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Introduction

> "People of the same trade seldom meet together, . . . but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." [I.x.]
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> "Consumption is the sole end and purpose of all production. . . . But . . . the interest of the consumer is almost constantly sacrificed to that of the producer." [IV.viii.]
>
> Adam Smith, *The Wealth of Nations*

Even casual tourists – perhaps especially casual tourists – immediately notice one major difference among the countries they visit: *prices vary*. The restaurant meal that would cost $50 in Los Angeles can be had for $15 in Ensenada but will lighten one's wallet by $200 in Tokyo. More astonishingly, what appear to be identical and fully tradable goods – a writing tablet, a package of brand-name diapers – retails for far more in Norway than in Spain, or – as some pioneering economic field studies have shown (Engel and Rogers 2001) – for far more on one side of the street (which happens to lie in

Switzerland and accepts only Swiss francs) than on the other (which is in France and accepts only Euros).

The person who actually moves to another country, and lives and works there for some time, notices another striking difference: *levels of regulation vary*. Whoever attempts to build a house, open a business, buy an automobile, or even change her address will find the process easy (or perhaps scarcely regulated at all) in some countries, but subject to repeated licensure and inspections in others.

Cross-border managers or investors will be struck by three other salient contrasts: *market competition, incentives to innovate*, and *service-sector efficiency* differ greatly across countries. In Britain or the United States (so at least the conventional wisdom has it), firms compete vigorously in most sectors, concentration and market power are limited, and shareholders are powerful. Hostile takeovers of underperforming firms are commonplace. In Germany or Japan, or more generally in the "organized" market economies (see, e.g., Hall and Soskice 2001), cross-holdings of shares and board seats, direct involvement of major banks, and sheer market concentration lead to muted competition and weak shareholders: hostile takeovers occasion astonishment and rarely succeed. Relatedly, *cost-cutting innovations* – computerized publishing, Wal-Mart-style retailing, Web-based retailing – are accepted rapidly in most "Anglo-American" economies but are often resisted tenaciously on the European continent.

Finally, acute social observers – whether tourists, residents, or scholars – will notice vast differences in *social and economic inequality* among countries. In Sweden, Finland, or even Germany, one encounters little of either the dire poverty or the wretched excess to which Americans have grown oblivious; but even Americans can be shocked by the inequalities they encounter in places like Mexico or Russia.[1]

Admittedly much of this variation can be explained simply by countries' circumstances: poorer countries have lower prices and more inequality, smaller countries will have more concentrated industries because fewer firms can achieve minimum efficient scale, authoritarian states will regulate more (and, usually, more arbitrarily). However, with all of those factors considered, a lot of variation will remain unexplained: countries that are similar in wealth, size, democracy, and even history will differ markedly in prices, regulation, competition, and equality.

In this book, we contend (a) that these variations are systematically related, and (b) that much of the otherwise

[1] The Luxembourg Incomes Study (LIS) now permits reliable comparisons among countries on such standard measures of inequality as the Gini index. Where zero represents total equality of incomes and one total inequality, in the period 1995–2000 Finland stood at .23, Sweden at .24, Germany at .25; Italy and the UK were at .34, the United States at .37, Russia at .44, Mexico at .49. Perhaps more vividly, in Norway the top decile earned 2.8 times what the bottom decile did; in the United States, that ratio was 5.5; in Mexico, 10.4. See www.lisproject.org/keyfigures/ineqtable.htm.

unexplained variation may be attributed to differences in political institutions, specifically – at least among the world's democracies – to the *kind of electoral system they employ*.[2]

The systematic relation is this: Countries have higher prices – again, controlling for other factors – in large part because their extensive regulations restrain competition and sustain oligopoly power. Weak competition, in turn, permits entrenched interests to resist innovation. Perhaps paradoxically, but particularly in a globalizing economy under wage pressure from third-world imports and outsourcing, monopoly power and resistance to innovation preserve traditional high-wage jobs and thus make for greater social equality. Less obviously, but quite intuitively, these protective arrangements inflict deadweight welfare losses. The economy produces less overall than it could, so the overall effect is to divide a smaller pie more equally. Thus, we expect the same countries to have high prices, weak competition, extensive regulation, sluggish innovation, lowered productivity, and comparatively high social equality.

