

Norman Schofield · Gonzalo Caballero · Daniel Kselman *Editors*

Advances in Political Economy

Institutions, Modelling and Empirical Analysis

This book presents latest research in the field of Political Economy, dealing with the integration of economics and politics and the way institutions affect social decisions. The focus is on innovative topics such as an institutional analysis based on case studies; the influence of activists on political decisions; new techniques for analyzing elections, involving game theory and empirical methods.

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645 The other principal effort made by NIE has been to escape from strict rationality
646 models in order to highlight the importance of cultural and cognitive factors such
647 as beliefs, ideology and myths. In this way, the instrumental rationality approach
648 of RCI meant that “the actors either have correct models by which to interpret the
649 world around them or receive information feedback that will lead them to revise
650 and correct their initially incorrect theories” (North 1990b, p. 356). Nevertheless,
651 the NIE and TCP reject instrumental rationality and assume bounded rationality.
652 North’s (1990b, 1994) proposal includes the idea that individuals make decisions
653 based on subjective models, which had already been presented by Weingast (1996)
654 as one of the challenges of RCI. In this manner, transactional institutionalism sur-
655 passes the suppositions of RCI.

656 This opens the possibility of indicating that history and ideology matter in order
657 to understand politics. The novelty of this perspective is that it is justified through
658 an institutionalism that had initially strictly assumed the following two foundations:
659 methodological individualism and rational approach.

660 Regarding the main contributions of TCP, we should point out that North (1990b)
661 and Dixit (1996, 1998) are the two fundamental contributors who provided the theo-
662 retical bases for the program, while Weingast and Marshall (1988) and North (1989)
663 formed the two relevant precedents. An important contribution to TCP from politi-
664 cal science has been Epstein and O’Halloran (1999), which applied the transactional
665 perspective to the delegation of powers. It included a review of the theory of TCP,
666 and it showed several differences and similarities between economic and political
667 interaction. Taking some lessons from the theory of the firm, Epstein and O’Halloran
668 analyzed the hold-up problem in political transactions.

669 The approach of TCP is useful for organization studies. Public bureaucracy, dele-
670 gation to independent agents and political parties are three relevant issues on which
671 TCP has significantly contributed. Firstly, TCP assumes that the adequate insti-
672 tutions of governance will depend on the characteristics of each type of transac-
673 tions. Then, all models of governance (markets, hybrids, firms, regulation, public
674 bureaucracy, ...) should be considered if we want to determine the best organiza-
675 tional structure that minimizes transaction costs so much as possible. For exam-
676 ple, public bureaucracy is well suited to some transactions, such as the “sovereign
677 transactions” of which foreign affairs is an example, and poorly suited to others
678 (Williamson 1999). In this way, TCP incorporates several efforts to study gover-
679 nance structures and institutional design in the public sector (Estache and Martimort
680 1999; Gallego-Calderón 1999; Ruiters 2005). Secondly, delegation of power to in-
681 dependent agents—such as the central banks or supranational institutions like the
682 European Commission—is best understood as a means of reducing political transac-
683 tion costs (Majone 2001). In fact, there are empirical studies that show that in
684 the process of the autonomization of government organizations, strictly economic
685 aspects are less relevant than factors as bounded rationality, opportunism and social
686 institutions (Ter Bogt 2003). Thirdly, some contributions of TCP have tried to ad-
687 vance towards a transaction cost theory of political parties. Jones and Hudson (1998,
688 2001) explored how political parties reduce voters’ information costs and they argue
689 that if voters reduce transaction costs by relying on party signal, politicians have an
690

691 incentive to maintain party reputation. Other topics in TCP have been the design
692 of budgeting institutions (Patashnik 1996), the countries' international institutional
693 choices and the hierarchy in international politics (Weber 1997), the institutional
694 design relying on separation of powers among specialized agents (Laffont and Mar-
695 timort 1998) and the governance of the relationship between private investors and
696 governments (Henisz and Zelner 2004).

699 **5 High Transaction Costs in Political Exchange**

701 The peculiar nature and intensity of transaction costs in political transactions convert
702 them into an irreplaceable concept when we try to get a better understanding of
703 politics. Several considerations are essential for understanding the relevance and
704 characteristics of political transaction costs, and some of the most important ones
705 must be emphasized.

