5

A Closer Look: Case Studies and Mechanisms

In the previous chapters, we have focused on building a theory of how electoral incentives tilt regulatory policy – and hence, price levels – toward producers or consumers. We have also endeavored to construct a persuasive empirical case that real price levels are indeed lower in majoritarian systems. Our results, although strongly robust over samples and methods, do exhibit one obvious limitation: they only capture the two endpoints of a long process between incentives and outcomes. How specifically do legislators bring about higher prices when votes are valued less and the obverse when they are valued more?

Our theory posits that regulatory policy is the key. Where legislators privilege producers, they insulate them from competition through regulations such as licensing schemes or barriers to entry for new competitors. Where consumers are ascendant, liberalization rules the day. Our theory is consistent with our results – producer-coddling regulation should raise real prices – but it is possibly not the only theory to connect electoral arrangements to price levels. Might other regularities between proportional and majoritarian countries explain price differences? Without a closer empirical examination of the mechanism, the actual policy-forming behavior of legislators under different electoral regimes, we cannot rule out rival explanations. We address these concerns here.

This chapter differs from its predecessors in both method and substance. Chapter 2 built a formal theoretical framework; Chapters 3 and 4 have presented systematic and copious empirical evidence; this chapter now reduces the level of abstraction with a concrete case study and the explicit empirical examination of our mechanism. While case studies cannot prove any relationship – perhaps even less so than other methods – they offer a valuable tool to illustrate how a model corresponds to actual events. In so doing, they strengthen theory by showing plausibility and highlighting possible mechanisms. Let us, however, also be explicit about what cannot be achieved: with the exception of some rare natural experiments in which nothing but the key independent variable changes, case studies cannot identify which variables precipitate an outcome, simply because they cannot control for simultaneous variation in multiple potentially causal variables. Indeed, because they only consider a single observation, they also cannot rule out causal processes that are absent in this specific case. There is no way to know whether the observed case is an outlier from a larger pattern. So why offer a case study? It offers insight into the complexity of the policy-making process and how outcomes may come about. With these caveats in mind, this chapter is devoted to an empirical examination of how electoral incentives influence or at least antecede regulatory outcomes and, consequently, prices.

We begin with a brief and simple comparison of regulatory policies across electoral systems. Politicians have a large and complex palette of policy tools by which they can insulate favored producer interests from competition. This abundance of policy tools obviously complicates the comparison of pro-producer regulation across countries because differences can emerge in various, sometimes unmeasured, policy areas. In general, we argue that this makes the ultimate outcome of all constraints on competition – higher prices – the best measure of systematic regulatory differences between countries. As our purpose here, however, is to expose the mechanism, we first examine a common means of privileging producers: barriers to entry for new competitors. At the same time, our case studies – in particular, that of Italy – will underline the point that electoral systems are ultimately endogenous, with informed producers (especially monopolists) strongly favoring proportional methods of election.

Next, we turn to a promising natural experiment. The early 1990s saw an unusual number of shifts in electoral law in developed countries with Italy and Japan abandoning mostly proportional systems (single nontransferable vote, or SNTV, in the case of Japan) for mixed systems in which the preponderance of seats was chosen from single-member districts (three-quarters of the seats in Italy, two-thirds in Japan). In 1993, New Zealand switched in the opposite direction from what had often been regarded as the world's purest Westminster system, bar none (unicameral parliamentary system; two major parties; single-member districts) to a proportional system with majoritarian trappings (mixed-member proportional, essentially copied from Germany). Each of these countries offers a rare opportunity to examine the changes in economic regulation that followed the introduction of a new electoral system. We focus here on Italy, but suspect that Japan and New Zealand would offer equally illuminating reforms.

In the closing section of the chapter, we then turn to two countries that experienced large shifts in their level of electoral competitiveness and again study changes in regulation and price levels. The mechanism of our argument, the different seats-votes elasticities under SMD and PR that yield different policy-making incentives for lawmakers, is effectively a proxy for electoral competition. Where small shifts in vote share correspond to large swings in seat share (SMD), competition is high and votes are dear; where vote share equals seat share (PR) or where shifts in vote share correspond to very little change in seat share (SMD in an uncompetitive, particularly a single-party dominant system), votes matter relatively less and money relatively more. What the seats-votes elasticity (τ) captures is essentially electoral competitiveness, or at least an important component thereof. Thus we should expect large changes in electoral competitiveness to manifest themselves in regulatory and price shifts much as would a change in electoral system. Legislators should be less inclined to enact competition-reducing regulations to protect producers when electoral competition is strong.[1] We test this argument on two countries that have experienced large shifts in electoral competitiveness, the United States and India.

Competition-Reducing Regulation across Electoral Systems

The assertion that governmental regulation can and often does serve the interests of the regulated is certainly not new. Arguments about the "capture" of regulatory agencies by producers were already made famous by the early successes of the public choice school of Buchanan, Tullock, Stigler, Peltzman, and others. Their argument contrasted sharply with the then predominant view of regulation as a means of countering negative externalities, monopoly competition, and other

[1] Although we do not wade into electoral behavior, our logic here builds on John Zaller's argument that real disposable income (RDI) is the best predictor of the incumbent vote share (in the United States). Higher prices, by definition, lower real income and, per Zaller, lower incumbent vote share as well.

market failures (see, for example, Pigou 1938). A cottage industry of empirical and theoretical work has emerged around this debate but it is only more recently that scholars have begun to examine how political institutions structure regulatory incentives and outcomes.

The influential research of Djankov et al. (2002) first showed that regulation in a key area for the welfare of established producers – the entry of new competitors into existing markets – responds to institutional incentives. Regulators inhibit the entry of new firms more where democracy is weak and government expansive. Consistent with the public choice theory of regulation, they find that this heavy hand of government in regulating entry is associated with greater levels of corruption and more extensive unofficial economies, but not with greater quality of public or private goods. While their measures are ones of democracy – constraints on executive power, *de facto* executive independence, the effectiveness of the legislature, competition in the legislative nominating process, and the Polity III Autocracy score – it is important to note that what Djankov et al. ultimately find is the effect of **political competition**. Consequently, it should not be entirely surprising that other institutions that mediate political competitiveness also influence regulatory behavior – and ultimately, we argue, real price levels.

Scartiscini (2002) confirmed the regulatory effect of electoral systems. Proportional, as opposed to majoritarian, electoral systems have been associated with more extensive welfare systems, greater budget deficits (Persson and Tabellini 2003), higher government spending (Milesi-Ferretti, Perotti, and Rostagno 2002), and more frequent strikes (Vernby 2007). Scartiscini, however, argued that the way in which legislators (and their agents) respond to organized and unorganized interests had consequences for which groups are privileged under SMD and PR. Following Bawn and Thies' (2003) modification of Denzau and Munger's (1986) model, Scartiscini demonstrated empirically that majoritarian electoral systems yield significantly lower barriers to entry than their proportional counterparts.

