

# **The choice of institutions**

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## 1. Economics and Political Institutions

The so called classical economists, Adam Smith, David Ricardo and Karl Marx had clearly in mind the importance of socio political forces as important variable for understanding economic development and transformations.

The neoclassical economic theory starting with Jevons, Walras and the general equilibrium theorists of the late nineteenth century and then twentieth century developed their economic theories in an institution free environment. Institution free economic theory has been the dominant school of thought at least until the nineteenth eighties.

There were however a few exceptions.

a) **Italian fiscal theorist of the late nineteenth century**

The Anglo Saxon School developed optimal taxation theory in an institution free world; the Italian Public Finance School of the late nineteenth century embedded fiscal policy discussion and fiscal theories into political considerations

b) **Constitutional theory**

The classical constitutional theory of Hayek (with his Constitution of Liberty) and by Brennan and Buchanan, (The Calculus of Consent) constitutes a major normative pillar on which we can today think about choosing institutions with an especially strong emphasis on the protection of minorities

c) **The Public Choice School**

This is the school that developed around the work by Buchanan and associates; As James Buchanan acknowledges in a paper in 1951, it takes some inspiration from the Italian public finance school of the late nineteenth century mentioned above. The key idea of this school of thought is politicians maximize self interest fairly narrowly defined. The government is viewed as a Leviathan to be restrained.

Unfortunately the Public Choice School remained vastly out of the mainstream of post war economic theory. Both sides are responsible for lack of communication.

Traditional economists tended to: underestimate the importance of institutions, and they were quite narrow minded in their approach to modelling policy making, refusing to understand the importance of politicians' motivations and constraints in choosing policy. Public Choice Theorists refused to embrace the methodological revolution of standard economic theory, such as a new way of thinking about expectations, standard modelling apparatus, and mathematical and statistical rigor that was becoming the norm in the field.

d) **The rational choice school in political science**

In the meantime the field of political science developed an area that was later known as the rational choice approach, in which researchers applied mathematical tools borrowed from economics to analyze voting behaviour and various issues of political institutions. This field owes a lot to Arrow's paper on the Impossibility theorem of 1951. The initial impetus from the field was to overcome the "negative" result by Arrow and developed model in which voting could be usefully modelled and understood in a predictive manner.

e) **Becker 1973 paper on lobbying**

Gary Becker with a path breaking paper in 1973 offered an approach to modelling lobbying pressure to buy policy from policymakers. This approach received wide applications to international trade and protectionist policies.

## **2. The New Political Economics**

The early nineteen eighties see the beginning of a new line of research sometimes referred to as “new political economics”. Contrary to the previous experience of the public Choice School this area of research become immediately fully integrated with the field of economics.

The key idea of this area of research is that economic policy should not be modelled as if it were chosen by institutional free social planners; instead economic policies are chosen politicians, facing elections in democracies or with other political constraints in non democracies. Also different electoral systems may lead to different strategic interactions amongst political agents.

This approach quickly developed applications in virtually every field in economics: macroeconomics, development, international trade and finance, economic growth, public finance etc. A useful interaction with political science also greatly enriched the field.

In fact this marks the beginning of a new wave of expansion of the topics covered by economics into bordering fields: sociology, physiology, political science even neuroscience.

## **3. Electoral Rules and Economic Policy**

On the topic that has received much interest including in a previous Munich Lecture by Guido Tabellini and the book that followed by Torsten Persson and Guido Tabellini is the effect of electoral institutions on economics outcomes.

Electoral systems vary a lot across countries, from a first pass the post majoritarian systems of Britain, to an almost fully proportional systems in Sweden to proportionality with thresholds like Germany etc. In a proportional system the fraction of votes casted by the citizens for a party translate more or less exactly in the same fraction of seats in the legislation. In majoritarian system generally speaking this is not the case and there is a prize for winning the majority in a district or plurality depending on the system.

