

# **The choice of institutions**

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# 1. Economics and Political Institutions

The "classical" economists, Adam Smith, David Ricardo and Karl Marx clearly thought that in socio political forces were important determinants of economic development and change. On the contrary the "neoclassical" school starting with Jevons and Walras developed their economic theories in an institution free environment. Institution free economic theory has been the dominant school of thought at least until the 1990s.

There were however a few exceptions.

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

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

## b) Economic theories of Constitutions

The classical constitutional theory of Hayek<sup>2</sup> and by Buchanan, and Tullock<sup>3</sup> provide a major normative pillar which greatly help our thinking today about the choice of institutions and constitutions. The emphasis on the risks associated with the tyranny of the majority remains one of their major contributions.

## c) The Public Choice School

This is the school that developed around the work by Buchanan and associates. The key idea of this school of thought is politicians maximize self interest fairly narrowly defined. The government is viewed as a Leviathan to be restrained because its goal is to "steal" from the private sector extracting taxes, rents and bribes.

Unfortunately the Public Choice School remained vastly out of the mainstream of post war economic theory. Both sides are responsible for lack of communication. Mainstream economists had a tendency to: underestimate the importance of institutions, and they were quite narrow minded in their approach to modelling policy making, refusing to understand the importance of politicians' motivations and constraints in choosing policy. Or if they did, they felt that it was not the economist's role to incorporate them in models of policymaking. Public Choice Theorists refused to embrace the methodological innovations in economic theory, such as a new way of thinking about expectations, new development in game theory and more generally the mathematical and statistical rigor that was becoming the norm in the field.

## d) The rational choice school in political science

In the meantime the field of political science developed an area that was later known as the rational choice approach, in which researchers applied mathematical tools borrowed from economics to analyze voting behaviour and various issues of political institutions. This field owes a lot to Arrow's paper on the Impossibility theorem of 1951.<sup>4</sup> In fact the initial impetus from the field

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<sup>2</sup> F. Hayek (1957) *The Constitution of Liberty*

<sup>3</sup> J. Buchanan and G. Tullock (1960) *The Calculus of Consent*, University of Michigan Press, Ann Arbor, MI

<sup>4</sup> K. Arrow (1951) *Social Choice and Individual Values*, New York: John Wiley

was to overcome the “negative” result by Arrow and developed model in which voting could be usefully modelled and understood in a predictive manner.

#### **E) Nordhaus’ political business cycle model**

William Nordhaus formalized the idea of an electoral business cycle in a traditional Phillips curve model with a stable trade off between inflation and unemployment<sup>5</sup>. Immediately after this contribution macroeconomic theory moved to rational expectations and his contribution remained a bit on the sidelines of the field.

#### **f) Becker’s paper on lobbying**

Gary Becker with a path breaking paper in 1983 offered an approach to modelling lobbying pressure to buy policy from policymakers.<sup>6</sup> This approach received wide applications to international trade and protectionist policies.

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

The late nineteen eighties see the beginning of a new line of research sometimes referred to as “new political economics”. Contrary to the previous experience of the public Choice School this area of research became immediately fully integrated with the field of economics and adopted the same methodological tools of the latter. This approach quickly developed applications in virtually every field in economics: macroeconomics, development, international trade and finance, economic growth, public finance etc.

Perhaps the timing is not surprising. The eighties were a decade of great turmoil and transformation in the American Economy. President Reagan was in the middle of his “revolution:” and of his large deficits, taxes were being cut and the economy deregulated. Continental Europe on the contrary was entering a long period of sclerosis, some countries in Europe (but not all) accumulated debt rising towards war time levels. The need for structural reforms and liberalization in Europe was evident, but they were delayed. A dozen of European countries were walking towards uncharted territories of monetary and some sort of political union. Latin America was in the middle of a huge debt crisis and of a “lost decade” with very high or even hyperinflations, foreign debt defaults and large budget deficits. Unavoidable policy reforms were delayed increasing the economic costs and leading to crisis. The Soviet Bloc was about to collapse and when it did, it opened a Pandora’s Box of politico economic questions.

It was increasingly difficult to fit all of the above complexities and varieties of experiences in traditional models of economic policy in which benevolent social planners maximize the utility of a repressive individual. Therefore the new political economics acknowledged as a starting point that economic policy should not be modelled as if it were chosen by institutional free social planners. If one wants to understand how policymaking actually occur and how to move towards optimality one needs to acknowledge that instead economic policies are chosen politicians, facing elections in democracies or with other political constraints in non democracies. More specifi-

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<sup>5</sup> W. Nordhaus (1975) ;“ The political Buisness Cycle“ *Review of Economic Studies*

<sup>6</sup> G. Becker (1983) “A Theory of Competition Among Pressure Groups for Political Influence” *Quarterly Journal of Economics*, 38, 371-400.

cally, and this brings us closer to the specific topic of this lecture, different electoral systems may lead to different strategic interactions amongst political agents, such as elected representative, the voters, party organizations.