More precisely, Scartiscini investigates how electoral arrangements influence the four specific barriers to starting and operating a new business first examined by Djankov et al.: the number of procedures, the number of days for licenses and approvals, cost, and cost plus time. Controlling for corruption (which, interestingly, reduces barriers to entry) and per capita GDP, he finds that majoritarian electoral systems are uniformly significant and negative predictors of entry regulation. This relationship, estimated from a sample of sixty-five democracies around the world, holds for the proportion of single-member-district seats in the legislature, a plurality dummy, and a form of inverted district magnitude (the number of districts divided by the number of directly elected legislators). This result – which contrasts with weak results for other institutional features such as presidentialism, federalism, bicameralism, and particularism – also speaks to the primacy of the electoral system in influencing electoral strategy and, consequently, regulatory behavior.

Hewing to the implicit theme of this chapter that simpler is sometimes better, we plot the distribution of the four barriers to entry employed by Djankov et al. in Figure 5.1.[2,3] Even in a small, twenty-three-country OECD sample, without controls for corruption or income, a difference between systems emerges.[4] By all four measures, the mean barrier to entry is lower in SMD states. The difference in the number of procedures and the cost of starting and operating a new business is trivial. The difference in the mean number of days required to complete all procedures, however, is quite substantial – nine

[2] Data are from 1999 and are available at http://www.doingbusiness.org/ExploreTopics/StartingBusiness/.

[3] Djankov et al. made several assumptions about the data to ensure comparability across countries. The business is (1) a limited liability company, (2) operates in the country's most populous city, (3) is completely owned domestically and has at least five owners, (4) has start-up capital of ten times income per capita, (5) performs general industrial or commercial activities but no foreign trade activities, (6) leases space and is not a proprietor of real estate, (7) does not qualify for investment incentives or any special benefits, (8) has at least ten and up to fifty employees one month after commencement of operations, all of them nationals, (9) has a turnover of at least 100 times income per capita, and (10) has a company deed at least ten pages long.

[4] The countries sampled are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and the United States.

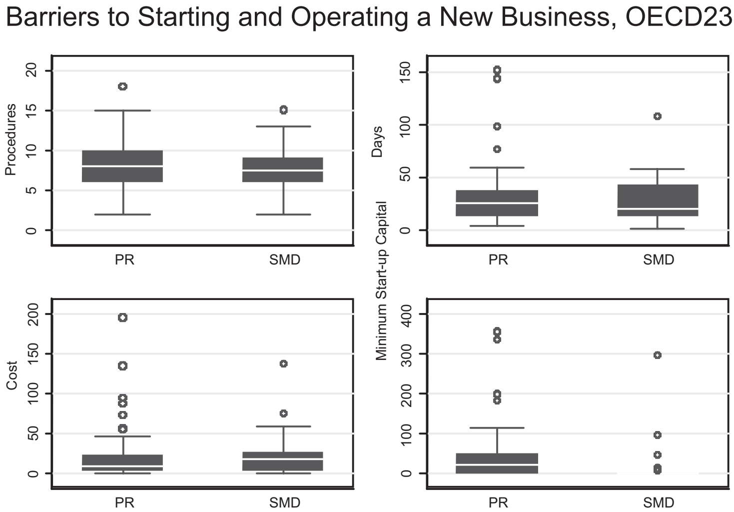

Figure 5.1. Electoral system and competition-reducing regulation

in SMD, sixteen in PR – and the minimum start-up capital shows a large and statistically significant gap. On average, entrepreneurs in majoritarian member states of the OECD23 need deposit only 7 percent of mean per capita GDP to start a company, while their counterparts in PR states faced a barrier of 16 percent. Logging these variables to reduce the influence of outliers does little to change the results.

These findings, of course, are more illustrative than definitive. We refer readers interested in more rigorous investigation to Djankov et al. (2002) and Scartiscini (2003).[5] Our

[5] Rosenbluth and Schaap (2003) also offer corroboration from the banking industry: Centripetal electoral systems (roughly: SMD) force banks rather

purpose here is primarily to examine first a static cross-sectional relationship in order to inform our case study in the following section. If countries with majoritarian electoral arrangements exhibit less competition-reducing regulation of business – and, consequently, lower real prices – should not changes in electoral system also imply changes in regulation and prices? We turn to Italy's experiment with majoritarianism to answer this question.

A Natural Experiment: Electoral Laws, Competition, and Regulatory Reform in Italy, 1993–2005

Long an epitome of proportionalism – perhaps of its flaws more than its advantages – Italy radically reformed its electoral system in the early 1990s to a mixed-member majoritarian system in which three-fourths of parliamentary seats were allocated to single-member district elections and the remaining one-quarter continued to be filled through list PR. Changes of electoral system have been extremely rare in developed countries since World War II, so examining even one case in detail offers important insights. If the cross-sectional association between electoral systems and regulation is indeed causal, we would expect a similar pattern to

than banking customers to pay for the stability of the financial system while the obverse holds under centrifugal (roughly: PR) electoral systems.

emerge over time as well. Italy's change of electoral system offers a rare opportunity (1) to see whether changes in electoral arrangements precede changes in regulation and (2) to examine the particular process by which regulatory reform occurs in greater detail.

In the remainder of this section, we examine origin and implementation of Italian regulatory reform in considerable detail. Our theory predicts a shift toward economic liberalization under the electoral incentives of Italy's experiment with majoritarianism. The multiple origins of regulatory policy and sometimes conflicting effects of numerous variables other than electoral incentives, of course, ensure a complex path to the rollback of anticompetitive regulations. We nevertheless conclude that the introduction of a predominantly majoritarian electoral system between 1993 and 2006 was both a tool for and a source of Italian regulatory liberalization.

The Demand for Economic Reform

As with most social and economic phenomena, multiple factors contributed to regulatory reforms in the Italian economy. Prominent on this list was the weakening economic performance that Italy experienced in the late 1980s and 1990s. The OECD (2002) estimates that potential (i.e., full employment) GDP growth in Italy experienced the largest decrease of all major European economies between the 1980s and 1990s. In per capita GDP growth, the Italian economy sank to a middle ranking among European economies after consistently ranking near the top during the 1980s. Simple conditional convergence – diminishing marginal returns on investment in a constant returns model – explains some of this slowdown. Italian output per capita simply caught up with that of its neighbors (Barro and Sala-i-Martin, 1995). Declining growth in multifactor productivity (MFP) – essentially a multiplier on factor inputs into an economy – also explains some of this change. In a study of growth rates in the OECD (2001c), the OECD explains this drop in MFP growth as a consequence of limited usage of information and communications technology and low spending on research and development but, notably, also as a result of weak competition in product markets.