706 Firstly, property rights are subject to strong constraints within political interac-
707 tions: they are not safe nor do agents possess them in an unlimited manner. While
708 economic competence takes place on property rights that are normally safe, polit-
709 ical competition includes the fight for authority and this means change of rights.
710 Therefore, politics revolves around a set of less safe rules.

711 Secondly, contracting parties are many and cannot be perfectly identified in many
712 cases of political transactions. This happens especially when one of the parties is a
713 multiple subject; furthermore, many political contracts are neither explicit nor for-
714 mal and rest on verbal and even tacit agreements. Moreover, political transactions
715 affect many agents due to the wide presence of spillover effects that enable interpre-
716 tation of interaction between political agents in terms of a "common agency" rela-
717 tionship with multiple principals (Dixit 1996). Furthermore, the structure of agency-
718 relation amongst political actors tends to be especially complex: an example can be
719 the vertical agency-relation that is configured by the chain "electorate-parliament-
720 government-bureaucracy", and yet another example can be the governance of terri-
721 torial distribution of power.

722 Thirdly, there are huge informational problems in political transactions. The
723 world of politics is opaque, unclear and it is difficult to observe and measure the
724 different factors of political performance, such as the objects of political transaction
725 (Pierson 2000). In this sense, political markets lack a measurement formula like the
726 price system in economic markets. Even if they were explicit, political contracts
727 clearly respond to an incomplete contract prototype, containing vague and inter-
728 pretable terms. This implies that the ex-post power relations matters exceedingly:
729 the possession of the residual rights of control is key when, for example, an un-
730 contracted eventuality occurs. Moreover, ex-post control rights may exert strong
731 influence over ex-ante contractual arrangements (Epstein and O'Halloran 1999).
732 Moreover, situations of asymmetric information are particularly relevant in polit-
733 ical transactions and the subjective models of the actors increase the amount of
734 transaction costs even more in political markets (therefore different ideologies af-
735 fect political exchange).

737 Fourthly, the problem of collective action characterizes a wide range of political
738 transactions. The collective nature of politics makes the consequences of my action
739 depend highly on actions of others, such that the relationship between effort and
740 effect becomes quite unclear and informational problems are augmented (Pierson
741 2000). Moreover, the short-term horizon of political actors, who are interested in
742 the electoral logic, contrasts with the nature of those political decisions whose im-
743 plications only play out in the long run. While the economic marketplace possesses
744 some strong mechanisms for lengthening time horizons (such as property rights and
745 capital markets), there are no analogous mechanisms that are equally effective in
746 politics (Pierson 2000).

747 Fifthly, regarding the passage of time, the choice and evolution forces in polit-
748 ical markets are slower and weaker than in economic markets, leading to a lower
749 efficiency and a less intense choice of organizations (Dixit 1996). That is to say,
750 the corrective and learning mechanisms are less effective in political scenarios char-
751 acterized by a path with increasing returns. Political institutions tend to establish a
752 bias towards *status quo* which hampers change and adaptation to new situations, and
753 there exists an institutional density that incorporates constraints based on authority.
754 In this sense, the structure of power can hamper exchange (Pierson 2000), and the
755 carrying out of institutional adjustments to reduce transaction costs. To the above,
756 we must add the difficulties of designing institutions that achieve a high influence
757 of incentives in the political process (Dixit 1996), and the incentive structures in
758 politics are significantly weaker than those in economic markets (Vanhuysse 2002).

759 Sixthly, regarding the enforcement mechanisms, political action promises are a
760 fundamental exchange unit in political contracts but such promises are typically
761 not subject to a compliance mechanism (*third party enforcement*) and limited com-
762 mitment possibilities constrain the political process. Since public policies are not
763 spot transactions, cooperation requires striking and enforcing intertemporal political
764 agreements, that is, agreements that should be enforced over time. The intertempo-
765 ral nature of political exchanges increases transaction costs (Spiller and Tommasi
766 2007). This is the case of those contracts whose bills are not simultaneously con-
767 sidered for a vote, and the case of those with non-contemporaneous benefit flows,
768 such as the next section will show. Moreover, public policies with more complex
769 transaction characteristics will require more institutional safeguards to make them
770 effective over time (Spiller and Tommasi 2007), because as Ostrom (2004) has con-
771 cluded, “rules without enforcement are but words on paper”.

