into the literature and even contribute to it.

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[1]The field is also sometimes known as *Political Economics* – see Alt and Crystal (1983) and Persson and Tabellini (2000).

2 Why now?

If we turn back the clock to the mid 1980s, there was much less interest in political economy issues in mainstream economics. There were places like Chicago and Virginia where this was taken seriously, but papers in top mainstream economics journals were comparatively rare. Policy economics was still dominated by the Pigouvian paradigm which develops the notion of optimal intervention based on notions of market failure. The landmark book by Atkinson and Stiglitz (1980) codified the literature for a generation of scholars of policy economics. Using the notion of a social welfare function, the approach also captured efficiency-equity trade-offs in a rigorous way. The literature had a technocratic feel – the focus was on optimal policies with little attention paid to institution design and policy implementation.

But twenty years later, things are quite different both in academia and in the world in general. Before 1990, the world was divided into two competing economic systems – the planned economies mostly located in Eastern Europe and the mixed economies throughout the remainder of the globe. But the socialist experiment came to an end and has given way to a two-dimensional consensus.

The first dimension concerns the role of markets – it is now widely accepted that when it comes to the production of private goods, a system of competitive production by privately owned firms has many advantages. The second dimension concerns policy making – most countries of the world are now governed by some form of representative democracy.

But these two elements of consensus leave many issues wide open. First, the consensus says nothing about the organization of collective good provision – for example, health, education and old-age support. Second, it says nothing about how to design appropriate market supporting institutions such as legal and regulatory systems. Third, there are many variants of representative democracy, for example differences in electoral systems, the structure of checks and balances, and the scope for direct democracy.

Rising to these challenges requires some kind of expansion in the competence of economists if they are retain their influential role in policy analysis. Looking at the problems of the world economies, it became increasingly clear that many issues had as much to do with providing incentives to pick good policies and to guaranteed that they were implemented well. This point is underlined by Larry Summers former Harvard Economists, U.S. Treasury Secretary and Chief Economist of the World Bank who when recently asked to review the lessons of the 1990s notes that

> "(an) overwhelming lesson that I think we have learned in the 1990s, is ...the transcendent importance of the quality of institutions and the closely-related questions of the efficacy of political administration. Well-executed policies that are 30 degrees off are much more effective than poorly-executed policies that are spot on." (Summers (2004))

Experience suggests that there are many policy problems that were not captured by the traditional optimal policy approach. First there are problems of rent-seeking and corruption. Consider, for example, the problem of implementing effective infant industry protection in the developing world. Even if a convincing case can be made that there are important market failures which make such policies optimal, there are also serious problems of effective implementation that need to be understood if policies are to be effective.

Another area where policy implementation is important concerns policies where success is only learned over long time horizons and governments have difficulty committing to a long-term strategy. This is not strictly a problem of politics as the problem also arises with a benevolent government.[2] However, the existence of periodic elections in representative democracies brings the problem into sharp relief. This kind of reasoning has had, for example, a significant impact on thinking about the of institutions for central banking.

But the issue is much more than dealing with problems of government failure. There are also issues of whether the benefits of state action are targeted to needy groups. One important policy issue where this applies is to decentralization in the developing world where the aim is to improve access to public resources among traditionally disadvantaged groups.

As we shall see, the new political economy responds to this challenge by finding a way of thinking about how policy design is affected by choices between institutions.[3]

Developments in economic theory are important too. One of the crowning achievements in economic theory in the 1970s was in developing the implications of imperfect information for markets. But the thrust of the research was towards finding many different ways in which (in theory at least) markets

[2] As was recognized by Kydland and Prescott (1977).

[3] See Djankov et al (2003) for a more general discussion of the institutional approach.

failed. The *reductio ad absurdum* was Greenwald and Stiglitz (1986) which showed that there was no presumption at all of market efficiency. Thus, the case for government intervention on grounds of market failure seemed limitless. But herein lies the problem – no longer does it seem that the case for intervening in markets can be resolved purely on economic grounds. In fact Stiglitz (1996) recognizes this when he says that:

> "the Greenwald-Stiglitz theorems should not primarily be taken as a basis of a prescription for government intervention. One of the reasons that they do not provide a basis for prescription is that doing so would require a more detailed and formal model of government." (Stiglitz (1996) page 33).

The New Political Economy is in part an effort to respond to this challenge.

3 Historical Antecedents

The term "political economy" has been used in many contexts to refer to different intellectual projects. Hence, it is useful to set the newer usage of this term in its wider historical context. It will also help to legitimate the adjective "new" for the enterprise that I am discussing in this lecture.

3.1 Classical Political Economy

The classical economists used the term political economy synonymously with economics. Some time in the late nineteenth century, scholars of the economy came to use the term economics apart from political economy and, ultimately use of the term political economy lapsed in mainstream economics.

Classical political economy engaged with broader interests than what we would now refer to as *economics*. In Book V of the Wealth of Nations, Adam Smith was engaged in the study of political economy in the narrower sense of the modern lecture. He was keenly aware that effective government involved dealing with incentives inside government. That said, he was not pre-occupied (perhaps not surprisingly given when he wrote) with the interplay between democratic institutions and the economy. However, later scholars such as Henry Sidgwick and John Stuart Mill readily traversed the porous boundaries between economics and politics in their writings.

