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THE NEW POLITICAL ECONOMY*

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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 colonise political science. Rather, the main concern is to extend the competence of economists to analyse issues that require some facility with economic and political decision making. 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. This article is not a survey of the field. It is a selective and personal view of some of the themes in the literature. It is framed more as 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.

1. Why Now?

In the mid 1980s, there was much less interest in political economy issues in mainstream economics than there is now. There were places like Chicago and Virginia where it was taken seriously but papers in top mainstream economics journals were comparatively rare. Policy economics was still dominated by the Pigouvian paradigm which studies optimal intervention based on notions of market failure or the desire to redistribute. The landmark book by Atkinson and Stiglitz (1980) codified this literature for a generation of economists interested in policy questions. Using the notion of a social welfare function, the approach also captured efficiency–equity trade-offs in a rigorous way. However, the literature was broadly technocratic in nature – the main focus being on optimal policies, with little attention paid to institution design and policy implementation.

But 20 years on, things are different both in academia and in the world at large. 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. With the latter development, it has perhaps become more acceptable to critique democracy and to examine its different forms.

The role of competitive markets and private ownership is now widely accepted as the basis for production and distribution of private goods. Morever, when it comes to policy determination, the vast majority of countries now subscribe to governance based on some form of representative democracy.

* This article is developed from my Keynes lecture delivered at the British Academy on October 13 2004. I have, however, endeavoured to maintain the relatively informal style of a lecture in the way that the article is written. I am indebted to an anonymous referee, Erlend Berg, Pete Boetkke, Peter Marshall, Mary Morgan and Torsten Persson for helpful comments on an earlier draft of this lecture and Steve Coate for numerous illuminating discussions.

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

While this gives less prominence to grand systemic comparisons, the consensus leaves many policy issues open. Within the broad ambit of 'representative democracy' remain many important choices regarding institutional structure including electoral rules, judicial oversight and many aspects of the architecture of government. For example, a number of countries choose to delegate monetary policy making to independent central banks whereas others determine it as part of a political process. Analysing these issues requires an understanding of the decision-making processes in these alternative institutions, and of their consequences.

The approach focuses less on picking good policies *per se*, and more on picking institutions apt to implement and sustain good policies.[2] This change of mood among economists is underlined by the following quote from Lawrence Summers, a former US Treasury Secretary and Chief Economist of the World Bank. When asked recently to review the lessons of the 1990s as part of a World Bank project, he argues 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).

This quotation is an example of a now greater acceptance among economists that institutions matter in general.[3] The increased interest in political economy is just one facet of this.

There is now firm emphasis on the need to weigh problems of government failure against those due to market failure. This has lead to a change in the way economists think about many kinds of policy. Consider, for example, the problem of implementing effective infant industry protection. While there are many convincing theoretical arguments for this, there is now a widespread acceptance of the principle that the political forces unleashed by such selective protection need to be weighed against the economic benefits that it can generate. This has increased scepticism about the use of such policies, particularly in the weakly institutionalised settings of the developing world.

There is also an increased focus on increasing government responsiveness, especially to 'needy' groups. This can be influenced by many aspects of institutional design, such as whether government is sufficiently decentralised.

Developments in economic theory have also been important in shaping interest in the political economy. One of the crowning achievements of economic theory in the 1970s was developing the implications of imperfect information for markets. The thrust of this research was towards finding many different theoretical ways in which markets failed. In many respects the *reductio ad absurdum* was Greenwald and Stiglitz (1986) who showed that in equilibrium models of imperfect information there could be no presumption of market efficiency. Thus, the case for government intervention on grounds of market failure seemed limitless.

[2] The early literature on time (in)consistency – for example, Kydland and Prescott (1977) – was the first to emphasise the fact that credibility is a central issue in the formation of public policy.

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

But at this point, the literature lost its relevance. It became clear that the case for intervening in markets could not be resolved purely on economic grounds. In fact Stiglitz (1996) recognises 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).

Therefore, what is needed is a theory of government intervention which understands the pitfalls of government intervention. The New Political Economy at least partly meets this challenge.

2. Historical Antecedents

The term 'political economy' has been used to refer to a variety of 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 here.

2.1. *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. He was, however, not pre-occupied with the interplay between democratic institutions and the economy, although this is not particularly surprising given the time at which he wrote.