772 Based on these characteristics, among others, transaction costs tend to be sys-
773 tematically higher in political markets than in economic ones (North 1990b; Dixit
774 1996; Caballero and Arias 2003). Several case studies show that political transac-
775 tions are very complicated due to the impact of high political transaction costs, such
776 as for example Sorensen (2006) evaluated when he studied local governments con-
777 solidations in Norway. Moreover, high transaction costs issues tend to gravitate to
778 polity from the economy (North 1990b) and political transaction costs sometimes
779 are increased intentionally; political actors manipulate them strategically to achieve
780 personal objectives. In this way, politically relevant transaction costs are also to
781 a great extent endogenously determined through self-interested use of government
782

783 mechanisms. There are several ways of political transaction-cost manipulation (us-
784 ing informational costs, costs of negotiation, agreement or enforcement), and there
785 are some specific conditions under which officeholders are predicted to act via ma-
786 nipulation of political transaction costs (Twight 1994). In this sense, for example,
787 there is empirical evidence that shows that the enacting coalition manipulates po-
788 litical transaction costs in designing US administrative agencies (Wood and Bohte
789 2004).

790 In a very relevant applied work, Spiller and Tommasi (2003, 2007) have studied
791 the institutional foundations of public policy in Argentina from TCP and they iden-
792 tified some key features that do not promote intertemporal political transactions in
793 the country: “a legislature uninterested in legislative activities, a bureaucracy with
794 no long-term objectives, a judiciary that has often been aligned with the executive, a
795 federal system that grants provinces little incentives for fiscal responsibility, and an
796 executive with excessive leeway for unilateral moves”. The institutional framework
797 of each country is the key factor to make political transactions difficult or easier,
798 and the number of players, time horizons and enforcement technologies are some of
799 the key institutional determinants (Scartascini 2007). In this sense, the framework
800 of Spiller and Tommasi (2007) has been extended to explain the workings of demo-
801 cratic institutions and political actors (Scarstacini et al. 2010). Finally, Dixit (2003)
802 expounds that transactions costs are higher in less-developed countries, where the
803 success of policy reform will depend on the ability to alter or adapt institutions in
804 the desired direction and where credibly commitment to good policies without rent-
805 seeking is difficult (Murshed 2001).

806 Therefore, high transaction costs in political markets imply that inefficient poli-
807 cies and institution can be prevalent (Acemoglu 2003). Studying the institutions
808 of governance that structure political processes in each society is fundamental. We
809 need to know in each scenario how political institutions and historical inheritances
810 lead to the interrelated political behaviors that characterize the policy-making pro-
811 cess (Spiller and Tommasi 2007).

812 813 814 **6 A Case-Study: The Governance of Political Transactions** 815 **in Congress** 816

817
818 A case study can be useful to show the possibilities of the approach of TPC on
819 political transactions and institutions. This section introduces the case of legislative
820 transaction and governance as a case analysis of TCP.

821 Political agreement among legislators is necessary to pass bills in Congress. Leg-
822 islators look for exchange and cooperation to pass those projects in which they are
823 interested. Pre-transactional analysis was focused on vote-trading or logrolling in
824 the tradition that was initiated by Buchanan and Tullock. But the logrolling tra-
825 dition was “too simple to solve fundamental problems in legislative exchange”
826 (North 1990b). In fact, legislative exchange has high transaction costs due to non-
827 contemporaneous benefit flows and non-simultaneous exchanges. It implies that,
828

829 firstly, differential patterns of benefit flows can inhibit trading and, secondly, many
830 potential legislative trades concern bills that do not come up for a vote simultane-
831 ously. The explicit market form of exchange does not resolve these problems of
832 enforceability of legislative transactions (Weingast and Marshall 1988). It is neces-
833 sary to establish an institutional structure of governance that allows the agreement
834 among congressmen and the industrial organization of Congress should try to make
835 legislative exchanges easier. In this sense, “political institutions constitute ex-ante
836 agreements about cooperation among politicians” (North 1990b).