The key question is:

Do different electoral systems and various voting rule have different effect one economic policy in general and fiscal policy in particular?

How much do electoral rules really matter?

Regarding this question, we can think of three types of answers given more or less explicitly in the literature.

### **1) The Chicago school**

according to which electoral laws really do not matter that much. Lobbying pressure will determine policies regardless of the details of electoral laws. What matters is lobbies’ abilities to gain voice in the political arena and this has very little to do with the details of the electoral law.

## 2) **Cultural-social capital school**

according to which what matter is not really the institutions of the polity per se but deeper variables like different cultures, various anthropological variables, measures of social capital and trust, social networks and interactions, structure of the family.

## 3) **Institutionalist school**

according to which electoral laws matter because they affect the political equilibrium, the nature and structure of party systems and therefore it has profound effects on policies. A vast literature in political science, the extensive work by Persson Tabellini, work by Milesi Ferretti Perotti and Rostagno and many others in economics holds this view

My view is somewhere in between. It is true that lobbies can manoeuvre around the intricacies of electoral laws to buy favours. It is also true that deeper cultural and social variables are critical. However electoral rules cannot be irrelevant, but the question is how to disentangle their specific effect.

## 4. **How can electoral rule matter?**

Electoral rules affect the nature of party systems, composition of legislature and the effect of the relationship between executive and legislature. Thus Rules can affect economic policy through their effect on the structure or parties. Also there could be differences between presidential versus non presidential systems and various rules affecting the relationship between executive and legislature may matter.

Here are a few examples discussed in the literature.

- i) Proportional electoral systems with large coalition governments produce larger budget deficits and have difficulties in promoting fiscal stabilization;
- ii) In proportional electoral systems social spending is higher and the welfare systems more generous because of more diffuse representation of various groups;
- iii) Presidential systems are more pro active stabilize sooner and spend less in social spending;
- iv) In US cities different voting rules for electing representative affect racial minority representation and policies in that respect.

But can electoral rule considered exogenous variables, to be taken as primitive? This is the key question of this lecture. The answer is not clear cut.

### **1 Electoral laws are costly and complicated to change.**

This is correct and would make it reasonable to use electoral rules as explanatory variables (predetermined or exogenous) as explanation of economic policies and outcomes. But, the original introduction of the electoral law even if unchanged may reflect historical characteristics of a society that may be correlated with what one wants to explain with the electoral law. For example we will

discuss below how differences in social policies in the US and Continental Europe stem from deeper variables ingrained in history than different electoral rules, or to put it differently the choice of electoral rules depend on those variables.

Also while in the nineteenth century electoral laws were rather stable but in the first half of the twentieth century with the extension of the franchise they changed dramatically, in general with a move towards proportionality.

Even if electoral laws do not change too often they cannot be taken always as fixed. In fact, in some cases electoral laws change frequently, consider for instance France after WWI, Italy after 1990, and Eastern Europe after democratization are some examples. Many former communist countries (those where non communist forces were dominant at the fall of Berlin wall) started with very proportional systems and then adjusted them in a more majoritarian direction. Countries where communist parties were still dominant stayed with majoritarian systems and then slowly moved towards proportionality. In Latin America we have had several movements back and forth from dictatorships to democracies. Often the electoral laws which are chosen depend upon the nature of previous dictatorship.

So only up to a point electoral law can be considered fixed. France has had 12 reforms of electoral laws from 1870 to 1988. Virtually all of the reforms can be tied to the desire of whoever was holding power to increase its expected electoral benefits at least the perceived benefits. Here are a few examples. In 1945 a proportional system was adopted for fear of too much concentration of power. Christian Democrats and Conservatives were afraid of a Communist Victory. In 1951 there were some modifications introduced to favour the parties then in office. In 1958 a Constitutional reform by De Gaulle presidentialism to avoid the problems of political deadlock caused by proportional representation and too many parties. In 1985 the Socialists realized that the chances of keeping the assembly were low so they returned to PR to avoid the size of the defeat.