Politics and political institutions enter the picture this way: high prices, weak competition, and regulatory barriers

[2] This is not to deny that the electoral system itself may be endogenous (a possibility we entertain at greater length in Chapter 6), or that it may work through additional channels. It is to affirm, as we find consistently, that a change in electoral system almost invariably has strong price effects.

to entry flow largely from governmental policies that favor producers or business firms. The triumph of such policies under some governments reveals a fundamental political fact about them, namely that producers are politically much stronger than consumers are. Producers can be politically stronger for many reasons, but political institutions are among the most important factors. The institutions that matter are the rules and conventions that translate citizen preferences into choices of leaders: in democracies, we look particularly at the electoral "rules" by which votes decide the allocation of parliamentary seats and executive offices. Our basic insight is just this: the more that a marginal shift in citizen preferences matters for the fate of political leaders – or, confining ourselves to democracies, the higher the seats-votes elasticity of the given electoral system – the more policy will be biased toward consumers (and away from producers). In addition, one sign of that bias, at least in countries with effective institutions, will be lower real prices, as political leaders restrain the cartels and regulations that permit producers to extract quasi-monopolistic rents.

The general logic behind our theory is as follows. Elected governments generate regulatory policies that broadly influence the costs to producers of manufacturing a wide array of goods. To the extent that regulations distort markets away from perfect competition, they also affect the prices producers may charge for the goods they produce. In short,

regulations play a significant role in determining both producer profits and consumer prices. The problem for politicians, who desire to maximize their political and electoral support from both producers *and* consumers, is that these two factors are quite at odds. Producers, of course, desire greater profits while consumers desire lower prices. Politicians must therefore mediate between these two conflicting preferences when devising regulatory policy. In the event that consumers are stronger than producers are, politicians will respond by setting policies that engender lower prices for consumers – but also lower profits for producers. Where and when producers are stronger than consumers, politicians will set policies that lead to higher profits for producers (at least in the short run) – but also higher prices for consumers. Strength, here, is equivalent to political power, and the regulatory policies that governments set reflect the relative power of these two constituencies.

What determines the comparative political strength of producers versus consumers is chiefly[3] the *electoral system* though which the interests of both groups are aggregated and expressed. Electoral rules and institutions determine how votes are tabulated and translated into election outcomes:

[3] However, not only. As will be seen in the formal discussion of Chapter 2, the rules of campaign finance also matter, because producers can typically mobilize more money – indeed, in our stylized model, *only* producers can mobilize money (although they can also mobilize votes).

namely, which politicians and parties get elected, and in what proportion. By shaping the power differential between producers and consumers, different electoral systems create different incentives for politicians to regulate markets. Ultimately, the choice of electoral systems has a significant impact on countries' price levels. Variation between electoral systems, cross-nationally and over time, predicts variation in the real prices consumers pay for goods.

In particular (and as will be developed in far greater detail later), as electoral systems become increasingly "responsive" – that is to say, as small changes in vote shares produce increasingly large changes in seat shares – politicians will increasingly prioritize consumers' (i.e., voters) wishes over those of producers. All else equal, in majoritarian or single-member-district electoral systems, or where strong presidents are elected directly, consumers are relatively strong and prices will be comparatively low. On the other hand, in proportional parliamentary electoral systems – where the seats-votes relationship is, by design, approximately one-to-one – consumers are weaker, and as a result, prices will be comparatively high.

Responsiveness is a term to which we will return repeatedly in this text. Assessing the formal structures of a country's electoral system is but one way, albeit usually the most important one, of getting at this idea. Where, for whatever reason, one party regularly captures a lopsided majority of the electorate

(India under Congress Party domination, Japan in the heyday of the LDP, Mexico under the PRI hegemony, Northern Ireland under the Unionists), incumbents have little reason to fear voter discontent whatever the electoral system – and indeed, as we demonstrate in Chapter 2, voters in such circumstances may actually have higher impact under proportional electoral systems.

Even where such one-party, or "one-and-one-half party" (Scalapino and Massumi 1962), systems do not prevail, responsiveness diminishes to the extent that voters are locked in to partisan loyalties by ascriptive (ethnic, religious, regional, racial) ties. This is especially the case when homogenous blocs of voters are geographically concentrated within particular electoral districts. If Catholic voters will support the Catholic party as a statement of tribal loyalty, and regardless of that party's performance on specific issues, Catholic party leaders can be as unresponsive as they wish to rank-and-file sentiment. To the extent that most or all voters in a given society vote only their ascriptive loyalties (and hence, as one wag once said of mid-twentieth-century Switzerland, "The election returns are but the census in another form"), overall responsiveness will be low. Hence, in practice, we must look not only at the electoral system (both for parliament and, if one exists, for a strong presidency), but at (a) how *competitive* elections are and (b) how *ethnically polarized* voters are.