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 the science of political economy as the discovery of truths which teach 'in what manner a nation may be made rich' (page 123). In contrast, the art of political economy is viewed 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, p. 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'. He 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.' (p. 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 scientific than other branches of economics.

2.2. *Comparative Social Systems*

The term political economy continued to be used in discussions of comparative economic systems – particularly in debates about the relative merits of socialism and capitalism.[4] This brand of political economy was in part the preserve of Marxist thinkers. But it was also evident in the writings of important Austrian thinkers such as Hayek and Schumpeter.

Marxist analyses of capitalism stressed its role as a method of economic, political and social organisation in which conflicting interests play out. Similarly, socialism is a system of social organisation which impinges on economics and politics. Thus, the major systemic debates seamlessly covered political and economic aspects of resource allocation. Thus, it is natural that the term political economy was retained in these discussions.

One interesting area where political economy considerations became important was in the so-called 'market socialism' debates of the 1930s. Oscar Lange and Abba Lerner proposed a system of planning which they claimed could replicate the market system under socialism. But the analysis did not take issues of government incentives or imperfect information into account. Hayek (1944) reacted to this debate with concerns that culminated in his book *The Road to Serfdom*. However, he did so by questioning the omniscience rather than the benevolence of government. Nonetheless by arguing the need to study government as an actor and not a passive player in the economy, political economy issues were central to his analysis.[5]

With the fall of socialism, debates about comparative systems are now relegated to the history of economic thought and offer little of concrete relevance to contem-

[4] Referring 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'.

[5] See Boettke and Lopez (2002).

porary 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.

2.3. *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 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 systematised into a body of understanding integrated with mainstream economics. The key contributors to 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 expenditure.

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. It 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, p. 20).

In fact, this supposition is far from new and echoes 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, 1742, http://www.econlib.org/library/LFBooks/Hume/hmMPL6.html)

To most economists, invoking self-interest seems 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 recognising the importance of civic virtue in the workings of effective government. The Public Choice approach marginalises this.

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

[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, p. 18).

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 distinctive aspect of Public Choice is its normative framework. Economists have tended to work with a particular welfare-economic framework in which good and bad outcomes are seen in terms of their impact on individuals' utilities. Specific measures of 'social welfare' are invoked to permit the kinds of trade-off which shape good and bad policies. Public Choice uses a contractarian framework rooted in a normative tradition going back to classical eighteenth-century liberal views of the state (particularly John Locke). Broadly speaking, this sees the legitimate domain of the state in terms of the functions that the citizens would freely consent to hand over to government.

Buchanan has championed the relevance of these ideas in defining government failure. However, it was the Swedish economist Knut Wicksell who first applied them in a concrete policy setting, namely the optimal level of public expenditures (Wicksell, 1896). Wicksell considers the implications of demanding that public provision generates a unanimous improvement over the status quo. He shows why this gives a central role to benefit taxation in public finance. However, this can conflict with standard welfare economic approaches to the same problem. The latter will frequently allow for someone to lose from *state* intervention provided that social welfare (which allows 'trade-offs' between the utilities of different individuals) increases.

This conflict between the Wicksellian perspective and the standard welfare economic approach is the basis of the so-called 'Public Choice critique of welfare economics'. On the whole, Wicksell's case for intervention is less permissive than the welfare-economic view. Moreover, the framework of the analysis has a libertarian flavour, since the basis for rejecting the kinds of intervention that some economic models sanction is that the welfare of some individuals is lower. In the limiting case, making just one person worse off would be enough – which amounts to an extreme respect for individual rights.

The Public Choice approach also gives precise content to the idea of political failure – the allocation of resources in a democratic process which does not meet Wicksell's test. As observed by Buchanan and Tullock (1962), there is no guarantee that policy choices by a system of representative government based on majority rule would satisfy Wicksell's principle of unanimity.

The Public Choice approach has inspired countless empirical and theoretical analyses, many of them by scholars who do not approach their work using the three features emphasised above. The New Political Economy is clearly an outgrowth from this broader body of research.[8]

[8] The Public Choice approach referred to above is often labelled the Virginia school of political economy. 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 modelling of the detailed institutional structure.