837 Weingast and Marshall (1988) analyzed how the Committee System of the US
838 Congress had relatively low transaction costs. Under this system, a legislator of com-
839 mittee A can cede his intention to influence the selection of jurisdiction of com-
840 mittee B. In return the members of committee B may waive their right so as not to
841 influence the proposals of the jurisdiction of A. The “institutionalization of rights
842 on the agenda control” substitutes the explicit market exchange mechanism. Leg-
843 islators seek a seat on those committees which are more highly valued for them,
844 instead of trading votes. The restrictive access to the agenda constitutes a mech-
845 anism by which each committee can avoid declining the agreements ex-post. Having
846 a position in a committee is a type of property right mechanism that reduces trans-
847 action costs and favors independent negotiations among congressmen regardless of
848 their party affiliation.

849 Legislative behavior and the organization of legislative institutions are affected
850 by political and electoral rules. It is important to distinguish between “party-
851 centered electoral rules” and “candidate-centered electoral rules”, since it is key for
852 the incentives of congressmen. Moreover, the institutional structure of committees
853 is relevant for the structure of property rights of individual congressmen. Electoral
854 rules and committee systems are two of the main institutional determinants of po-
855 litical property rights in legislative organization, and they determine the structure of
856 governance of legislative organization.

857 While the American Congress represents a prototype model of Congress in which
858 congressmen have strong property rights that facilitate the legislative transaction
859 (candidate-based electoral politics, powerful committees with individual property
860 rights), recently the industrial organization of the Spanish Congress has been charac-
861 terized by party-based electoral politics, weak committees and the power of national
862 leaders of each political party (Caballero 2011). In this sense, different models of
863 institutional governance are presented to facilitate political transactions. The indus-
864 trial organizational model of the Spanish Congress does not grant property rights to
865 the individual deputies for their committee seats, and the head of each parliamentary
866 group has the property rights on committees.

867 In this way, legislative transactions and agreements are carried out via a hierar-
868 chical system in the Spanish model. As long as the executive and the majority of
869 the legislature represent the same political preferences, the role of the Congress is
870 clearly reduced. On the other hand, the system of property rights regarding the US
871 committees reduces the high transaction costs of legislative exchange, being that the
872 United States Congress establishes a system of committees that allow transactions
873 between congressmen in order to achieve majorities that permit changing the *sta-*
874 *tus quo*. Therefore, political parties (hierarchy) in the Spanish case and committees

(decentralized system) in the American case appear as key factors in the different models of governance that facilitates decision making and transacting. Each institutional structure has different implications for policy-making (Caballero 2011).

7 Constitutional Political Economy and Transaction Cost Politics

Previously to NIE and TCP, the instrumental rationality approach constituted the main research program on madisonian political analysis from economics. Public Choice and Constitutional Political Economy (CPE) implied a rational approach to politics. Comparing CPE and TCP will show some of the characteristics of the new institutional approach with more clarity.

The Public Choice research program has been developed over half a century. Its hard core can be summarized by three presuppositions: methodological individualism, rational choice and politics-as-exchange. According to Buchanan (1966), such exchange approach is especially useful at the level of constitutional political choices, when the interests of individuals and groups are not clearly identifiable and “the great game of politics” is configured as a positive sum game. The study of this type of choice gave rise to the principal development within Public Choice: CPE.

CPE studies the efficiency of constitutional rules in their positive and normative dimension. Starting from *statu quo*, CPE indicates how the veil of uncertainty in constitutional decisions generates a cooperative attitude towards consensus, and concludes the convenience of the unanimity rule for making this type of decisions (the “rules over rules” system is studied).

The main contribution of Buchanan and Tullock (1962) was to impose a two-level framework on analyzes of collective action, by categorically distinguishing the level of ordinary-politics from the level of constitutional politics (Buchanan 2003). This book meant the start of the CPE, which was founded on the same methodological postulates as Public Choice. CPE studies constitutional order of democratic societies to research into the effects of such order and offer possible improvements to the same.