### 3. Electoral Rules and Economic Policy

On of the topic that has received much interest including in a previous Munich Lecture by Guido Tabellini and the book that followed by Torsten Persson and Guido Tabellini <sup>7</sup> is the effect of electoral institutions on economics outcomes.

Electoral systems vary a great deal across countries, from a first pass the post majoritarian systems of Britain, to an almost fully proportional systems in Sweden to proportionality with thresholds like Germany etc. In a proportional system the fraction of votes cast by the citizens for a party translate more or less exactly in the same fraction of seats in the legislation. In majoritarian system generally speaking this is not the case and there is a prize for winning the majority in a district or plurality depending on the system. Some of the implications of these differences are clear: in proportional system without thresholds even very small parties can gain representation<sup>8</sup>, while with thresholds very small parties are not viable but still one can have a multitude of parties if they overcome the threshold. In majoritarian systems (and there are various types) in general parties have incentive to form blocs and majoritarain systems tend to produce a two party or at least two coalitions blocs, the so called Duverger's Law. Whether or not such coalitions or blocs remain stable or squabble after the election varies across countries. We also have Presidential systems in which presidents are elected by the people like in the US and France an hold substantial executive power while in other countries he is elected by Parliaments and holds either a purely ceremonial role, or some executive and procedural power.

The key question is: Do different electoral systems and various voting rule have different effect one economic policy in general and fiscal policy in particular?

In the literature we can find a few answers, not all in agreement with each other

#### 1) The Chicago school

According to this school electoral laws really do not matter that much. Lobbying pressure will determine policies regardless of the details of electoral laws. What matters is lobbies' abilities to gain voice in the political arena and this has very little to do with the details of the electoral law.<sup>9</sup>

#### 2) Cultural-social capital school

According to this line of thought, what matters is not really the institutions of the polity per se but deeper variables like different cultures, various anthropological variables, measures of social capital and trust. Economists are re)discovering the importance of culture in explaining attitude

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<sup>7</sup> T. Peresson and G. Tabellini (2003) *The Economics of Constitutions*, Munich Lectures, MIT Press, Cambridge, MA.

<sup>8</sup> How small depends on details on the system such as the size of districts etc.

<sup>9</sup> For a recent example of this argument see C. Mulligan and X. Sole I Martin (2004) "Do Democracies Have Different Public Policies Than Non Democracies?" *Journal of Economic Perspectives*, winter, 51-74

towards the economy and economic policy. While i am not aware of a paper that directly test the superiority of “culture” versus “elector institutions” the argument is “in the air” so to speak.<sup>10</sup>

### **3) Institutional school**

According to this line of argument electoral laws matter because they affect the political equilibrium, the nature and structure of party systems and therefore it has profound effects on policies. A vast literature in political science, the extensive work by Persson and Tabellini, work by Milesi Ferretti Perotti and Rostagno and many others in economics holds this view.<sup>11</sup>

My view is somewhere in between. It is true that lobbies can manoeuvre around the intricacies of electoral laws to buy favours. It is also true that deeper cultural and social variables are critical. However electoral rules are relevant. But the question is how to disentangle their specific effect.

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

Electoral rules affect the nature of party systems, composition of legislature and the effect of the relationship between executive and legislature. Thus rules can have an impact on economic policy through their effect on the structure or parties. Here are a few examples discussed in the literature which I will touch upon in my lecture.

i) Proportional electoral systems with large coalition governments produce larger budget deficits and have difficulties in promoting fiscal stabilization;

ii) In proportional electoral systems social spending is higher and the welfare systems more generous because of more diffuse representation of various groups;

iii) Presidential systems are more pro active, they stabilize sooner and spend less in social spending;

iv) In US cities different voting rules for electing representative affect racial minority representation and policies in that respect.

There are only a few examples of the effect on electoral rules on policy outcomes, but there are many others. The critical question, however, is the following: how can electoral institutions be considered explanatory variables, that is “exogenous” variable in economic jargon? After all they are chosen by individuals in different societies, they are not randomly assigned. So why do different societies choose different rules?

Let me begin by reviewing the arguments in favor of treating electoral rules as “primitive”, exogenous courses of economic polities.

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

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<sup>10</sup> See however G. Tabellini (2005):

<sup>11</sup> T. Peresson and G. Tabellini, (2003). G. Milesi-Ferretti, R. Perotti and M. Rostagno (2001) “Electoral Systems and Public Spending”, *Quarterly Journal of Economics*, 117, 609-658.