2.4. *The Downsian Model*

Downs (1957) was a watershed in the development of political economy. The book was filled with many important ideas, but the one that caught on most strongly among economists was his 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 – specifically the median voter. Similar ideas were also being developed in Black (1958) who recognised 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 as an intellectual framework.

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 who is credited with being the first to realise that majority rule can lead to 'cycles', i.e. situations where a majority of the population would prefer *A* to *B* and *B* to *C*, while at the same time *C* is preferred by a majority to *A*. (These are known as Condorcet cycles.) A case in which cycles always occur is in policy problems where the issue is the distribution of a cake of fixed size between three people. For any proposed division of the cake, there is always another division that can be proposed and is preferred by a majority. While real world politics does not yield problems as simple as this, many practical problems preserve the flavour of cake division. Such Condorcet cycles present an insurmountable problem for the Downsian approach since one party can always propose a policy platform that beats any other. So vote-maximising parties would never reach a Downsian policy equilibrium.

Countless papers have been written which elaborate this point and many propose work-arounds. 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.

A second theoretical problem with the Downsian approach is that it assumes that politicians are infinitely pliable – adopting any position to get elected. But this averts the issue of what makes policies credible. If politicians do care about policies, they will have an incentive to choose their preferred policies after the election and voters would be naive to believe their policy pronouncements. Thus, there is a need to develop approaches where the issue of policy credibility is given pride of place. This challenge was taken up in Alesina (1988) who finds that in this setting convergence to the median voter outcome no longer holds.

The Downsian approach has 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.[9] The model offers little insight into where convergence might happen and where it would be absent.

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

The Downsian model also offers little that is useful when studying the implications of institutional differences. If politics is really about seeking out median preferences among the electorate, then it is preferences of voters – not institutional structures – that drive policy. But, as we discuss below, there is now ample evidence that institutional structures matter in practice.

While this discussion has been critical of the Downsian approach, it did help to keep alive to some interest in political economy issues. Downs' book also contains many other insights which have received less attention. However, it is fair to say that much of the recent progress in political economy has been made by setting aside many features of the Downsian approach.

3. Aspects of the New Political Economy

The New Political Economy borrows ideas and develops themes from all of its historical predecessors. This Section distills some of the main ideas that shape current thinking. I begin by discussing new developments in theory, emphasising its eclecticism. Second, I discuss the importance of confronting the theory with relevant data. Third, I examine the relevance of comparative institutional analysis for studying the implications of alternative 'rules of the game'. Fourth, I discuss the central role of imperfect information in contemporary thinking on political resource allocation. Finally, I look at dynamic issues – i.e. political resource allocation over time.

The New Political Economy is really a collection of studies of specific phenomena.[10] Hence I end this Section by providing concrete examples in three main areas. This will illustrate how progress is being made in general.

3.1. *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 kept this issue firmly in the background. There are some new modelling approaches but the literature has not tried to build around any dominant theoretical paradigm. However, a few key ideas are gaining currency.

Part of the difficulty in the Downsian paradigm is the fact that there is little institutional restriction on policy proposals. In many settings it is very difficult to get a stable point when any policy can be proposed by any political actor as part of the political game. By adding more institutional structure to a model, the degrees of freedom open to political actors is generally diminished and it becomes easier to understand the policy formation process.

This idea is a key insight of Shepsle and Weingast (1981) who discuss how restrictions in the structure of proposal-power within a legislature can be used to generate a stable point in a multi-dimensional policy space in which no Condorcet winner may exist. Roemer (2001) restricts proposal-power by modelling 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.

[10] Besley and Persson (2007) also approaches its review of the field in this way.

Restricting proposal power is also at the heart of the 'agenda-setter' model of Romer and Rosenthal (1978).

Probabilistic voting also features in many recent contributions. This allows for random elements in voting decisions which make the mapping from policy choices to political outcomes difficult for policy makers to predict. This simple analytical device is useful in making concrete progress in studying political strategy.[11] The influential monograph by Persson and Tabellini (2000) makes extensive use of the approach 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.[12]

Traditional political economy paid little attention to the selection of politicians. As we noted above, Buchanan's version of Public Choice removes any scope for one politician to be 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 formalised 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 *et al.* (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 US elections. As we discuss in one of our examples below, there is mounting evidence that patterns of representation – in terms of who is selected to office – matter.