The need to reform the regulation of Italian product markets to spark innovation and competition was widely understood in the early 1990s. Politicians and businesspeople alike recognized the importance of raising domestic competitiveness given the expected competition both from the Single European Act (SEA), which removed barriers to trade for goods within the European Union in 1992 and from the European Economic and Monetary Union (EMU) that Italy aspired to join at the end of the decade. For decades, Italy had avoided reforms to competition policy and the labor market (among other areas), through a combination of protectionist barriers, collusion of producers and, when unavoidable, currency devaluation to lower real prices and thus boost international competitiveness. This represented a systematic privileging of producer over consumer interests as competition from foreign producers and among domestic producers would have lowered real prices without devaluation. Repeated devaluations, similarly, eroded the real incomes and domestic savings of consumers. The SEA and EMU required that Italy find a new means of maintaining international competitiveness: domestic reform. Nevertheless, Italy, wracked with patronage and corruption, proved incapable of reform in the first half of the 1990s. Vincenzo Visco, a former finance minister, captured the frustration of the period: "Italy appeared to be, and indeed was, a country without an economic discipline, characterized by a low level of social cohesion, mal-governed by a ruling class that was incapable of making brave choices, that yielded to the requests and pressures exercised by interest groups, and which was increasingly and openly corrupt and therefore less authoritative."

Italian bureaucracy for most of the postwar years was burdensome, inefficient, and corrupt. Between the 1950s and 1990s, the Italian state erected an increasingly interventionist web of regulatory requirements, procedures, and rules. Italian legislation – regulatory or otherwise – rarely repealed earlier legislation so, in effect, the state successively laid down layers of confusing, anticompetitive, and sometimes contradictory demands. The public administration could not fully implement much of the legislation, nor could even the most punctilious members of the public comply. The accumulation of regulations together with their low quality – sometimes only social statements of preference, devoid of all details, legislated for political purposes – generated complexity and ambiguity. As a consequence, much regulation became a negotiation between regulators and the regulated, inviting corruption and undermining accountability. Interest groups often captured portions of the administrative bureaucracy that allowed them, in turn, to form policies favorable to incumbent producers and against those of potential market competitors.[6]

In many countries, blaming corruption for political outcomes (or the lack of reform) is little more than populist rhetoric; in Italian politics, however, corruption is indeed an important explanatory variable. Examining judicial requests for the removal of legislator's immunity, Chang, Golden, and Hill (2007) report that an astounding 54 percent of all deputies who served in the Italian lower house between 1948 and 1994 were charged with criminal wrongdoing. Many of these charges were minor and politically motivated, but even the proportion charged with major crimes – quite often involving accusations of political corruption, illegal party financing,

[6] Many of the characterizations and assertions of this paragraph find support in OECD's (2001b) *Regulatory Reform in Italy.*

or abuse of office – remains impressively high: the median proportion of deputies charged with major crimes in the eleven postwar legislatures before 1994 was slightly more than 15 percent, while the final legislature elected under PR reached the dubious landmark of 35 percent of deputies charged with serious malfeasance. In 1995, Italy ranked 32 out of 41 countries in the Transparency International corruption index, a remarkable achievement for an advanced industrial country.

The chronic inability of the Italian legislature to reform itself or the economy and its insulation from voters and consumers was likely related to the low levels of political accountability. Consistent with the conventional understanding that PR delivers less accountability (Powell 2000) and, consequently, greater corruption (Kunicova and Rose-Ackerman 2005, Tavits 2007) than majoritarian systems, Chang, Golden, and Hill (2007) report that the only legislature in which accusations of serious criminal wrongdoing hurt deputies' probability of reelection was the eleventh and final one that faced reelection during the collapse of the Italian party system. Little reform, regulatory or otherwise, took place under the proportional arrangements that governed Italian elections for most of the postwar period.

Italian voters became increasingly frustrated with the absence of economic and political reform. Just as increasing exposure to international economic competition under the terms of the SEA raised demand for greater competitiveness in the early 1990s, the *mani pulite* (clean hands) judicial investigations of the early 1990s, which revealed widespread corruption among public officials at even the highest levels, increased the public demand for political change. This came to a head in April 1993, following a stream of corruption accusations against prominent officials including even Bettino Craxi, leader of the Italian Socialist Party. Voters overwhelmingly backed a referendum that abolished Italy's proportional electoral system. It was replaced that August by a mixed-member majoritarian system.

Given the degree of corruption and deadlock in the Italian legislature, it is not surprising that the impetus for change in the electoral system came from outside of government and parliament. The Italian constitution, somewhat fortuitously, allowed an "abrogative referendum" by which voters, acting directly, could remove parts of legislation with which they disagreed. As Richard Katz (2006) reports, by removing thirteen words from the existing electoral law of the Senate, voters were able to convert a PR system into a mixed-system in which three-fourths of the members would be elected by plurality from single-member districts. Once the Senate's electoral arrangements were changed in the referendum of April 18, 1993, pressure mounted on the lower house of parliament to reform as well. The following August, after considerable dissent within the chamber, they adopted the Senate's new electoral system as their own.[7] This concession was too late to deflect the public's disillusionment, however, and voters again expressed their anger in the elections of March 1994, which ended the eleventh legislature and severely punished all of the governing parties elected in 1992. Eventually all four parties in the then-ruling coalition – the Christian Democrats, the Socialists, the Social Democrats, and the Liberals – would cease to exist, in a major realignment of the Italian party system. Ironically, the first government elected under SMD was that of Silvio Berlusconi in 1994, a prime minister certainly not associated, then or now, with reformist zeal against corruption or cosseted producers.

Electoral System Change as a Tool for Reform

In Chapter 2 of this book we described how electoral incentives under majoritarian electoral arrangements favor regulation that enhances competition and benefits consumers. This association of single-member-district systems with regulatory liberalization and reform, however, might also explain why reform-oriented actors have sometimes urged the abandonment of proportionalism. Thus, Italy's change of electoral system in 1993 might have been a tool for actors seeking

[7] Because the Italian constitution (Article 94) makes the cabinet equally responsible to both houses of parliament, it has long seemed essential to elect both by the same method.

to reform, among other things, the economic role of the state. Although it is certainly not necessary that politicians understand all the consequences of electoral system choice – indeed, many politicians probably remain ignorant of the existence, let alone the effects, of alternative electoral arrangements – it certainly is illustrative that in Italy in 1993 some politicians seemed aware of the link between SMD and pro-competitive policies.[8]

In Italy, the proposal for a predominantly majoritarian system – at first, only for the Senate – was placed on the referendum ballot by its chief advocates, the Committee for Democratic Reform (CORID), as one part of a package of measures intended to reduce sharply state intervention in the economy. Among the companion measures to the Senate electoral reform were (Donovan 1995, 56) abolition of:

- the Ministry for State Participation, which supervised parastatal corporations and hence controlled vast patronage;
- the Ministry of Agriculture, font of farmer-coddling subsidies and of rural patronage;
- partisan control over bank directorships.