A key idea in classical political economy was the distinction between political economy viewed as a science and as an art. This distinction, for example, is central to John Stuart Mill [1844/1948] in his essay on the definition of Political Economy. He views political economy as a science as the discovery of truths which teach "in what manner a nation made be made rich" (page 123). Political economy as an art, he views as body of rules for running a successful economy that are similar to prescriptions for good housekeeping. Thus, he remarks that:

> "the great practical *application* of Political Economy, would be to accomplish for a nation something like what the most perfect domestic economy accomplishes for a single household.." (Mill [1844/1948, page 125 – emphasis original).

Of particular note in this era is the work of John Maynard Keynes' father – John Neville Keynes – who published his *The Scope and Method of Political Economy* in 1891. On page 34, he identifies three branches of economics: positive science (what is), normative or regulative science (what ought to be) and the art of political economy – which he refers to as "formulation of precepts". As for John Stuart Mill, it is apparent that John Neville Keynes views the art of political economy as the branch of economics by which practical maxims are formulated. He remarks:

> "when we pass ... to problems of taxation, or problems that concern the relations of the State with trade and industry, or to the general discussion of communistic and socialistic schemes – it is far from being the case that economic considerations hold the field exclusively. Account must be taken of the ethical, social, and political considerations, that lie outside the sphere of political economy regarded as a science." (page 55).

There is little evidence, however, that studying the art of political economy as described here was of great interest to mainstream economists in the first half of the twentieth century. Nonetheless, the new political economy is re-engaging with the art of political economy as envisaged by the classical economists. That said, the New Political Economy does not view the study of practical policy making as any less of a scientific enterprise than any other branch of economics.

3.2 Comparative Social Systems

One area where the term political economy continued to be used was in discussions of comparative economic systems – particularly in debates about the relative merits of socialism and capitalism. This brand of political economy was in part the preserve of Marxist thinkers. But it was also evident in Austrian thinkers such as Hayek and Schumpeter.

Socialism is a system of social organization which impinges on economics and politics. Thus, it is natural that the term political economy was retained in debates about comparative economic systems. Thus, Marxist political economy studies the capitalist system and the structure of power relations within it as they impact on both economics and politics. The Austrians, especially von Mises and Hayek, emphasized the political and economic benefits to resource allocation in markets.

Political economy considerations surfaced particularly in the market socialism debates of the 1930s where once again they intersected with mainstream economics. Lange and Lerner had proposed a centralized system which could replicate the market system by using a social planner. It was to this that Hayek reacted culminating in his book *The Road to Serfdom*. However, his primary concern was not so much with the problem of benevolence in government, but whether a social planner could be omniscient as the market socialism model appeared to require.[4]

With the fall of socialism, these debates make interesting history of economic thought but offer little of concrete relevance to contemporary economics and politics. But it is clear that the new political economy does have its roots in a prior set of debates in which political and economic issues were jointly influential.[5]

3.3 Public Choice

In continental Europe, the schism between economics and politics was less marked than in the English speaking world. This was particular clear in the field of public finance which remained imbued with law and political

[4] See Boettke and Lopez (2002).

[5] Referring back to the quote above from John Neville Keynes, it is clear that he saw debates about the merits of socialism as falling under the "art of political economy".

science throughout.[6] But it was not until the post war period with the creation of the field of Public Choice that these ideas were systematized into a body of understanding that were integrated with mainstream economics in the English speaking world. The key contributors in this enterprise were Buchanan and Tullock whose 1962 book *The Calculus of Consent* provides a landmark analysis of problems of log-rolling and implications of democratic governance for taxation and public expenditures.

In some circles the term Public Choice is used to refer to *any* analysis that links economics and politics.[7] But here, I am using it more narrowly to represent the work beginning in the Virginia School in the 1950s. This has three distinctive features.

The first key idea in Public Choice analysis is to draw out the implications of rational self-interest for political interactions. Thus, Buchanan says:

> "Individuals must be modeled as seeking to further their own narrow-self interest, narrowly defined, in terms of measured net wealth position, as predicted or expected." (Buchanan (1989, page 20)).

In fact, this supposition is far from new and has echoes of David Hume who notes that:

> "In contriving any system of government and fixing several checks and controls of the constitution, every man ought to be supposed a knave and to have no other end, in all his actions, than private interest. By this interest, we must govern him, and by means of it, nothwithstanding his insatiable avarice and ambition, co-operate to the public good." Hume xxx, page xxx

To most economists, this may seem innocuous. After all, economic agents as rational egoists is a firmly established tradition in a market context. But there is a much older tradition going back at least to Aristotle recognizing the possibility that individuals might curb their self-interest in the pursuit of public service. The Public Choice approach marginalizes this.

The second key idea in public choice analysis is the importance of constitutions as constraints on self-interest. Here, Buchanan says:

[6] The excellent collection edited by Musgrave and Peacock (1958) brought these contributions to the attention of the English speaking world.

[7] For example Mueller (2003).