CPE defends a contractarian framework, both for political analysis as well as for economic theory. However, the application and analytical extension of this contractarian approach turned out to be limited: on the one hand, it was unable to expand as a methodological fundament in the economics mainstream; and on the other hand, the transactional analysis in political studies of the CPE was short and was centered on specific issues (for example around *logrolling*, or around the study of the cost of reaching constitutional agreements). On the other hand, TCP assumed the contractual or transactional approach, initially for economic analysis, and such approach was later expanded from economics to political theory. Transaction is converted into a par excellence unit for political analysis in TCP.

A notable difference between CPE and TCP resides in the human behavior model which they assume. The orthodox CPE adopts the model of substantive rationality (which has been inherited from neoclassical economy), while TCP incorporates the

921 model of bounded rationality (which is characteristic of NIE). These suppositions
922 are key to understand why a greater economicism emanates from CPE that is not
923 quite patent in TCP because TCP integrates economic and political logics on more
924 flexible human behavioral approaches.

925 The theoretical framework of constitutionalists indicates that constitutional decisions
926 are carried out behind a veil of uncertainty, thereby permitting the analysis of
927 “the great game of politics” such as that of a positive sum game. This framework
928 links constitutions with the notion of rule and confers a key role to constitution to
929 understand the operation and results of economy and politics (“the constitution determines everything”),
930 thereby making any political action irrelevant whenever it is not carried out in the constitutional decision level.
931

932 According to the TCP theoretical approach, the agents involved for making constitutional
933 decisions will act strategically despite information problems. Dixit (1996) states that such agents
934 are not behind a “rawlsian” veil of ignorance. Therefore, constitutions are elaborated-rules
935 wherein not everything is a “justice criterion” but where negotiation power structure and the interests
936 of several groups and agents also exert their influence. Furthermore, constitution is just one more
937 element within the complex institutional framework of a society, and this framework integrates formal
938 and informal institutions. According to TCP, constitutions are perceived as incomplete contracts
939 due to their incapacity to foresee all future contingencies, due to the complexity of specifying rules
940 even for foreseen contingencies and due to the difficulty to objectively observe and verify contingencies.
941 Thus, constitutions leave many contractual terms open for future specification and one can gauge the weight
942 of political acts, especially when some of them have long-lasting effects. In this manner, TCP
943 defends that the distinction between rules and political acts is more a matter of level than type
944 and furthermore that the path of institutional evolution is made up of constitutional rules and past
945 political acts (Dixit 1996).
946

947 Works carried out within the TCP program highlight the relevance of transaction costs in political
948 exchanges, thereby permitting us to explain the difficulties entailed in achieving a cooperative
949 solution that leads to optimal efficiency. On the other hand, CPE does not stress the central role
950 of transaction costs for political analysis and, in any case, it assumed a static and simplistic view
951 of political transaction that did not incorporate elements such as intertemporality.
952

953 TCP assumes a theoretical perspective that incorporates the importance of the historic dimension
954 in political studies and assumes the challenge of delving into cognitive matters. In this manner,
955 history and ideologies matter in order to understand political actions. However, CPE assumes a
956 non-historic and non-ideological perspective in positive analysis, and is reinforced in normative-philosophical
957 theoretical developments.
958

960 8 Conclusion

961
962 North (1990b) and Dixit (1996) provided the two founding contributions to TCP.
963 Since then, the TCP research program has indicated the importance of transaction
964
965
966

967 costs in political markets and has studied how political institutions determine the
968 volume of transaction costs and political outcome. In this manner, political insti-
969 tutions become the object of study from a transaction point of view and the map
970 of the new institutionalism in social sciences must incorporate TCP as one of its
971 approaches.

972 TCP is a transactional institutionalism that studies political institutions with its
973 own approach, and has very few common elements with the institutional approaches
974 of normative institutionalism, empirical institutionalism, sociological institutional-
975 ism, interest-representation institutionalism and international institutionalism. On
976 the contrary, the appearance, content and development of TCP was possible based
977 on the institutionalist advances of the programs of RCI, NIE and historical institu-
978 tionalism.