In fact, electoral laws do not change that often BUT note that frequency of changes increase future frequency of changes. Why? In countries where the constitution make it easier to change the electoral law costs of changes (majority needed smaller). Very old electoral law assumes an aura of founding father aura and are harder to change.

## **2 Risk aversion and unpredictability of results of changes**

For a ruling group to change laws one has to be sure about the outcome. A high degree of uncertainty about what the effect of a rule change might be may lead to a status quo bias and low frequency of change. Even when the institutional costs of changing the laws are relatively low, risk aversion about not knowing what the result would be may lead parties to keep the law unchanged. An example is Germany in 1947. After the war and after the Nazi period there was much uncertainty about the distribution of preferences across the population, so lots of uncertainty about which party would have benefited from alternative rules. The result of this uncertainty was proportionality, corrected with a relatively high threshold to avoid the Weimar problems of excess fragmentation.

### **3 Role of former colonizers**

Former colonies often adopted the electoral rules of former colonizers. For example India adopted a majoritarian system and never moved to full proportionality despite the fact that a religiously fractionalized society may be prone to adopt more proportionality.

### **5. Who chooses electoral Laws?**

So electoral law seem to matter in the sense that they seem to be correlated with different political equilibria and party structure but the next is the chicken or the egg questions: what causes what? Let me explain with an example. Duverger's law suggests that in a first pass the post system only two parties emerge in equilibrium. But perhaps in systems where we only have two dominant parties they choose a first pass the post system because such choice is in their interest. Conversely proportionality of electoral rules creates many parties and a system which sometimes is accused of not being capable of delivering fast and pro active legislation because of veto power of even small parties of ruling coalitions. But perhaps multi party fragmented systems reflect fragmentation of society and proportional systems are chosen precisely because it is the only way to grant representation to all groups and avoid social conflict.

In a narrow sense one may argue that electoral systems derive from the desire of ruling elites and ruling parties to maintain their power. So electoral rules change if the ruling elites are threatened by changes of conditions that require a change in electoral rules, an obvious example is the introduction of universal suffrage. As we discuss below the introduction of universal suffrage often lead to a move towards proportionality if the ruling elites felt that they could not control growing socialist parties and believed that maintaining a majoritarian might have led to a socialist victory. Sometimes proportional electoral systems were in the interests of the Socialists and they obtained them because of strikes and street revolts despite opposition of ruling elites.

In general a combination of history, distribution of power within society of various ethnic, religious groups, distribution of income, culture determinant electoral rules. All of these variables that determine the choice of electoral rule also determine policy preferences therefore the correlation between electoral rules and policy outcome may be overstated or simply be the result of third factors. Also the initial level of income inequality may affect the choice of electoral systems. Even culture may matter. Certain culture may have a preference for broad participation rather than delegation, proportionality versus majoritarianism.

### **6. Normative versus Positive Models**

Extensive work on normative models of Constitutions namely how Constitutions should be written behind a Rawlsian veil of ignorance (The classic: Hayek, Brennan Buchanan more recently Caplin and Nalebuff, Barbera and Jackson)

But in reality constitutions and electoral reforms are not chosen behind a veil of ignorance, those who change the rules generally know who will benefit or at least they can form expectations. There are of course some more or less egregious examples. Italy in 2005 a reform of the electoral rule

immediately before the election to make it less majoritarian and by doing so minimize the expected loss of the ruling majority. A case in the opposite direction is New Zealand in 1997 which witnessed a move toward proportionality (a German type model) as a result of the recommendation of a technical commission's which was non partisan and ruled against the stated interests of the two major parties.

## **7. Summing up**

Electoral laws are not irrelevant as determinants of political equilibria and economic policy, but treating simply as given, not changeable and exogenous can lead to seriously misleading results. Especially if one is interested in long run phenomena like the size of welfare state, the evolution of minority protection in voting rights, the structure of society's groups representation in the polity, long run economic policy one has to keep in mind the endogeneity of electoral laws.