> "To improve politics, it is necessary to improve or reform rules, the framework within which the game of politics is played. There is no suggestion that improvement lies in the selection of morally superior agents who will use their powers in some "public interest"" (Buchanan (1989, page 18)).

In his analysis of constitutional issues, Buchanan draws inspiration from Madison's *Federalist Papers*. That said, there is a tension between Madison and Buchanan on the issue of self-interest. Madison is indeed concerned with how institutions can constrain self-interest, but he also believes in the goal of political systems to select "persons of character" to office which presumably means those who take their fiduciary responsibility seriously.

Buchanan distinguishes two dimensions of constitution design. One is the *procedural* constitution whereby the rules for political engagement are determined. The other is the *fiscal* constitution which puts direct constraints on policy choices.

The third key aspect of Public Choice is its normative framework. Economists have tended to work with a particular (broadly Utilitarian) framework in which good and bad outcomes are seen in terms of their impact on individual's utilities taken as an indicator of well-being. Various proposals have been made for how to trade these off to get measures of "social welfare" which allows the analyst to engage in policy debates about good and bad policies. But the Public Choice approach is rooted in a quite different normative tradition – one that goes back to classical eighteenth century views of the state (particularly John Locke). The main idea is that the legitimate domain of the state is related to what freely contracting individuals would be willing to agree to, but only that.

While Buchanan has been a champion of these ideas, it was the Swedish economist Knut Wicksell who first applied these ideas in a concrete policy setting – the provision of public expenditures. (see Wicksell (1896)). He studies the problem of public provision via unanimity rule and observed that with benefit taxation, the allocation would obey the contractarian ideal. This approach conflicts with a standard welfare economic framework which appeals to some other authority (the guardian of social preferences) as the arbiter of the justness of the allocation.

This intellectual framework gives rise to the Public Choice critique of welfare economics observing a conflict between its recommendations and the kind of idealized world that Buchanan and Wicksell envisaged. On the whole, the case for intervention is less permissive than the welfare economic view. Moreover, the framework of the analysis has a libertarian flavour.

The Public Choice approach also gives precise content to the idea of *political failure* – the allocation of resources in democratic process which does not meet Wicksell's test. Moreover, there is no guarantee that a system of representative government based on majority rule would be immune to such failures – a key insight of Buchanan and Tullock (1962). It is also clear that these concerns were not inspired by observing problems in non-democratic societies, but even in the open democracy of the United States.

The Public Choice approach has inspired countless empirical and theoretical analyses, many of them among scholars who do not buy into the three key features of the approach that I have outlined. The New Political Economy is clearly an outgrowth from this field.

The public choice approach referred to above is often labelled as the Virginia school. The other main political economy school emanates from Chicago and is associated with the work of Becker (1983), Peltzman (1976) and Stigler (1971). The latter are associated with reduced form models of the political process where policies balance political support from those for and against the policy. However, unlike the modern literature, there is little modeling of the detailed institutional structure.

3.4 The Downsian Model

In 1957, Anthony Downs wrote a path breaking book *An Economic Theory of Democracy*. The book was filled with many important ideas, but the one that caught on among economists was a justification for the idea that politics would converge to the preferences of the median voter. Downs described politics in the language of competing firms called "parties" where customers were voters. He observed that if parties cared only about winning, then they would have an incentive to converge to the centre. Similar ideas were also being developed in Black (1958) who recognized the importance of preference restrictions (*single-peakedness*) to this prediction.

So persuasive was this approach that it came in many ways to dominate economists' approaches to political economy issues for a generation. But there are deep-seated problems with it.

First, the reason that parties pick the median outcome in simple models is that this outcome is a *Condorcet winner*. This term is named after the french aristocrat the Marquis de Condorcet. He first discovered the problem that majority rule could lead to cycles where alternative A could be beaten in a vote by B which could be beaten by C, while the latter is beaten by A. Such Condorcet cycles present an insurmountable problem for the Downsian approach. This would not matter, but the for the fact that they are the norm in just about any interesting policy problem – particularly those with multiple policy dimensions where the notion of a median does not make much sense any way.

Countless papers have been written elaborating this point and trying to propose ways around it. But the bottom line is clear. There is relatively little to commend median voter predictions from a theoretical point of view, except in very special circumstances. But this observation belies the fact that the model gained so much influence among economists.

There is another important theoretical problems with Downs' approach. The model assumes that citizens care about policies while politicians are infinitely pliable – adopting any position to get elected. But the latter is knife-edge. If politicians have even a little preference for policies then they will have an incentive to renege after the election. Thus, the model needs to build in reasons why the policy pledges of politicians are credible, a challenge that was taken up by Alesina (1988).

The Downsian approach held much more appeal for economists than political scientists. The latter had long been aware of the evidence from polling data suggesting systematic divergence between median preferences and policy outcomes on key dimensions.[8] The model could offer little insight into where convergence might happen and where it would be absent.

The final problem with an agenda building on the Downsian model is the fact that it is not particularly useful in looking at institutional differences. Indeed if politics is about seeking out median preferences among the electorate, there would be little scope for institutional structure in shaping preference aggregation. There is plenty of good evidence that structures matter in practice and hence that something is at work beyond voter preferences in determining policy outcomes.