[8] The other cases of electoral system change in our sample (France, Japan, and New Zealand) were either instigated for short-term strategic advantage (France) or offer too complex a transition to claim that awareness of implications for competition policy played a role (Japan, New Zealand).

While the major issue was undoubtedly Italy's unraveling web of corruption, nepotism, and thuggery, clearly the cartelistic structure of the economy, extensive subsidies, and out-of-control budgetary deficits were also important targets of the electoral reformers (ibid.). Only by abolishing the dominant "cartel" of parties, it was argued, could Italy's equally cartelized economy be freed from subsidies and state intervention (ibid. 50). Making these issues more urgent was the increasing competition to which the Italian economy was being opened, both by more fluid international financial markets and by its financial integration with the rest of Europe under the Single European Market, effective in 1992 (Golden 2004; Hiwatari 2001b, 4–6 and 14; Donovan 1995, 56). Moreover, the militantly pro-reform Northern League, which attacked particularly the subventions to Italy's South but emerged as a more general advocate of the North's economic vibrancy, moved swiftly (if somewhat opportunistically) to support the majoritarian system that it had initially opposed. Among electoral reform's leading opponents were the "cartel parties" – a majority of the Christian Democrats (DC), Craxi's Socialists (PSI), the Southern-anchored neo-Fascist Italian Social Movement (MSI), and (through its opposition to the leading reformer within the DC, Segni) the Catholic hierarchy (Donovan 1995, 54 and 58).

While it is a truism that many profound institutional changes are enacted by "sleepwalking" actors, unaware of deeper causes, in this instance some of the most important players seem to have understood, however imperfectly, the links among electoral system, economic competitiveness, and price levels.

The First Wave of Reforms, 1990–2001

The importance of the reforms that precipitated, accompanied, and resulted from Italy's switch to a predominantly majoritarian system cannot be overemphasized. Despite that two attempts at a "root-and-branch" reform of the Italian constitution failed – that of the D'Alema Bicameral Commission in 1998 and the center-right coalition's proposed constitutional amendments, rejected by the voters in 2006 – the legal and administrative reforms that did take place were unprecedented in the history of the Italian republic. The OECD (2001b) simply characterizes the changes of the early 1990s as "the most important reform of the Italian state since 1860." Legislators, likely mindful of their greater accountability for voters' welfare under majoritarianism, launched numerous initiatives under a succession of six governments. Competition-enhancing – and, hence, pro-consumer – policies were launched (1) to reduce the state's role in the economy through privatization, replacing old regulatory regimes and institutions and making laws and regulations both simpler and more transparent, (2) to limit the size of the public spending and borrowing (with an eye on EMU admissions requirements), and (3) to shift legislative, regulatory, and administrative authority to subnational levels of government. Government spending and regulatory giveaways would be constrained by a greatly strengthened finance ministry (Hallerberg, 2004, ch. 7).

In broad terms, these reforms succeeded. In the assessment of the OECD (2001b):

> The Italy of 2001 is far different from the Italy of 1990. Step by step, the interventionist producer-oriented, rigid and centralized state of postwar years is being transformed into a market-based, consumer-oriented, and decentralized state. This is being done through a continuing program of privatization, market liberalization and opening, deregulation followed by re-regulation, institution building, and regulatory quality initiatives.

Reform began with the enactment in 1990, even before the advent of the new electoral system and the Single European Market, of a competition law that enjoyed surprisingly effective enforcement throughout the decade. Then in 1993, among the other urgent reforms of that year, parliament passed legislation dramatically simplifying and restructuring regulatory and administrative bodies. The number of inter-ministerial committees was substantially reduced, independent authorities for public services – more insulated from politicians – were established, and new internal controls and audits of results were imposed on administrators (OECD 2001b). The election of the first government under the new three-quarters SMD electoral system in 1994, ironically delayed reform by sweeping into power, along with the new prime minister, Silvio Berlusconi, a class of officials who were provincial, inexperienced, and uninterested in international economic commitments (Visco 2002). The power of voters to hold the government accountable for economic discontent under the new electoral system, however, was soon demonstrated as economic crisis returned the Left (under Lamberto Dini) and accompanying fiscal reforms back to power the following year.

While the initial surge in reforms after 1993 focused most heavily on fiscal governance, by the second half of the decade legislators in the newly majoritarian parliament shifted focus to increasing competitiveness by reducing the state's intervention in the economy, privatizing enterprises, and opening markets. Italian privatization quickly became one of the largest programs among developed economies (OECD 1999b). Between 1996 and 2001, privatizations valued at a total of more than 82 billion Euros were completed (Visco 2002). As one consequence, stocks traded on the Italian Exchange increased by 400 percent in value, growing from a capitalization of some 10 percent of GDP in the early 1990s, to 70 percent in the spring of 2001, similar to that of

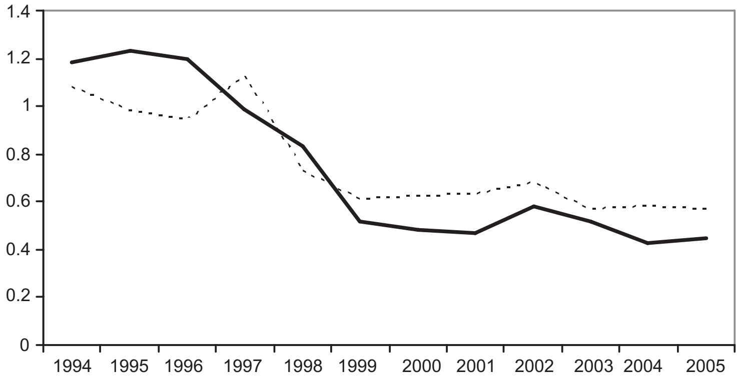

Figure 5.2. Total sectoral and ad hoc state aid as a percentage of GDP (Italy bold; EU15 dotted). *Source:* EuroStat: http://epp.eurostat.ec.europa.eu/portal/.

other European countries (ibid.).[9] An expanded private sector also called for better corporate governance – increasing transparency, protecting minority investors, and ensuring competition – which soon followed. In short, legislators, acting under predominantly majoritarian electoral incentives, removed the state from many of the economic sectors in which it had been deeply involved since the 1950s. State aid as a percentage of GDP only captures part of state involvement in the economy but EuroStat data in Figure 5.2 are indicative of the size of the change in the Italian economy in this period. Although European governments were, on average, retreating from direct

[9] In 1997 and 1998, in the rush to meet Maastricht requirements for entry into EMU, Italian privatization reached 2.4 and 1.1 percent of GDP, well above the European average (Vassallo 2007, 704).

involvement in the economy in the 1990s, changes in Italy outstripped those of its peers.