This is correct, and this consideration would make it reasonable to use electoral rules as explanatory variables (predetermined or exogenous) as explanation of economic policies and outcomes. However, the original introduction of the electoral law may reflect stable historical characteristics of a society that may be correlated with what one wants to explain with the electoral law. For example we will discuss below how differences in social policies in the US and Continental Europe stem from deeper variables ingrained in history than different electoral rules, or to put it differently the choice of electoral rules depend on those variables.

In other words, even though electoral rules may be relatively stable over time, they may still be correlated with other stable characteristics of a society, and the latter may be the true explanatory variable. Stability of electoral rules is not a completely valid explanation for talking them as exogenous.

In addition, electoral laws are not always so stable. In the first half of the nineteenth century and with the extension of the franchise, they changed frequently. But even after this turbulent period, electoral rules were not exactly cast in stone. In fact, in some cases electoral laws change frequently, consider for instance France after WWI, Italy after 1990, and Eastern Europe after democratization are some examples. Many former communist countries started with very proportional systems and then adjusted them in a more majoritarian direction. Countries where communist parties were still dominant stayed with majoritarian systems and then slowly moved towards proportionality. In Latin America we have had several movements back and forth from dictatorships to democracies. Often the electoral laws which are chosen depend upon the nature of previous dictatorship. For instance, stringent term limits in that region stem from the fear of a return of a one-person dictatorial rule common in Latin America in the fairly recent past.

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

In fact, electoral laws do not change that often BUT the frequency of changes increase over time. Why? There are two reasons. One is that if a constitution makes it too easy to change electoral laws then it is relatively easy for a government to change the rule in its favour. The second reason is that the longer rules remain unchanged, the more they acquire a status of “focal point” and of “tradition” that the reputational costs of a government trying to strategically manipulate them may become quite high.

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

For a ruling group to change laws one has to be sure about the outcome. A high degree of uncertainty about what the effect of a rule change might be may lead to a status quo bias and low frequency of change. Even when the institutional costs of changing the laws are relatively low, risk aversion about not knowing what the result would be may lead parties to keep the law unchanged.

An example is Germany in 1947. After the war and after the Nazi period there was much uncertainty about the distribution of preferences across the population, so lots of uncertainty about which party would have benefited from alternative rules. The result of this uncertainty was proportionality, corrected with a relatively high threshold to avoid the Weimar problems of excess fragmentation. A majoritarian system would have produced a clear winner and a clear loser, and risk aversion coupled with a large uncertainty made this prospect too risky for everyone.

Thus risk aversion may increase the stability of rules but as we discussed above, stability is not a synonym of exogenous.

### **4.3 Role of former colonizers**

Former colonies often adopted the electoral rules of former colonizers. For example India adopted a majoritarian system and never moved to full proportionality despite the fact that a religiously fractionalized society may be prone to adopt more proportionality. In this case then to some extent electoral rules are exogenous to the country in question because they are imposed from above.

Obviously however, not all countries were colonies and in fact much of the work on the effect of electoral rules on economic outcomes is on OECD countries which have never been colonies.

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

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

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

In general a combination of history, distribution of power within society of various ethnic, religious groups, distribution of income, culture determinant electoral rules. All of these variables

that determine the choice of electoral rule also determine policy preferences therefore the correlation between electoral rules and policy outcome may be overstated or simply be the result of third factors. Also the initial level of income inequality may affect the choice of electoral systems. Even culture may matter. Certain culture may have a preference for broad participation rather than delegation, proportionality versus majoritarianism.

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

Extensive work on normative models of Constitutions namely how Constitutions should be written behind a Rawlsian veil of ignorance. But in reality constitutions and electoral reforms are not chosen behind a veil of ignorance, those who change the rules generally know who will benefit or at least they can form expectations. In this case electoral rules are chosen strategically to benefit (or at least attempt to benefit) the ruling coalition. There are of course some more or less egregious examples. Italy in 2005 a reform of the electoral law was introduced immediately before the election allegedly to make the system more proportional and, by doing so, minimizing the expected loss of the ruling majority. The ruling coalition did indeed lose, by a handful of votes, and because of some technicalities, even though they were well behind in the poll. A case in the opposite direction is New Zealand in 1997 which witnessed a move toward proportionality (a German type model) as a result of the recommendation of a technical commission's which was non partisan and ruled against the stated interests of the two major parties.

These two examples suggest that one can certainly not assume that changes in the electoral rule are dictated by a welfare maximizing social planner, nor can be thought as being chosen behind a veil of ignorance. But often ruling majorities do not have a completely free hand in choosing the rules that maximize their narrow interests. In fact in some countries electoral rule can be changed only with qualified majorities which is a good check against excessive manipulation by narrow ruling majorities.

## **7. Summing up**

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

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

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

Solid empirical evidence suggests a strong correlation between proportionality of electoral systems and the level of social spending. This is one of the major theme of the book by Persson and Tabellini that originated by an earlier Munich lecture series.