4 Aspects of the New Political Economy

The New Political Economy borrows and develops themes from all of its historical predecessors. This section constitutes an effort to distill some

[8] See, for example, Weissberg (1976).

of the main ideas that shape current thinking. We begin by discussing new developments in theory, emphasizing its eclecticism. The second is the centrality of confronting theory with data. The third theme is comparative institutional analysis – aiming to study the implications of alternative "rules of the game". Fourth, we discuss how issues of imperfect information figure centrally in our thinking about politics. Fifth, we discuss dynamic issues.

The New Political Economy is really a collection of studies of specific phenomena. This specificity is the sixth theme. To illustrate, I take three studies from the literature and discuss their findings. This provides a way of illustrating how the other themes shape specific applications.

4.1 Theoretical Eclecticism

The New Political Economy has not solved the problem of studying political competition in the absence of a Condorcet winner. But it has made sure to keep this firmly in the background. There are some new modeling approaches, but the approach is not built around any kind of dominant political paradigm. A few key approaches are, however, gaining currency.

Part of the difficulty in the Downsian paradigm is the fact that there is little institutional restriction on policy *proposals*. It is very difficult to get a stable point when any policy can be proposed by any political actor at any time. By adding more institutional structure to a model, the degrees of freedom open to political actors is diminished and it may be easier to understand policy formation. This idea was a key insight of Shepsle and Weingast (1981) who discuss how restrictions of the structure of proposal power within a legislature can be used to generate a stable point in a multi-dimensional policy space. Roemer (1999) restricts proposal power by modeling within-party conflict. Such restrictions improve the odds of developing a model that predicts an equilibrium outcome in a particular policy context, providing a basis for empirical analysis. Restricting proposal power is also at the heart of the "agenda setter" model of Romer and Rosenthal (1978).

Probabilistic voting features in many recent contributions. This recognizes that there are random shocks to voter intentions which make the mapping from policy choices in political outcomes very difficult for policy makers to predict. This simple device is enormously useful in making concrete progress in studying political strategy.[9] The influential monograph by Pers-

[9] It also helps to overcome some of the technical difficulties associated with finding an

son and Tabellini (2000) makes extensive use of this device in exploring the policy implications of different models. This approach often assumes that there are some fixed and some pliable policy dimensions with competition taking place on the latter.[10]

Old style political economy paid little attention to the selection of politicians. Buchanan's Public Choice approach sees now scope for one politician being better than another. The Downsian model sees policies not politicians as the currency of political competition. But in a representative democracy, it is politicians who are elected and are charged with making policy. This idea has been formalized recently by Osborne and Slivinski (1996) and Besley and Coate (1997). These models suppose that citizens elect politicians who then implement their preferred outcomes. An implication of the candidate centred view of political competition discussed above is that the identity of candidates matter to policy outcomes. A recent ingenious paper by Lee, Moretti and Butler (2004) has looked at close elections (i.e. those determined by a few points) and argue that the data support the candidate centred view of politics for U.S. elections. As we discuss in one of our examples below, there is mounting evidence that patterns of representation matter.

Models of extra-electoral policy making are important. Recent contributions have been heavily influenced by Grossman and Helpman (1994) who formulated the problem of lobbying using an approach in which policy favours are auctioned to the highest bidder. Policy outcomes then reflect the "willingness to pay" of organized lobbies. This approach has provided a much more transparent way of thinking about lobbying compared to the previous generation of models which typically had a black box "influence function".

Even though the tool kit has been refined somewhat, the key issue is to pick that theoretical framework that will give an insightful and transparent account of the phenomenon at hand. There is no reason to believe that any single theoretical approach will dominate.[11]

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equilibrium point in a Downsian model which has an inherent 'discontinuity' in the payoff function around the point at which a party switches from winning to losing or vice versa. A probabilistic voting model tends to make the probability of winning a smooth function of policy choices over some range.

[10] Lindbeck and Weibull (1987) is an important precursor.

[11] Returning to the history of thought, the New Political Economy corresponds to the kind of tool box economics that has largely dominated the latter half of the twentieth century. See Morgan (2003) for discussion.

4.2 Theory meets Data

The New Political Economy has a core concern with empirical testing of ideas. There is a wealth of data to be exploited as well as scope to generate new data sets. Loosely speaking, three main sources of data can be discerned.

There are many studies that look at cross-country variation – exploiting the many differences in institutions that we see between national governments.[12] The great advantage of this is that the extent of institutional variation is vast creating many possibilities for comparisons of institutions. However, on the downside, such institutions tend to be relatively fixed over time and there many sources of heterogeneity across countries which it is difficult to control for in a convincing manner. The difficulty then lies in telling the differences between the effect of institutions and some other unmeasurable factor that is correlated with institutions. In some cases this can be overcome with ingenuity.

Another class of studies exploits variation within countries – where there are differences in politics across sub-jurisdictions. This is not immune to the problems of unobserved heterogeneity discussed in relation to cross-country studies. The fact that many institutions remain fixed over time is also an issue. However, there are sometimes cases where a change in institutions can be exploited or some suitable interaction with a time-varying factor exploited. More generally, sub national data probably suffer less than cross-country data in having highly heterogeneous cross-sectional units. But such studies typically have less variation in interesting outcomes and institutions to exploit.