Not only did Italian legislators and their agents in the bureaucracy scale back state aid in the economy and privatize many state-owned enterprises, but they also dramatically restructured Italian regulation within a few years of the switch to SMD. A series of reforms after 1997, often adopting OECD guidelines on best practices, replaced layers of regulations accumulated over the postwar decades. Regulatory reform began in 1997 with a shift to fiscal federalism intended to reduce regulatory burdens. All competencies not explicitly reserved for the state were transferred to subnational units (Law 59/1997). The following year, parliament simplified administrative provisions and implemented an annual "delegislation" law that would require future governments to suppress administrative procedures and abolish concessions that were judged to have higher costs than benefits (Law 127/1998, 191/1998; Keesings and OECD 2001b).

The push toward enhancing competition can be seen in reforms of the retail sector early in the same year. The government of Romano Prodi proposed to abolish many of the regulations that protected Italian shopkeepers from competition. Shops of less than 300 square meters would be allowed to open without a license; all shops would be permitted to conduct business at any time between 7 and 10 P.M. up to a maximum of thirteen hours per day; and stores would be allowed

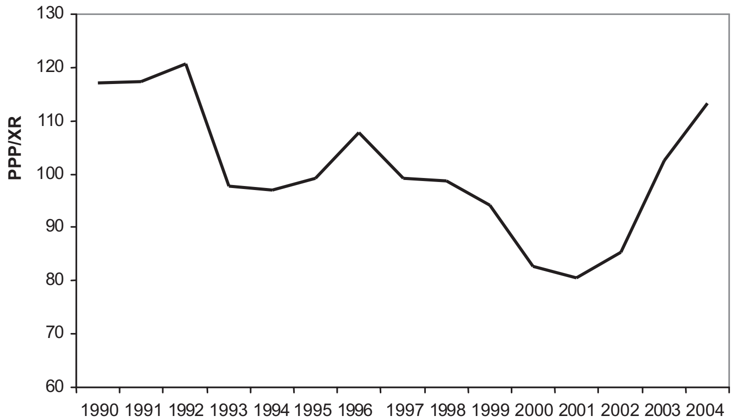

Figure 5.3. Real GDP price level in Italy (USA = 100). *Source:* Penn World Tables 6.2

to sell a greater diversity of products. Prior to these changes, regulations had insulated retailers from competition at the expense of higher price levels borne by consumers. Local outlets could only sell produce within one of fourteen narrowly defined categories. Grocers, for example, could not sell confectionery or tobacco, and butchers could not sell dairy products (Keesings).

Of course, such a large-scale shift in Italian regulation toward open competition and the interests of consumers should also be reflected in real price levels. Figure 5.3 reveals such a change. Italian real price levels, scaled against a level of 100 for the United States, experienced a precipitous drop after the advent of the Single European Market in 1992, then relative stability through the regulatory reforms of 1997, after which prices again steadily declined until the election of the second Berlusconi government in 2001. As we discuss later, however, the Berlusconi government marked a departure from the competition-enhancing reforms of the 1990s.

The final act in the string of pro-competitive reforms that followed Italy's shift to a more majoritarian electoral law arrived in 2001. The simplification bill of that year clarified, simplified, and reduced administrative hurdles to competition. It contained three important components. The *nucleo*, the relatively new unit of government responsible for administrative simplification, was given the right to submit proposals directly to the government, bypassing all ministries. The simplification bill also introduced the "guillotine system" to improve efficiency of regulatory codification. All of the rules to govern a particular sector would be laid down in new legislation and all preexisting rules in the sector would be annulled. Finally, opportunities for confusion and corruption were reduced by creating a centralized, electronic register of all administrative procedures and formats for business and forbidding administrators from requiring any formality not on the Web site. To gauge the scale of the push for deregulation, consider that approximately 10 percent of all legislative acts in the 13th and 14th legislatures (1996 to 2006) concerned deregulation provisions (Vassallo 2007, 701). Not all deregulation provisions, however, stimulated competition.

Competition Policy under Berlusconi, 2001–2005

The election of 2001 brought with it the return of Silvio Berlusconi to what would prove to be Italy's longest serving post-war government. The five years under the second Berlusconi government continued to see major institutional reforms but notably few reforms increasing market competition. Indeed, two of the most infamous reforms under Berlusconi consolidated the dominant market position of his media companies and inoculated him from prosecution for past business misdeeds.

The new government got off to an inauspicious start with its first reform: a "decree law" decriminalizing accounting fraud. Berlusconi himself was implicated at that time for offenses involving the establishment of slush funds by his own companies. Opposition politicians stated that among the hundreds of investigations dropped when accounting fraud was decriminalized were three charges against Berlusconi's business interests (Keesings, August 3, 2001). In 2004, parliament delegated the power to reform national broadcasting to the government. The reforms that emerged the following year reduced market competition by consolidating the dominance of the Prime Minister's own media group.

The momentum in government streamlining achieved in the late 1990s also tapered off. The consolidation of Italy's numerous governmental ministries promised to reduce uncertainty, redundancies, and contradiction in competencies and, of course, regulation. Although not the explicit purpose of governmental simplification, a smaller number of administrative bodies with clearer responsibilities would, in theory at least, reduce the bureaucratic hurdles imposed on business and increase competition. Here too, the Berlusconi government reversed direction. Following up on an earlier reform consolidating the Treasury, Budget, and Finance ministries, parliament passed a broader measure in 1999 reducing the number of Italian ministries – twenty-four in the 1980s, and still eighteen in 2001 – to twelve. By the time this came into force in 2001, however, the new center-right government had amended it to raise the number of ministries to fourteen, maintaining independent communications and health policy ministries (Vassalo 2007, 705).[10]

Reformers interested in improving Italian competitiveness were generally disappointed with the Berlusconi government. As expressed by Luca Cordero di Montezemolo, chairman of Fiat and Confindustria, the Italian business lobby, the highest priority for economic reform in Italy had been greater competition, which included privatization. Berlusconi, in Montezemolo's opinion, did not deliver (*Economist*, November 26, 2005). Possible evidence of this retreat from the

[10] The subsequent Prodi government again raised this number back to eighteen.

pro-competitive reform agenda of the 1990s can be seen in real price levels in Figure 5.3. In steady decline since the reforms of 1997, Italian real price levels, along with the balance of consumer-producer power, quickly reversed with the return of Berlusconi to power in 2001.

Though criticized for its failure to introduce competition to such industries as utilities, insurance, and financial services, as well as for limiting tax reforms to corporate taxes, the Berlusconi government did push through a cluster of three notable economic changes, all in 2003 and 2004. The government passed legislation raising the retirement age from fifty-seven to sixty in 2008 in order to cut pension expenditures. Parliament also approved the “Biagi Laws” liberalizing the labor market by, among other things, permitting for the first time jobs that were neither permanent nor full time.[11] Raising the retirement age and introducing flexibility into the Italian labor market, however, had little direct effect on the balance of consumer and producer interests. The final reform, however, did.