That said, we return to our main point, which we argue in detail in the next chapter: that less responsive democracies will disadvantage consumers and impose higher real prices. Of course, our theory assumes, perhaps too implicitly, that institutions have effects; that governments actually govern. In what Huntington (1968) first called "weakly institutionalized" regimes, including ostensibly democratic ones, policy is chaotic, laws go unenforced, government revenues are insecure, and corruption is pervasive. Elected politicians often win votes by patronage rather than policy (Kitschelt and Wilkinson 2007). Is it possible that less developed countries (LDCs), or some subset of them, have particular properties that would negate our expectations about electoral-system effects? Certainly one can imagine that in economies that depend heavily on a few primary-product exports and import almost all consumer goods – in earlier periods, Chilean or Zambian copper, Argentine wheat and beef, Brazilian coffee – producers might paradoxically demand low prices (a devalued exchange rate), while consumers might agitate for an overvalued exchange rate (i.e., "high" prices; see again Bates 1997). Whether, in such circumstances, the exact form of the electoral system matters for regulation remains for us an open question, to be decided empirically rather than theoretically. As we find later (somewhat to our surprise), electoral systems have almost exactly the same effects in poorer as in richer democracies.

Plan of the Book

Chapter 2 states our theoretical argument, including a fuller development of the welfare implications and possible endogeneity of electoral systems. Chapter 3 offers a first empirical test, focusing on panel evidence from the advanced industrial economies between 1970 and 2000 – a period that, fortuitously, included some important changes in a few of the richer countries' electoral systems (with, happily for us, almost exactly the effects our argument would predict). We concentrate on these countries because of their longer democratic histories, the greater likelihood that their institutions affect outcomes, and their readier availability of reliable data. To put the matter more strongly: if the effect we predict did not show up here, and prevail also in over-time analysis, our theory would simply be wrong.

Chapter 4 greatly extends the empirical test to include all democracies – indeed, all extensive periods of democratic rule in all countries – between 1972 and 2000. While our theoretical argument explicitly foresaw the possibility that electoral systems would have weaker, or indeed perhaps opposite, effects in poorer democracies, we find that the impact of electoral systems on competitiveness and prices is almost identical. Hence what we intended as a somewhat daring extension turns out to be strong evidence of the theory's robustness – and, in our view, of the improbability that some alternative

mechanism (e.g., the kind of centralized wage bargaining that prevails mostly in more advanced economies) explains enduring price differences. Broadening the sample of democratic countries from twenty-three in Chapter 3 to more than seventy-five in Chapter 4 also enables us to apply a different set of statistical models for the analysis of time-series cross-sectional data. In particular, in Chapter 4 we employ a generalized estimating equation approach rather than the OLS models used in Chapter 3, which makes it possible to model directly the time-dynamics of real price levels within countries. This method also better accommodates that so few countries, in practice, ever actually change electoral systems from proportional to majoritarian, or vice versa.

Because we know (and helpful critics have occasionally reminded us) that large-N studies can conceal important exceptions and can "black box" crucial mechanisms, in Chapter 5 we supplement our overall picture with a closer examination of mechanisms (including the link between electoral systems and barriers to entry) and two highly relevant case studies: the change(s) of electoral system in Italy in the 1990s, and the "vanishing marginals" in U.S. congressional elections in recent decades. What motivations were involved (particularly in the Italian case), and did the changes in these two cases have the predicted effects?

In Chapter 6, we enlarge on two aspects repeatedly mentioned at earlier points in the book, namely the ultimate

endogeneity of electoral systems but, at the same time, their general "stickiness" or resistance to change. We offer an explanation for both that rests on the link between electoral systems and *economic inequality*. In brief, because inequality both sustains and is sustained by less responsive electoral systems – a point we argue in detail in Chapter 2 – countries tend to alter their methods of election only when some large exogenous shock (e.g., a major war) greatly increases or decreases inequality. Appropriate tests against historical data from the period between the two world wars support this hypothesis. Chapter 7 concludes, less with a summary of the argument than with a statement of further implications and future directions for research.