Finally, there is scope for increasing collection of bespoke data sets to examine specific policy issues. Economists have long undertaken household survey work to investigate economic behavior. There is similarly a tradition of collecting data sets to examine political behavior – voting, activism etc. But only rarely have the two been put together to get a more complete picture. There is growing interest in doing so and in developing pictures of how policy choices evolve. Bespoke data sets could also be used to supplement standard data from official sources.

[12] Persson and Tabellini (2003) is an excellent compendium of what can be achieved using such sources.

4.3 Comparative Institutional Analysis

One of the central themes in the New Political Economy is developing theoretical and empirical implications of alternative institutional arrangements for making political choices. Institutions can be modeled following Douglass North as the humanly devised constraints that shape social interaction or sometimes simply "the rules of the game". For students of game theory or contract theory this is an extremely natural way to look at institutions.

Comparative institutional analysis proceeds by describing an institution in terms of the way it structures interactions in the political sphere or between economic and political actors. The aim is then to find some way of drawing implications of different structures. A good example of theoretical work which looks at these issues is Myerson [1993] which looks at the incentives in electoral systems affects the way in which politicians will target public resources to specific groups. Comparative institutional analysis sees how changing the rules of the game affects resource allocation.

Comparative institutional analysis is also a place where complexity and subtlety can be brought in to capture the ways in which institutions work. One important concerns the possibility of multiple equilibria. This implies that there is no unique prediction associated with a particular institutional arrangement. Moreover, norms or conventions may also have force over and above purely institutional rules.

As we discussed in the last section, comparative institutional analysis is also at the heart of empirical analysis. The aim is to find ways of identifying and then measuring differences between institutional arrangements. This can either be between broad (poorly defined) categories or more detailed differences.

4.4 Importance of Information

One of the central advances in economic theory in the past fifty years has been the development of tools for studying situations where individuals interact in situations where information is imperfect. Indeed, it is now deeply ingrained in the way that economists think about contracts and exchange in markets.

The New Political Economy literature is beginning to gain insights using some of these advances some of which adapt readily in the political sphere. It is clear that political processes operate with actors who have limited information. For example voters are asked to choose between alternatives with only limited information about policies and leaders.

Information is important in thinking about the role of electoral accountability. Here, it is useful to think about the difference between formal and real accountability. A politician is formally accountable if there is some institutional structure that allows the possibility of some action to be taken against him or her (such as being voted out of office) in the event that he/she does a poor job. But there is no guarantee that this ensures that such accountability mechanisms are used effectively. *Real* accountability requires that those who holding politicians to account have sufficient information (for example about the politician's action) to make the system work.

Thus, the conflict of interest between governors and governed is not entirely solved.[13] Insights developed by economists to study other "principal-agent problems" can then be applied. There are problems of moral hazard (unobserved actions by politicians) and adverse selection (unobserved types – either honesty or competence). In the event of a conflict of interest, voters need to find ways of exercising control over politicians and of selecting/retaining those with desirable characteristics. The more information that voters have, the more likely it is that they can do this job effectively.

When information is both dispersed and imperfect then elections serve a role in aggregating information. However, to work effectively, this requires that the informed voters play a dominant role in elections. As long as this is the case, one might be less concerned about declining turnout. Feddersen and Pesendorfer (1996) look at how elections work when some voters are rational but uninformed and they show that it is optimal for them to abstain. They draw the analogy between auctions and voting, where the decisive voter suffers something akin to the winner's curse in an auction.

This informational perspective on politics leaves a role for the study of information providers such as the media and civil society (think tanks and policy analysts) in improving politics. Information provision of this form is increasingly being studied by the New Political Economy and the emerging evidence suggests that policy outcomes *are* affected by media activity. This grounds the possibility that there is a special case for media regulation differently from other industries. It is also clear that low quality media in the developing world may be a factor behind the difficulties of sustaining good policies.

[13] The literature on information in this context began with Barro (1973) and Ferejohn (1986). It is reviewed in Besley (2004).

4.5 Dynamics

Public resource allocation has both short and long run effects on the economy. One distinctive feature of the New Political Economy is the attention that it pays to the dynamics of politics and economics. A key aspect of democratic political life is that governments are typically short-lived while the consequences of many policies are not. Kydland and Prescott (1977) observed that even benevolent governments would have an incentive to make promises that were not credible – for example promise low taxes to encourage investment and subsequently renege on the promise. But the problem is much worse with short-lived government.

A variety of issues have been studied in models that emphasise this feature of political life. A key example is the incentive to incur public debt as a strategic measure to constrain future governments.[14] The political business cycle is another example. Accounts of government incentives to inflate the economy before an election have been around for a long while. But only fairly recently has it been understood how to think about this when voters are not being systematcally fooled.[15]

It is also now clear that long-run patterns of development are tied up with the process of political development. Problems of state failure are endemic in low income countries and their study has been to central to appreciating the forces that shape economic development.[16]

4.6 Specificity

A lecture such as this is not the place to review the huge literature on political economy.[17] Instead, I will pick three examples of research which illustrates the power of the some of the general ideas discussed in the previous section. These are picked somewhat arbitrarily from among the many excellent studies available.