In 2004, one of Italy’s largest companies, the food conglomerate Parmalat, was revealed to be bankrupt. As the accounting fraud that had allowed the company to amass large and unsupportable amounts of debt unfolded, analysts estimated

[11] Marco Biagi, the architect of the labor market reforms, was assassinated for his efforts.

that the cost to the Italian economy could amount to 1 percent of GDP (Keesings, January 2004). Resistance to financial sector reform quickly dissolved. By the end of the following year, parliament had returned the Bank of Italy, the primary financial regulatory body, to public ownership and transferred many of its regulatory powers to Italy's competition authority. Prior to the Parmalat scandal, the Bank of Italy, rather amazingly, had been owned by a consortium of private banks and insurers which it, in turn, was responsible for regulating. It had long been reputed to protect domestic institutions from foreign banking competitors interested in the lucrative Italian market – bank charges (and profits) were among the highest in Europe (*Economist* 2005) – and had already come under scrutiny from the European Commission. (Keesings 2005).

In sum, although the Berlusconi government did shepherd through several reforms, its tenure represents a slowdown of reform, especially as regarded competition-enhancing (de)regulation. Most notably neglected was the service sector that, given the rising share of services in the Italian economy, as in most developed economies, was not negligible. In the last year of the Berlusconi government, services constituted about two-thirds of GDP (*Economist* 2005). Large swathes of the service sector were protected from competition through special rules and regulatory procedures. Small retail, taxis, pharmacies, notaries, and tradespeople were cited as especially cosseted businesses in the press, but the single most important area was probably tourism. In 2005, the *Economist* noted that Italy's position as a tourist destination – top in 1970 – had fallen to fifth by 2005 because of underdevelopment and high prices – both likely the result of barriers to new competition.

The Carryover of Ongoing Reforms under the Left and PR: 2006 to the Present

One reform that the Berlusconi government had no compunctions about pushing through in the final months before its term expired was a return to proportional representation. Although it had been the largest beneficiary of the majoritarian reforms of 1993, the government did not hesitate to jettison majoritarianism when their waning popularity made an election under PR look less risky. In October 2005, the government pushed an electoral reform bill through both houses of parliament returning Italy to full PR before the 2006 elections, scheduled for April 9.[12] Surprisingly, perhaps partly because

[12] The Italian electoral law of 2005 has one majoritarian component built in to create stronger governing majorities. Parties form preelection coalitions. The coalition with a plurality of the national vote share (in the lower chamber) is then given bonus seats to raise them to 340 legislative seats (about 54 percent). In the Senate, the coalitions receiving a plurality of the vote in each region are awarded bonuses. The campaign against the 2005 electoral law argued that the Senate system was likely to result in unworkable majorities in the Senate or a hung chamber. The 2008 election dispelled this fear, however, rewarding a clear majority of 55 percent of the Senate seats to Silvio Berlusconi's coalition.

the backlash against the electoral changes, the Center-Right lost the April 2006 election. Romano Prodi came to power as prime minister at the head of a large and diverse coalition of centrist and leftist parties.

At first glance, the retreat from market competition under the Berlusconi government poses a challenge to our claim about majoritarianism. We assert, however, that few electoral incentives could overpower financial self-interest when the head of the government himself was one of the nation's preeminent producers; and it is indicative that, to try to insulate himself from consumer wrath, Berlusconi reinstated PR. All governments under SMD that did not have a direct material interest in suppressing competition, which is to say all except Berlusconi, presided over competition-enhancing reform. The three governments of the 13th legislature that immediately preceded Berlusconi, consistent with the pro-consumer electoral incentives of majoritarianism, enacted the single largest wave of pro-market reforms in postwar Italian history.

It would have been difficult to predict the tilt of regulatory policy after the second Berlusconi government ended in 2006. Unlike Berlusconi, Romano Prodi's government could be expected to respond to electoral rather than financial incentives; but at the time many elected officials expected a return to a mostly SMD electoral system before the next election. Indeed, when the government did fall in January 2008, Giorgio Napolitano, the Italian president, did attempt, albeit in vain, to revise the election law before new elections.

Thus, the new government pressed ahead with delayed reforms of the service sector. Partly because of the Left's past criticism of Berluconi's failure to reform the service sector and because of uncertainty about how long the current PR rules would endure, and very likely because the small service providers who would be most affected tended to vote for the Center-Right, the Prodi government guided through legislation to improve consumer welfare. Taxi drivers, pharmacists, lawyers, veterinarians, notaries, banks, and bakers lost special protections from competition under a set of reforms named after the economic development minister Pierluigi Bersani.[13] The press reported estimates that the average Italian family would save approximately 1,000 Euros per year (*Economist* 2006a). In October of the same year, it passed competition-augmenting legislation for one more area protected under the previous government, the private television market in which Berlusconi's four channels exercised a near monopoly.

13 Among other things, the "Bersani Decree" increased the number of taxi-licenses, allowed cabs to be driven by more than one license-holder, permitted local government to impose fixed fares for certain taxi routes, allowed nonprescription drugs to be sold outside of pharmacies as long as a pharmacist was present, abolished minimum fees for lawyers and veterinarians, legalized "no-win, no fee" payments for lawyers, and removed notary requirements for selling used vehicles.

Italy in Conclusion

The resurgence of liberalizing reforms after Italy's return to PR as well as the slackening of competition-enhancing reforms during the final five years of majoritarianism testifies to the complex collection of factors that motivated politicians to tilt policy toward consumers or producers. The facts that major reforms first emerged with the shift to SMD, and that SMD had been advocated precisely as a means to such reforms, suggests an important role for majoritarianism. The Berlusconi government's aversion to continued liberalization speaks to another determinant: the partisan orientation of the likely beneficiaries and losers. Berlusconi was hesitant to harm small business in the service sector, a core constituency for the center Right; but the Prodi government, once in power, did not hesitate. And it is revealing that Berlusconi, having repudiated reform, reenacted PR. Finally, no accounting of the causes of regulatory reform in Italy can neglect the dire economic need for more competitive firms able to compete in the single European market introduced in 1992 and the more responsible fiscal policy necessary to gain admission to the nascent European Economic and Monetary Union.

It is probably most accurate to describe the relationship between the electoral system and liberalizing reforms as mutually reinforcing. Reformers supported a shift to SMD because they associated it with the capacity for change.

Once SMD (MMM) was in place, it reinforced the direction of change as legislators realized the heightened value of votes under SMD. It is difficult to overestimate the degree to which four decades of single-party dominance under PR had entrenched anticompetitive regulations favoring special interests. In its survey of Italy in 2005, over a decade after the switch to majoritarianism, the *Economist* still described Italians as suffering from “a pervasive anti-business, anti-customer culture,” and noted that “Italians may be entrepreneurial and creative, but they are by no means pro-market.” That may be so, but no observer of Italian reform in the last two decades can deny that a remarkable shift toward liberalization and competitive markets has taken place.