979 TCP coincides with RCI because both are interested in political markets and
980 institutions, both understand political institutions as a cooperative structure and as-
981 sume a model of rationality for political behavior. However, TCP is different from
982 RCI because TCP assumes three characteristic foundations of NIE (bounded ratio-
983 nality, a transactional approach, passage of time matters). In this sense, TCP con-
984 stitutes an extension of NIE towards an analysis of politics from a *madisonian* per-
985 spective (Shepsle 1999).

986 Historical institutionalism has had an important indirect influence on the TCP ap-
987 proach. The main influence was through NIE, which understood the importance of
988 history for institutional analysis but eliminated any historic determinism doses and
989 established an institutional theory based on the fundament of individual choices.
990 This historical perspective of NIE was exported to political analysis by TCP. Like-
991 wise, there were considerable points of intersection and overlap between historical
992 and rational choice institutionalism, and in this sense, there was an overlap with the
993 historical institutionalist content when TCP was in contact with RCI.

994 TCP thus appears as a true and intrinsically institutional research program that
995 occupies its niche in the new institutionalism map of social sciences. This program is
996 centered on positive analysis and concludes the importance of comparative analysis
997 in order to understand the role of the different institutions on political transactions
998 and outcomes.

999 As a conclusion, we should point out some strengths, weaknesses and challenges
1000 of TCP. Three relevant strengths of TCP are the following ones: (a) political trans-
1001 actions are considered as the unit of analysis; (b) political transactions costs can
1002 explain the existence of inefficient institutions, therefore the governance structure
1003 matters; (c) this approach incorporates bounded rationality into the analysis. Among
1004 the weakness of TCP, three issues should be considered: (a) TCP lacks a general the-
1005 ory of political institutions, and possibly this general theory does not exist; (b) TCP
1006 is an approach whose contents are slightly diffuse and the limits of the approach are
1007 not always well-defined (for example, North's shared mental models goes beyond
1008 bounded rationality); (c) power and coercion are very important factor in political
1009 life but TCP has not adequately incorporated the role of coercion in political trans-
1010 actions (Nye 1997; Moe 2005). In any case, these three weak points of TCP are
1011 present too in the NIE.
1012

1013 Finally, three challenges for the future are presented: (a) TCP needs more em-
 1014 pirical work: case-studies, institutional comparative analysis, econometrical work
 1015 and experimental techniques are useful in a TCP that assumes methodological plu-
 1016 ralism. (b) There should be more and more dialogue and exchange between the
 1017 several types of institutionalisms. In this sense, Shepsle (2006) sustains that the dif-
 1018 ferences between some types of institutionalisms are fewer than in the past. In order
 1019 to understand the notion, role and change of institutions, we need to assess and
 1020 integrate contributions coming from the different institutional approaches. (c) Tran-
 1021 scending disciplinary institutionalism implies too that a multidisciplinary profile in
 1022 social sciences is convenient when we are interested in institutions. In this sense,
 1023 Coase (1999b, p. 4) defended the convenience of linking economic science with
 1024 other subjects to convert it into hard science: “We have to take account of the effects
 1025 of the legal system, the political system, etc., and if my impression is correct, their
 1026 theories often have a stronger empirical base than is usual in economics”. North
 1027 (1999) works on the hypothesis of the marriage of political and economic theory
 1028 and Bates (2010) points out the relevance of politics for the new institutionalism.
 1029 Coase (1999b, p. 5) likewise highlighted how “hybrid subjects are often astonish-
 1030 ingly fertile” in science as against the scientific disciplines that remain too pure,
 1031 and proposed transactional analysis as a hybrid subject prototype. The several in-
 1032 stitutionalisms should simultaneously assume a multidisciplinary vocation in social
 1033 sciences.

1034 The transactional approach born in economic analysis managed to tackle the
 1035 study of politics through TCP. The search for a theory of institutions based on
 1036 individual choice favors reconciliation among the different social sciences (North
 1037 1990a). According to North (1999, p. 315), “What Coase started with transaction
 1038 cost approach, is well on its way to being a foundation for restructuring social sci-
 1039 ence theory in general, not just political theory or economic theory”. In this sense,
 1040 there is a road to the New Institutional Social Sciences.

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