[14] See the discussion and references in Persson and Tabellini (2000).

[15] Rogoff (1990) uses a dynamic model with imperfect information to develop a "signalling theory" of equilibrium business cycles.

[16] See Acemoglu and Robinson (2004) for a recent insightful discussion of these issues.

[17] See Persson and Tabellini (2000) for a review of the main theoretical ideas, Persson and Tabellini (2003) for a review of cross-country evidence and Besley and Case (2003) for review of evidence from across U.S. states.

4.6.1 Majoritarian versus Proportional Electoral Systems

A classic problem in comparative politics concerns the consequences of electoral systems for the pattern of representation and policy choice. Important works by political scientists such as Lijphart (1999) have looked at these issues. This has also been the focus on work in the new political economy with important contributions by Persson and Tabellini (1999, 2003, 2004). In fact the latter look at broader issues, including the difference between Parliamentary and Presidential systems.[18] However, it is the electoral institutions on which we will focus here.

One important theoretical difference between a majoritarian and proportional system concerns the incentive to target particular groups of voters. Majoritarian systems encourage targeting on "swing districts" while proportional systems encourage broader based targeting. Persson and Tabellini (1999) observe that the data should show a greater use of narrowly targeted transfers in majoritarian systems but a tendency towards larger government in proportional systems.

The constitutions of the main democracies in the world can be classified in terms of two key dimensions – Presidential versus Parliamentary and Majoritarian versus Proportional. Figure 1, which is from Persson and Tabellini (2003) illustrates their classification. It shows that there is fairly wide geographical variation in constitutional arrangements.

The form of political institutions can be correlated with policy outcomes using econometric analysis. Here, I focus on the prediction that proportional representation tends to be correlated with larger government. I illustrate this finding in Table 1 using data from the 1990s collected by Persson and Tabellini. The table gives the result from running a regression of the size of government (measured in either expenditure or revenue terms) on the form of the constitution using this two-dimensional classification.

The main finding is that we tend to find larger governments under proportional representation (the same is also true in Parliamentary systems). The effect is sizeable – a 4% point lower revenue take in Majoritarian systems and a 6% point lower size of expenditure. Given that the mean value of revenues in GDP is 26% and the mean of expenditures 28%, these are sizeable effects. Obviously, the form of evidence in Table 1 is crude, but

[18] In a Parliamentary system (unlike a Presidential system), there is a vote of confidence procedure for retention of the political chief executive.

Persson and Tabellini have shown this to be a highly robust conclusion.[19]

Apart from its contribution to debates about constitution design, this study illustrates many of the themes from above – taking the predictions of theory seriously and then investigating their implications in data. It also illustrates how an agenda which examines the implications of alternative constitutional arrangements can be structured.

4.6.2 Political Reservation

My second illustration comes from India which has experimented with reservations in legislatures for women and traditionally disadvantaged groups (scheduled castes/tribes). The implications of reservation have been studied theoretically and empirically by Pande (2003) using state level data and Chattopadhyay and Duflo (2004) using village level data from Rajasthan and West Bengal. It is the latter study that I shall draw on to illustrate the findings.

The Downsian model of political representation does not have much to say about the implications of political reservation – reservation does not change the identity of the median voter. The citizen-candidate approach can be used to think through its implications and is used by both Pande (2003) and Chattopadhyay and Duflo (2004). If candidates of certain types cannot or will not run, and reservation changes this, then we would expect to see a shift in policy outcomes in favor of the reserved groups. That said, if political power is really in the hands of traditional elites whose influence extends beyond the electoral system, then we would not expect to find any effect.

Chattopadhyay and Duflo (2004) exploit the fact that the placement of women candidates in local elections (Gram Pachayats) is random – one third of the seats are reserved randomly for women. Hence, political reservation provides a true natural experiment. Its implications can investigated simply by comparing activism in village governments in reserved and unreserved villages. Table 2 illustrates their findings. It focuses purely on water projects – Chattopadhyay and Duflo looks at many policy dimensions and other issues besides. Water is an important case to consider since studies of preferences show that this an issue that matters a great deal to women.

The findings in the table show that in both West Bengal and Rajasthan,

[19] They worry in particular about the non-random placement of political institutions.

there is significantly more activism in water projects in villages where there is reservation for women in the village council. The effect is large – with more than a 25% increase in water provision as a consequence of reservation. Hence the data support the proposition that constitutional engineering is having an impact on policy outcomes and that changing political representation matters.

This work complements the related study by Pande (2003) which looks at the impact of reservation for scheduled castes and scheduled tribes at the state level in India. She finds that states with greater reservation consistently target more transfers to these groups.

This work shows that focusing on who is elected to office is important and a narrow focus on political competition as purely competition between policy is likely misleading. This study is also an exercise in comparative institutional analysis. The data used by Chattopadhyay and Duflo (2004) was collected with specific reference to this study. In developing countries in particular, this is becoming an important strand of research in the field of political economy.