Electoral Competitiveness and Consumer Power in the United States

Few countries ever change their electoral system, a fact that seems to preclude extensive case study. Although our mechanism focuses on how electoral systems change electoral incentives, the seats-votes elasticity in different electoral systems is but one component of electoral responsiveness. The electoral system governs how vote shares affect contestation in districts but, of course, the balance of vote shares itself should also affect incumbents’ electoral incentives and regulatory behavior. In countries where the electoral system has not changed, it is electoral competitiveness that matters for consumer power. In this final section, we examine how changes in political competiveness have affected the balance of consumer-producer power in the United States.

Consider first the argument: the different seats-votes elasticities that yield different policy-making incentives for lawmakers in different electoral systems are effectively a proxy for electoral competition. Where small shifts in vote share correspond to large swings in seat share (SMD), competition is high and votes are valued; where vote share equates to seat share (PR) or where shifts in vote share correspond to very little change in seat share (e.g., SMD with many "safe" seats), votes matter relatively less and money relatively more. The seats-votes elasticity (τ) captures the rate at which electoral shifts are translated into changes in seat share. Of course, this is only one facet of electoral competitiveness.[14] Our stripped-down model in Chapter 2 assumes an even split of electoral support between two parties, thereby isolating τ, the seats-votes elasticity, as the measure of electoral competitiveness that should influence legislators. Once parties' vote shares diverge, however, both τ and vote share should matter until we reach the opposite extreme.[15] When one party is highly dominant – for

[14] See Kayser and Linzer (2008) for a method of fully measuring electoral competitiveness across different electoral systems.

[15] We even showed in Chapter 2 that the consumer advantage of SMD should be surpassed by proportional systems in cases of extremely weak electoral competition.

example, Mexico under PRI, India under the Congress Party, or Japan in the heyday of the LDP – even a large τ is unlikely to affect the incentives of legislators.

Because the elasticities of SMD ($\tau \approx 2.5$) and PR ($\tau \approx 1$) systems are well known, cross-national research comparing majoritarian and proportional electoral systems offers a useful, if rough, tool to examine the broader effects of electoral competition in cross-national research. In a single-country case study where the electoral system does not change, electoral competitiveness itself is what matters. Absent changes to the electoral system, however, most countries rarely experience large shifts in electoral competition. One prominent exception – and the one we examine here – is the United States.

In the early 1970s, political scientists began to document a dramatic decline in the level of electoral competitiveness in elections for the U.S. House of Representatives. Robert Erikson (1972) revealed that incumbency advantage was increasing; Edward Tufte (1973) demonstrated that the swing ratio – the increase in seats associated with a given increase in the vote – was declining; and, most famously, David Mayhew (1974) showed that the average portion of the two-party vote captured by incumbents had risen while the number of competitive races has dropped. The number of competitive districts – those won by 10 percent of the two-party vote or less – in the U.S. House elections declined from an average of

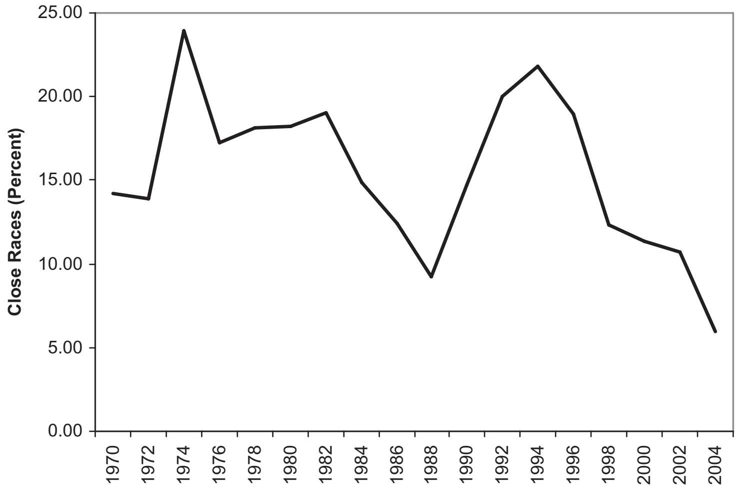

Figure 5.4. Electoral competitiveness in U.S. House races. *Note:* The *y*-axis represents the percentage of House races contested by both major parties in which the two-party vote margin was less than 10 percent. Notice spikes following the Watergate scandal and the 1994 Republican takeover of the House (Gingrich's Contract with America and the Southern realignment). Compiled by author from district level election results. Data sources: CQ Voting and Elections Collection, America Votes 26, 2004–2004 (Richard M. Scammon, ed.), and "United States Congressional Elections, 1788–1997," (Michael J. Dubin, ed).

ninety-four between 1956 and 1964 to only fifty-nine in 1972. Since Mayhew's observation, as we document in Figure 5.4, this trend has continued. Indeed, in the 2004 House elections the number of districts that qualified as competitive by Mayhew's definition sank to twenty-two.

The causes of this long-term decline in electoral competitiveness, rare for a developed democracy, are highly disputed. Scholars have advanced competing theories, locating the source of growing incumbency advantage in areas as diverse as a decline in partisan identification (Erikson 1972, Ferejohn 1977), name recognition and House franking privileges (Mayhew 1974), the growth of the bureaucracy (Fiorina 1977), incumbent quality (Zaller 1998), campaign finance (Green and Krasno 1988) and gerrymandering (Tufte 1973; Cox and Katz 2002).

More consensus prevails on the likely consequences of rising incumbency advantage. The growing weight that voters seem to give to incumbents rather than to their parties when casting their vote implies a decline in the effectiveness of parties and their responsiveness to voters. Among other effects, the growing personal vote suggests that congressional leaders have less influence over the rank-and-file (Collie and Brady 1985) and presidents less influence over congressional co-partisans (Edwards 1980). More worrisome are concerns about responsiveness to voters. Insulated incumbents, accustomed to lopsided victories and weak challengers, have weaker incentives to promote the interests of voters, diminishing the value of each vote and, we predict, tilting their regulatory priority toward consumers.

Against these claims stands a secondary literature asserting that electoral competitiveness, measured correctly, has not changed. Most prominently, Gary Jacobson (1987) has argued that greater volatility in the vote means that "incumbents are no safer now than they were in the 1950s; the marginals – properly defined – have not diminished, let alone vanished; the swing ratio has fallen little, if at all; and so competition for House seats held by incumbents has not, in fact, changed." Others have identified the vanishing marginals as a self-selection problem. After a series of landmark judicial rulings on congressional reapportionment in the 1960s,[16] the more frequent redrawing of constituency boundaries enabled incumbents in facing redistricting to anticipate a competitive race and retire (Cox and Katz 2002). These retirements, they argue, lowered the number of incumbents involved in close elections and increased the average advantage of those who remained.