Models of extra-electoral policy making are also important in recent analyses. Recent contributions have been heavily influenced by Grossman and Helpman (1994) who formulated a model of lobbying in which policy favours are auctioned to the highest bidder. Policy outcomes then reflect the 'willingness to pay' of organised 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 in any analysis is to pick the 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 come to dominate.[13]

3.2. *Theory Meets Data*

The New Political Economy emphasises empirical testing with three main sources of data being used.

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

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

[13] 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.

First, there are many studies that use cross-country data. This often exploits differences in institutions that are observed between national governments.[14] The great advantage of pursuing this approach is that the extent of institutional variation creates many possibilities for comparing political institutions. The disadvantage is that institutions tend to be relatively fixed over time and that there are many sources of heterogeneity across countries which are difficult to control for in a convincing manner. The difficulty then lies in telling the difference between the effect of institutions and some other unmeasurable factor that is correlated with institutions. In some cases this can be overcome, but it often requires ingenuity.

Second, there are studies that exploit variation within countries, particularly across sub-national jurisdictions. This does suffer from some of the problems discussed in the context of cross-country studies, since regions may vary for cultural, economic and social reasons which are difficult to control for. The fact that many institutions remain fixed over time is also an issue. However, there are sometimes cases where a change in institutions or some suitable interaction with a time-varying factor can be exploited. More generally, sub-national data probably suffer less than cross-country data from having highly heterogeneous cross-sectional units. On the other hand, within-country studies typically have less variation in interesting outcomes and institutions to exploit.

Finally, there is scope for collecting more bespoke data sets to examine specific policy issues. Economists have long undertaken household surveys to investigate economic behaviour. There is similarly a tradition of collecting data sets to examine political behaviour – 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 thereby to develop pictures of how policy choices evolve. Bespoke data sets could also be used to supplement standard data from official sources.

3.3. *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 modelled 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 a 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 for different structures. A good example of theoretical work on these issues is Myerson (1993) which looks at how incentives in electoral systems affect the way in which politicians will target public resources to specific groups. In general, comparative institutional analysis discusses how changing the rules of the game affects political 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 concern is the possibility of multiple equilibria, meaning that there is no unique prediction

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

associated with a particular institutional arrangement. Norms or conventions may then also have force over and above purely institutional rules.

As 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 and their outcomes. This can either be between broad (poorly defined) categories or more detailed differences.

3.4. *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, the concept of imperfect information is now deeply ingrained in the way economists now think about contracts and exchange in markets.

The New Political Economy literature is beginning to generate insights that stem from bringing these ideas to bear on problems of political resource allocation. This is motivated by the observation that actors in political processes often operate with limited and asymmetric information. For example, voters are asked to choose between alternatives with only limited information about policies and leaders. This ignorance may then affect how political campaigns are conducted.

Information is important in thinking about the nature of political accountability and the links between accountability and policy outcomes. Here, it is useful to differentiate 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 such accountability will be effective in practice. Real accountability requires that those who are holding politicians to account have sufficient information (for example about the politician's actions) to make any sanctions effective.

Limited accountability due to imperfect information is one of the main reasons why conflicts of interest between governors and governed cannot be completely resolved.[15] Insights developed by economists to study other related 'principal–agent problems' can be applied in political economy. 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 voters have, the more likely it is that they can do this job effectively.

When information is both dispersed and imperfect, 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

[15] The literature on information in this context began with Barro (1973) and Ferejohn (1986). It is reviewed in Besley (2006).

and 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 to observe 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 policy environments.

3.5. *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 it pays to the dynamics of politics and economics, i.e. the evolution of economies and policies over time. 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) observe 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, even if such governments are benevolent.

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.[16] 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 systematically fooled.[17]

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 central to appreciating the forces that shape economic development.[18]

3.6. *Specificity*

A lecture such as this is not the place to review the voluminous recent literature in the field of political economy.[19] However, a better feel for the contribution of the field to policy making can be gained by looking at a few examples of recent work. While these

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

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

[18] See Acemoglu and Robinson (2006) for a recent insightful discussion of these issues.

[19] 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.

are picked somewhat arbitrarily from among the many excellent studies available, they will serve to illustrate some of general themes raised above.