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

A prime example of this relationship is a comparison between the United States and Western Continental Europe, an issue addressed in a recent book by Ed Glaeser and myself<sup>12</sup>. In Europe proportionality introduced as a result of increase in power of Marxist parties after first and second world war. Two forces were at play. First growing socialist communist parties demanded representation in post first world war. Before WWI only Belgium Finland Portugal and Sweden had some form of proportional representation. Between 1917 and 1920 Austria Denmark France Germany Italy and the Netherlands adopted various forms of proportional representation often in the aftermath of leftist insurgencies. In some cases the left demands were peaceful (Switzerland Netherlands Sweden in 1907) in some cases violent (Belgium, Italy Germany). These are cases in which conservative forces had to acquiesce to the demand of the streets dominated by the left. That is, from the point of view of maximization of electoral advantages ruling elites would have preferred a majoritarian system but the pressure from the streets and the weakened armies after First World War made it not possible for the ruling elites not to concede proportionality semi insurgent movements. Second, when Marxist parties were very strong it was even in the interest of ruling parties to introduce proportionality to avoid defeat. For instance this was the case of Italy and France in the aftermath of the Second World War. In Sweden in 1909 at the time of the extension of the franchise, the conservative party was afraid of losing against radical and socialist parties changes laws into proportional.

Thus, the reason why the US did not adopt a proportional representation system is because of the lack of pressure from a Socialist movement in this country, contrary to most countries in Continental Western Europe. In the US, communist parties were weak and could not impose to ruling elites the choice of proportional representation. The latter was indeed debated, and in some cases adopted. The state of Illinois adopted proportional representation in 1860. In the first thirty years of the twentieth century several cities, especially in Ohio, also did the same. But it did not catch on because with the extension of the franchise it became clear that proportional representation would have allowed elections of blacks and representatives of the small socialists or even communist parties. In the south not only proportional representation was not adopted after the abolition of slavery but a variety of measures were introduced to disenfranchise blacks.

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

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<sup>12</sup> A. Alesina and E. Glaeser (2004) *Fighting Poverty in the US and Europe: A World of Difference*. Oxford University Press, Oxford, U.K.

uprising in Europe came after the devastation of the first and Second World War. The US did not suffer such devastation.

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

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

Multiparty systems (the result of proportional electoral rules) may make policymaking more difficult because of veto power, weak and unstable coalition governments etc. In particular, a large amount of evidence shows that coalition governments have more trouble reacting quickly to budget deficits and allow the latter to grow often way too much. A good example stems from a comparison of the United Kingdom and Italy in the seventies and eighties. Both countries went through difficulties but in the UK despite the period of decline up to the early eighties there were never budget deficits for great significance. In Italy with at the time a strict proportional system and multi party coalition governments deficits accumulated so that in the early nineties the debt to GDP ratio in this country was more than 120 per cent of GDP.

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

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

Therefore it would be incorrect to conclude that proportional representation and multi party systems are responsible for the breakdown of policy making, delays in reforms, **etc.** Multi party systems may be the product of fragmented societies. This fragmentation is what ultimately determined the policy failures discussed above. In fact, one may make an even stronger argument: proportional representation and a multi party system may be the only feasible plan for a fragmented and diverse society. Alternative rules that do not allow broad representation in these types of societies may be even worse, leading to social conflict, tension, even violence.

Whether or not multiethnic societies generate more parties and more participation of various groups depends on the nature of who writes the constitution and the distribution of power. If a group (religious ethnic linguistic) is dominant at the Constitutional table it may choose rules that allow it to rule the country without opposition, in the extreme eliminating democracy in less extreme cases choosing systems that do not allow the non ruling opposition to interfere Aghion Alesina and Trebbi (2004) show that in a vast sample including all countries in the world less

protection of minority rights is observed in more ethnically fragmented societies, another indication that Constitutions are not chosen behind a veil of ignorance.<sup>13</sup> There is then a difference between advanced democracies and autocracies. In the former more diversity in society leads to more proportionality, in the latter more diversity may lead to one group seeking power and the expense of all the others.

## 10 Conclusions

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

Do institutions in general and electoral institutions in particular evolve towards optimality? Douglass North<sup>14</sup> argued yes they do, for an evolutionary principle, namely only wealth or utility maximizing institutions survive. However he then argued that (not often well specified transaction costs) may interfere towards the move towards optimality of institutional design. The arguments developed in this lecture serve as a clarification of what these transaction costs are. They are due to the fact that institutions are chosen endogenously by groups of society that have power and intend to keep it. These groups are not maximizing optimality for society as a whole but their own self interest.

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<sup>13</sup> P. Aghion, A. Alesina and F. Trebbi (2004) "Endogenous Political Institutions" *Quarterly Journal of Economics*,

<sup>14</sup> D. North ( )