4.6.3 Term Limits

My final example concerns the impact of term limits on political behavior. Relationships between politicians and voters are not contractual – resembling something closer to a fiduciary relationship. There are a number of disciplinary mechanisms – for example through political parties. But the ultimate sanction is electoral – a poorly performing incumbent is removed from office by the voters. But since a lame duck politician will leave anyway, this sanction should (in theory) have little bite.

The theory suggests two ways of thinking about term limits – incentive effects and selection effects (see Smart and Sturm (2003)). The former arise because politicians face a shorter time horizon and are less obliged to please voters. Whether this increases or reduces the quality of policy is moot. On the one hand, politicians may have less incentive to please voters and hence will "make hay". On the other, politicians may pander to voters eschewing hard trade-offs in fear that voters will treat them unkindly. This lead term-limited politicians to do the right thing. Either way, if electoral incentives matter, then we should expect term-limits to matter.

The second effect is a selection effect. This arises because politicians have to be elected to a lame duck term and rational voters should anticipate this when deciding whether to elect them. This will tend to make politicians who are elected to a lame duck term "better than average". This may counteract any adverse incentive effect.

US states provide a natural experiment for looking at the impact of term limits since Governors are subject to such limits in around half the states. This allows two kinds of comparisons – governors who are subject to term limits compared to their first period in office, i.e. when they were not term-limited, and comparisons of term-limited and non-term limited governors.

Besley and Case (1995) identify the effect of a term limit from the difference between first and second terms in office for incumbents who face term limits. Controlling for state fixed effects and year effects, and using annual data from the 48 continental U.S. states from 1950-86, they find that a variety of policy measures are affected by term limits. Specifically, state taxes and spending are higher in the second term when term limits bind in states that have them. Such limits tend to induce a fiscal cycle with states having lower taxes and spending in the first gubernatorial term compared to the second.

List and Sturm (2001) apply a similar methodology to cross-state variation in environmental policy. They find that governors in their last term in office are significantly more likely to spend resources on environmental protection using data for the period 1960-1999. However, this term limit effect is muted in states where a larger fraction of citizens belong to environmental organizations. They also show that their term limit effect varies according to the margin of victory in the gubernatorial race – with term limit effects being attenuated when the margin of victory is larger.

These results are illustrated in Table 3 which results reports of a regression of state expenditures per capita in 1992 dollars on state dummy variables, year dummy variables and whether or not the incumbent governor is constitutionally barred from running for re-election. There is a positive significant effect on state expenditures per capita when the Governor is term-limited. The effect constitutes an 4% increase in state spending in years in which the Governor is term-limited.

Again, this example exploits an empirical difference between constitutions to gauge its impact. It also illustrates how results can be interpreted in relation to a theory which puts models of political accountability at centre stage.

5 Concluding Remarks

The contributions that I used to illustrate the New Political Economy show the value in focussed research asking a specific answerable question using appropriate data. The new political economy as I have described is much less about grand issues of states versus markets, democracy versus non-democracy. Debates about these issues very often end up being ill-focused and unanswerable. The institutional details of political structure really matter and debating these lofty issues is often just too hard.

The new political economy rises to specific challenges. At a broader level, it is looking behind institutions that generate policy. It is not encouraging us to be more conservative in our appraisal of the capacity for government intervention. But it is improving our understanding of how the institutional structure affects policy outcomes. It concentrates on specific examples, eschewing grand comparisons.

I emphasized at the outset that the New Political Economy is not about economic imperialism, but about bringing new insights into important policy issues in situations where economists have a comparative advantage. I focused on three specific applications to illustrate this, but there are countless others in this burgeoning field. What we learn is a complement with, rather a substitute for, knowledge generated in other branches of the social sciences. In that sense John Neville Keynes was prescient in the following observation:

> "... the great majority of all schools have at least desired to take ... a complete solution of practical problems for social purposes. The conception seems .. to raise the economist to a position of greater importance than he can occupy, so long as he limits himself to purely theoretical investigations or merely conditional precepts. But does he not herein become a good deal more than an economist? He will certainly need for his scientific basis very much more than economic science can by itself afford, for he must be a student of political and social science in the widest sense. ... We have, in fact, no exception to the general rule that arts, claiming to lay down absolute rules, cannot be based exclusively on single theoretical sciences." (Keynes (1891), page 80).

Given the compartmentalization of social scientific disciplines of twenty years ago, this would not have seemed plausible. But today, this is a reasonable ambition at least at the intersection of economics and politics.

I close with a personal anecdote. After finishing my D.Phil at Oxford, my first academic job was as an Assistant Professor at Princeton University. I recall very well an early encounter with one of my senior colleagues – someone whom I continue to admire and respect. On discovering my interest in problems of economic development, he cautioned me that he too had once been interested in such problems but had ceased to be when it dawned on him that the problems of under-development were political rather economic. I recall being dismayed, mostly because if he was right, then most of what I had learned about development would be redundant and I had absolutely no idea about how to think about political problems. I now have more grounds for optimism.

The New Political Economy is about expanding the domain of economic policy analysis and hence enhancing its relevance. We have made good progress in finding ways to integrate politics and economics to think about important problems. Much remains to be done, but the foundations are laid.