So what is left for the student of electoral laws and economic policy? A difficult task that cannot simply be to look at electoral rules as exogenous and look at correlation between such rules and economic policy. One has to go deeper. Here are a few examples.

## **8. Example 1: The choice of proportionality and the effects of proportionality on welfare spending.**

Solid empirical evidence suggests a strong correlation between proportionality of electoral systems and the level of social spending. This is one of the major theme of the book by Persson and Tabellini that originated by an earlier Munich lecture series and a widely cited paper by Milesi Ferretti Perotti Rostagno in 1994.

There is indeed a strong correlation between generosity of the welfare systems and level of social spending as a fraction of GDP. BUT: in many countries the introduction of proportionality had a lot to do with the strength of socialists and communist parties which of course were also in favour of generous welfare states. So proportionality of the electoral system may be only an intermediate variable not the original cause

A prime example of this relationship is a comparison between the United States and Western Continental Europe, an issue addressed in a recent book by Ed Glaeser and myself (Fighting Poverty in the US and Europe, A world of Difference). In Europe proportionality introduced as a result of increase in power of Marxist parties after first and second world war.

Two forces were at play. First growing socialist communist parties demanded representation in post first world war. Before WWI only Belgium Finland Portugal and Sweden had some form of proportional representation. Between 1917 and 1920 Austria Denmark France Germany Italy and the Netherlands adopt various forms of proportional representation often in the aftermath of leftist insurgencies. In some cases the left demands were peaceful (Switzerland Netherlands Sweden in 1907) in some cases violent (Belgium, Italy Germany). These are cases in which non leftist parties had to acquiesce to the demand of the left. This is a case in which perhaps from the point of view of strict maximization of electoral advantages ruling elites could have maintained a majoritarian

system but the pressure from the streets and the weakened armies after First World War made it not possible for the ruling elites not to concede proportionality semi insurgent movements.

Second, when Marxist parties were very strong it was even in the interest of ruling parties to introduce proportionality to avoid defeat. For instance this was the case of Italy and France in the aftermath of the Second World War. In Sweden in 1909 at the time of the extension of the franchise, the conservative party was afraid of losing against radical and socialist parties changes laws into proportional.

Thus the reason why the US did not adopt a proportional representation system is because of the lack of pressure from a Socialist movement in this country, contrary to most countries in Continental Western Europe. In the US communist parties did not grow enough to obtain proportionality and in fact the lack of it in the US is precisely one tool of ruling elites to prevent representation of the (small) socialist parties in the US. Proportional representation was popular and discussed in the US in the nineteenth century. Illinois adapted proportional representation in 1860. In the first thirty years on the twentieth century several cities especially in Ohio adopted proportional representation. But it did not catch on because with the extension of the franchise it became clear that it would have allowed elections of blacks and representatives of the small socialists or even communist representatives. In the south not only proportional representation was not adopted after the abolition of slavery but a variety of measures were introduced to disenfranchise blacks.

The key issue is then the lack of a strong communist party in the US; this is the deeper reason that explains both the lack of proportional representation in the US and less pressure for a more generous welfare state.

Why didn't the US have a strong communist party like in European countries? This is a question that had already received attention by Engels, and later by Sombart in the early nineteenth century. In my book with Ed Glaeser mentioned above we discuss in detail several reasons. First is the role of racial fragmentation of the American working class. As already recognized by Engels and Sombart ethnic diversity made more difficult to develop a unified and cohesive working class sentiment in the US, more so than in Continental Europe and this made it more difficult for Communist organizers in the US. The open frontier to the west allowed some respite from the social tension in eastern US cities and country side. The low density and high distances between cities made it more difficult for communist movements to organize. Finally much of the communist uprising in Europe came after the devastation of the first and Second World War. The US did not suffer such devastation.