Despite such skepticism, there is strong evidence that both electoral competitiveness and congressional responsiveness to votes have declined in the United States. As we discussed previously, two important components of electoral competitiveness are vote margins and the seats-votes relationship. As Ansolabehere, Brady, and Fiorina (1992) argue, the debate about the consequences of declining electoral competition has gone astray by focusing on the first while

[16] *Baker v. Carr*, 1962; *Gray v. Sanders*, 1963; *Reynolds v. Sims*, 1964; *Wesberry v. Sanders*, 1964.

the U.S. House has experienced a decline in the latter. It does seem that incumbents in "safe" districts are indeed less "safe" as Jacobson argued. Moreover, incumbents' response to greater uncertainty – more trips to their constituencies, more constituency service, and more resources for their districts – does suggest that the responsiveness of individual legislators to their constituents has not declined.[17] However, this is beside the point: What matters is whether the responsiveness of Congress as a whole has declined.

The decline in the number of marginal districts and the growth in the volatility of vote margins imply that "defeats of incumbents today are less systematic than in the 1950s." That is, a national shift in vote share implies less of a shift in seat share for a party than it did in earlier decades when marginal districts were both more numerous and more dangerous to incumbents than they are in the present. There are indeed fewer marginal districts, and incumbents in these districts are indeed less endangered than they used to be, even while colleagues in seemingly safer districts may be less safe. Thus the change in the distribution of vote margins itself has not insulated individual representatives who suddenly find themselves ensconced in 'safe' districts. The decline in the number of (and peril to incumbents in) marginal districts, however, has had large repercussions for parties as a

[17] See Griffin (2006) for an argument to the contrary.

whole by lowering, contrary to Jacobson's claim, the swing-ratio – akin to what we estimate as the seats-votes elasticity.[18] Ansolabehere, Brady, and Fiorina carefully document this decline and thereby explain the puzzling absence of a drop in the responsiveness of individual representatives – at least as measured by contact to their constituents.

We devote the remainder of this section to examining the consequences of this drop in the seats-votes ratio. As we argue throughout this book, any such change should bear consequences for the regulatory tilt of legislators toward consumers and producers. By examining the U.S. House of Representatives in detail, we have been able to establish with greater certainty a case in which electoral competitiveness dropped. Consistency with our theory, of course, demands that the regulatory advantage of producers over consumers should also diminish. As we argued earlier, the best way to measure such advantage – which can materialize in numerous highly varied forms – is through measuring the ultimate purpose of regulatory protection: changes in prices. When producer influence waxes, we expect concurrent increases in consumer prices. Of course, prices increases can also arise from international shocks to supply or demand, not just from changes in the

[18] There are many methods of measuring the "swing ratio," of which ours is only one.

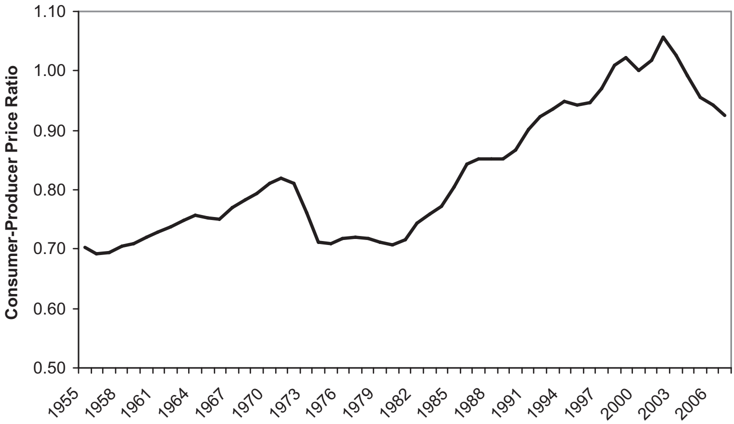

Figure 5.5. Producer Advantage. *Source:* OECD Main Economic Indicator Producer Price Index and Consumer Price Index series.

regulatory tilt of government. We accordingly employ here the ratio of consumer to producer prices as a measure of producer advantage.[19] Higher consumer prices relative to those paid by producers, of course, favor producers. Thus, we call this ratio "producer advantage."

Certainly, in no way does the broad co-movement of two trends establish causality, although as a necessary condition, it establishes plausibility. That is all we can hope for with such a simple analysis. As Figure 5.5 demonstrates, movements

[19] The indexed PPP/XR measure of real prices used in the earlier chapters is not an option for the United States because these data are indexed to a baseline value of 100 for the United States.

in U.S. price levels broadly comport with our argument that secure legislators favor narrow over broad interests. Much as legislators in countries with PR systems (low 'swing ratios') value votes and, hence the interests of consumers, less than do their counterparts in majoritarian systems (high 'swing ratios'), changes in the seats-votes relationship in the United States over time yield corresponding shifts in the power of consumers. The long decline in electoral competitiveness in the U.S. Congress – as captured in the declining number of seats captured by a given increase in a party's national vote share – has been associated with an attendant erosion of consumer power. This association, we argue, is no coincidence but attributable to the interests of rational representatives.

Conclusion

Chapters 3 and 4 of this book exposed a substantively strong and robust relationship between electoral arrangements and real price levels across countries and over time. This chapter has examined this relationship in greater detail – first in terms of barriers to entry, a key regulatory variable related to prices, then via a case study of the regulatory consequences of the change in the Italian electoral system, and finally via brief examination of the changes in electoral competitiveness in the United States. Following our theory developed in Chapter 2, we posited that different electoral incentives of legislators yield changes in regulation that systematically favor consumers or producers. Case studies certainly do not establish causality, nor do they perform well in assessing the relative magnitude of various causal variables. However, they do highlight plausible sources of causation, causal paths, and interactions. By examining actual cases of change in electoral system and electoral competitiveness, we now have greater confidence that regulatory change, with its price implications for consumers and producers, often follows changes in political incentives.

We have demonstrated that proportional systems are systematically, albeit not always significantly, associated with producer-friendly regulation – such as barriers to entry for new competition – that suppresses market competition and yields higher prices. We are now also more confident that legislators indeed respond to the electoral incentives in majoritarian systems by favoring consumer-friendly policies such as deregulation, administrative simplification, privatization, and removal of quotas that raise market competition and lower prices. Despite the noise inherent to any detailed study, our examination of a rare natural experiment – Italy's experimentation with majoritarianism between 1993 and 2006 – has shown that the single biggest wave of regulatory reform in Italian history began a few years after the adoption of a predominantly SMD system. Of no less interest is that several of the actors who initiated the electoral reform of 1993 were known advocates of liberalization, and that an antireform government returned to PR.

Our theory, of course, bears implications not only for cases of wholesale electoral system change but also for any nontrivial shift in electoral incentives. We therefore also predict and find price consequences from the decline of electoral competitiveness in the U.S. House of Representatives. In both Italy and in the United States, when votes mattered more, legislators delivered more consumer-friendly policies and lower prices. In sum, closer examination of individual cases provides important insight into the often complex regulatory mechanism underlying our cross-national studies in Chapters 3 and 4.