3.6.1. *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 work has been done on this topic by political scientists such as Lijphart (1999). It has also been the focus of 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.[20] However, it is the electoral institutions on which we will focus here.

One important theoretical difference between a majoritarian and a 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. 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 Persson and Tabellini have shown this to be a highly robust conclusion.[21]

Apart from its contribution to debates about constitution design, this study illustrates many of the themes discussed 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.

3.6.2. *Political reservation*

The 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

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

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

Table 1

Relationship Between Majoritarian and Presidential Systems: 1990s

	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

Notes. Absolute value of robust t-statistics in parentheses. Source of data: Persson and Tabellini (2003).

village level data from Rajasthan and West Bengal. I will draw on the latter to illustrate the findings.

The Downsian model of political representation does not have much to say about the implications of political reservation. After all reservation does not change the identity of the median voter. The citizen–candidate approach mentioned above can, however, be used to think through the implications of reservation. It is used by both Pande (2003) and Chattopadhyay and Duflo (2004) to motivate their work. 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 favour 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 this could emasculate the consequences of changing who holds political power.

Chattopadhyay and Duflo (2004) exploit the fact that the placement of female candidates in local elections (Gram Panchayats) is random – one third of the seats are reserved randomly for women. Hence, political reservation provides a true natural experiment. Since placement is random, its implications can be investigated 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 look at many policy dimensions and other issues besides. Water is an important case to consider since studies of preferences show that this is an issue which matters a great deal to women.

The findings in the Table show that in both West Bengal and Rajasthan, 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 propo-

Table 2

Number of Drinking Water Facilities Newly Built or Repaired

	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

Note. Standard errors in parentheses.
Source. Chattopadhyay and Duflo (2004, Table 5)

sition that constitutional engineering has 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 supports the importance of studying who is elected to office in a democracy. The study is also an exercise in comparative institutional analysis. The value of collecting data specific to an issue is also illustrated, since Chattopadhyay and Duflo (2004) collected new data for their study.

3.6.3. *Term limits*

The final example concerns the impact of term limits on political behaviour. 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 may follow their private agendas. On the other hand, politicians may be tempted to pander to voters, in the process eschewing hard decisions that may impose short-run costs in exchange for long-run benefits. This latter effect can lead term-limited politicians to 'do the right thing'. Either way, if electoral incentives matter, then we should expect term limits to matter to political behaviour.

In addition to the incentive consequences, terms limits will induce a selection effect. Politicians have to be elected to lame duck terms. 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 US states from the period 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.

Table 3

Term Limits and State Expenditures 48 Continental US States – 1950–2000

	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.
Source of data: Data from Besley and Case (2003).

List and Sturm (2001) apply a similar methodology to cross-state variation in environmental policy. Using data for the period 1960–99, they find that governors in their last term in office are significantly more likely to spend resources on environmental protection. However, this term limit effect is muted in states where a larger fraction of citizens belong to environmental organisations. They also show that the 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 reports the results 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.

Like the preceding two, 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 gives prominence to achieving political accountability.

4. Concluding Remarks

The contributions used here to illustrate the New Political Economy show the value in focused research asking a specific question using appropriate data. The New Political Economy occasionally engages in debates about grand issues such as the role of states versus markets and the differences between democracy and autocracy.[22] However, a lot of the work is focused on how the institutional details of political structure matter for policy outcomes 'in the small'.

The New Political Economy rises to specific challenges. At a broad level, it is looking behind the institutions that generate policy outcomes. While this occasionally results in a more conservative appraisal of the capacity for government intervention, it also gives a way of thinking about how to make government intervention more effective.

The New Political Economy is not about economic imperialism. The aim is to generate new, policy-relevant insights, particularly in areas where economists may have a comparative advantage. What we learn complements rather than substitutes knowledge generated in other branches of the social sciences. John Neville Keynes was prescient in the following observation:

[22] See Acemoglu and Robinson (2006) for an important contribution on this.

> '. . . 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, p. 80).

Given the compartmentalisation of social scientific disciplines of 20 years ago, this would not have seemed plausible. But today, this is a reasonable ambition at least at the intersection of economics and politics.

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 help us think about important problems. Much remains to be done but the foundations are laid.

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