The bottom line is that the effect of proportional representation on welfare policies needs to be understood in the context of the deeper historical and sociological variable that led at the same time at the choice of proportional representation and the preferences of society for welfare policies via the strength of socialist movements amongst other things.

## **9. Example 2: Fragmentation of society and fragmentation of party systems**

Multiparty systems (the result of proportional electoral rules) may make policymaking more difficult because of veto power, weak coalition governments etc. In particular vast evidence shows that coalition governments have more trouble reacting quickly to budget deficits and allow the latter



to grow. Compare the United Kingdom and Italy in the seventies and eighties. Both countries went through difficulties but in the UK despite the period of decline up to the early eighties there were never budget deficits for great significance. In Italy with at the time a strict proportional system and multi party coalition governments deficits accumulated so that in the early nineties the debt to GDP ratio in this country was more than 120 per cent of GDP.

So are multi party systems responsible for budget deficits? Perhaps, but multiparty systems may be the results of fragmented societies, so it is really social fragmentation that causes difficulties in policy making not the fragmentation of party systems per se.

Should we expect more diverse societies (ethnically, linguistically religiously) to have more parties? This is the message of work by political scientists on OECD countries like Lijphart 1977 or more recently by Cox and Ordeshook and Svetlova. In fact, imagine a constitutional assembly whose goal is to have representation of all societal groups, more fragmentation of the population will lead to a choice of party structures that allow many groups to feel represented and the choice of an electoral rule that allow, many parties to be represented, a proportional rule precisely. Therefore multi party systems and electoral rules that allow their existence are not the cause of policy inadequacies but they are simply the reflection of cleavages in society. In fragmented societies is difficult to make policies regardless of the nature of party systems.

Therefore it would be incorrect to conclude that proportional representation and multi party systems are responsible to breakdown of policy making delays in reforms etc, but it may be the result of societal forces that would be present even with different electoral rules which in fact might be even worse given the nature of society.

But whether or not multiethnic societies generate more parties and more participation of various groups depends on the nature of who writes the constitution and the distribution of power. If a groups (religious ethnic linguistic) is dominant at the Constitutional table it may choose rules that allow it to rule the country without opposition, in the extreme eliminating democracy in less extreme cases choosing systems that do not allow the non ruling opposition to interfere Aghion Alesina and Trebbi in a 2004 paper show that in a vast sample including all countries in the world less protection of minority rights is observe in more ethnically fragmented societies, another indication that Constitution are not chosen behind a veil of ignorance. There is then a difference between advanced democracies and autocracies. In the former more diversity in society lead to more proportionality, in the latter more diversity may lead to one group seeking power and the expense of all the others.

Also in a recent nice research paper Ticchi and Vindigni provide an example in which the outcome regarding majoritarianism or proportionality in fragmented societies depends on the degree of income inequality. More income inequality lead to majoritarianism and more income equality lead to proportionality and they provide some supporting evidence for it. If that is true more income inequality may at the same time influence the policy choices (say budget deficits).

## **10 Conclusions**

The study of the effect of electoral law on party formation and policy outcomes is complicated because electoral laws are endogenous, i.e. they respond themselves to the socio political economic forces. Especially in a long run perspective and for cross country comparison taking electoral laws as predetermined or exogenous may lead to misleading results and one needs to understand carefully the evolution of laws. The same applies to institutions more generally not only electoral laws.

Do institutions in general and electoral institutions in particular evolve towards optimality? Douglass North first argued yes they do for an evolutionary principle, namely only wealth or utility maximizing institutions survive. However he then argued that not well specified transaction costs may interfere towards the move towards optimality of institutional design. The arguments developed in this lecture serve as a clarification of what these transaction costs are. They are due to the fact that institutions are chosen endogenously by groups of society that have power and intend to keep it. These groups are not maximizing optimality for society as a whole but their own self interest.