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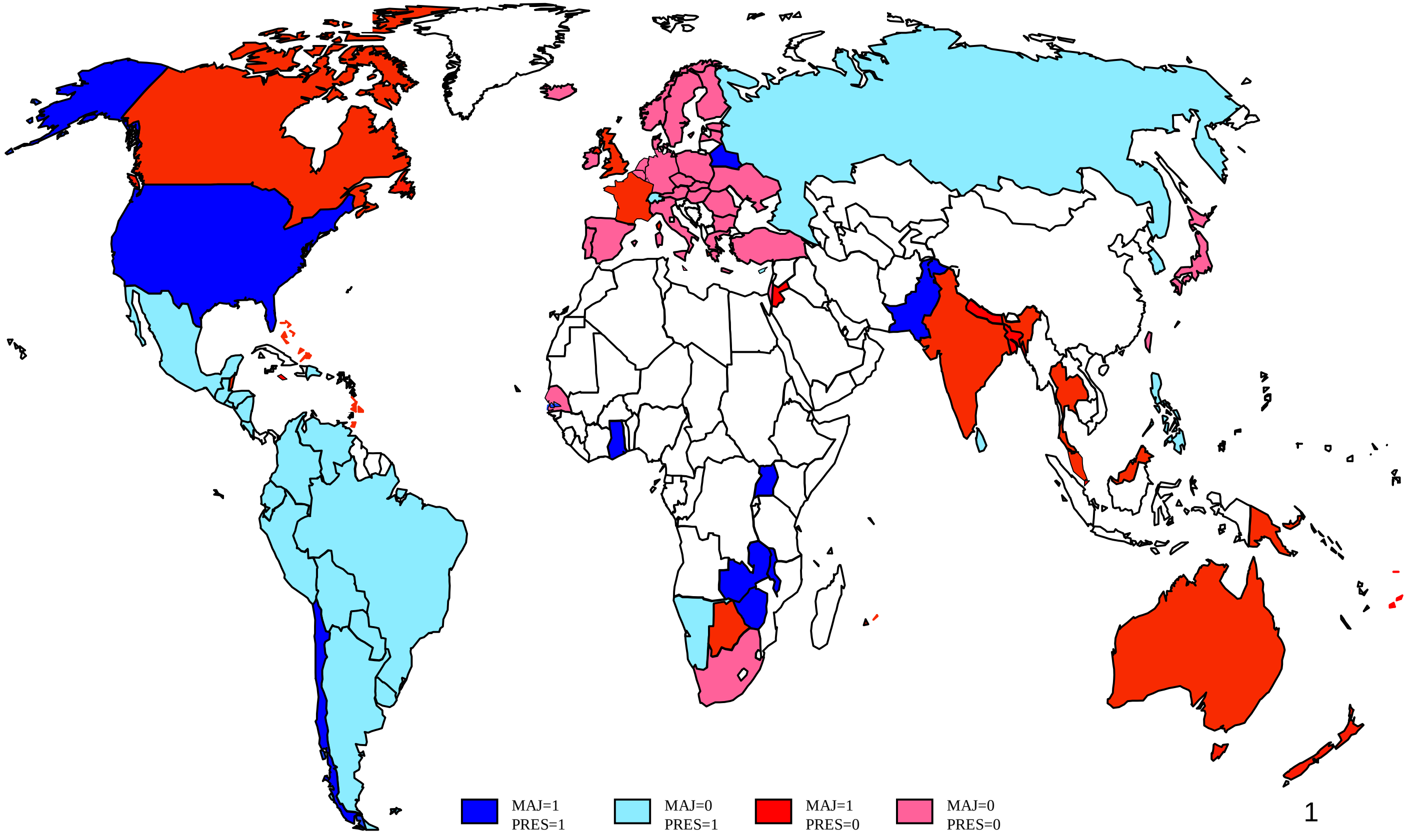
Political institutions 1998



	Central Government Revenue (percentage of GPD)	Central Government Expenditures (percentage of GDP)
Majoritarian	-4.34 (2.10)	-6.04 (3.03)
Presidential	-10.91 (5.92)	-11.52 (6.09)
Constant	32.44 (22.13)	35.73 (25.37)
Number of Observations	78	82

(absolute value of robust t-statistics in parentheses)

Relationship between Majoritarian and Presidential Systems: 1990s

	West Bengal	Rajasthan
Mean Value in Gram Panchayat Reserved for Women	23.83 (5.00)	7.31 (0.93)
Mean Value in Unreserved Gram Panchayat	14.74 (1.44)	4.69 (0.44)
Difference	9.09 (4.02)	2.62 (0.95)
Number of Observations	322	100

(Standard errors in parentheses).
Source: Chattopadhyay and Duflo, *Econometrica* 2004, Table 5.

Number of Drinking Water Facilities Newly Built or Repaired

	Real Government Expenditures per Capita (Mean = $1093 (1982))
Governor Incumbent Cannot Run for Re-election	30.91 (4.07)
Year Dummy Variables	Yes
State Dummy Variables	Yes

Absolute value of robust t-statistics in parentheses)

Term Limits and State Expenditures
48 Continental U.S. States – 1950-2000