

# Political Institutions and Policy Competition

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## 1 Introduction

The theme of this year's WDR is how to structure institutions to bring about an effectively functioning market economy. There is no question that political institutions play a key role here. In most countries political institutions determine the rules of access to considerable discretionary coercive power.

Political institutions determine the context in which key functions of government are undertaken. These include redistribution of income and assets between citizens, correcting market failures and promoting the provision of collective goods. It is widely agreed that the nature of political institutions is critical to having these functions performed effectively. The key question is how to design decision making institutions that guarantee that these functions are performed adequately. In these notes, I will focus primarily on the role of political institutions as promoting effective policy competition.

Policy competition is the process by which society is confronted with alternative solutions for achieving policy ends. Policy competition has three broad dimensions.

- Proposal – a process by which alternatives are placed on the agenda.

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- Monitoring and Evaluation – the process by which alternatives are scrutinized.
- Selection – the process by which proposals are chosen.

Societies with effective policy competition will possess strong institutions to perform these three functions.

*Policy* competition is not the same thing as *political* competition. The latter is principally concerned with the process of competition to hold office. However, it is neither necessary nor sufficient for policy competition. Although, it is my general belief that political competition promotes policy competition under many circumstances, it certainly does not guarantee it. Moreover, it is possible to conceive of effective policy competition even where political competition is absent, even though I suspect that empirically this is not likely.

The literature on political competition has traditionally focused mostly on proposal and selection of policies, but much less on monitoring and evaluation. One of the virtues of the focus on policy competition will be to emphasize the importance of institutions that perform this function.

The paper is organized as follows. In the next section, I discuss why policy competition is valuable. I will also discuss some concrete instances of policy debates where policy competition is important. In section three, I discuss how institutional arrangements contribute to policy competition. Section four discusses some particular institutional rules in terms of their impact on policy competition. Section five offers some concluding remarks and suggests a slightly different perspective on the value of democracy as a system of governance as a means to promoting policy competition.

## 2 The Value of Policy Competition

Economics is full of policy debates – competing analyses and perspectives abound on the right course of action to pursue to achieve given ends. On the one hand this may seem at odds with the long-standing tradition that attempts to characterize optimal policies – those that maximize a given objective under feasibility and information constraints. There are two main reasons why economists may disagree about what is optimal – either because they have different views about the objectives that should be pursued or because of differing views about the incentive effects of policy.

Some economists believe, for example, that policies should be evaluated in terms of a particular notion of efficiency called social surplus (Harberger (1971)). Others pursue other distributional judgements and may, for example, weight the well-being of the poor highly. Thus, policy debate could be viewed as means of reconciling competing distributional objectives.

However, equally important in practice are different views about key behavioral parameters. It is often the case that our knowledge of the magnitudes (and in some cases the sign) of these parameters is imperfect. Consider, for example, the huge effort that has gone into estimating labor supply elasticities (see Blundell and MacCurdy (2000) for an excellent review). Those who believe that labor supply is elastic are inclined to be more concerned about the efficiency costs of tax financed government programs and advocate a smaller public sector than those who believe that such incentive effects are small.

In general, there are areas where a reasonable degree of consensus has been achieved and others where estimates differ widely. There are other areas which are periodically revised. Card and Krueger (1995) is a famous example – they argued that the large efficiency costs associated with minimum wages were over played.

In a developing country context consider, for example, the link between land titling programs and poverty reduction. On the one hand, land titling can strengthen the bargaining power of the poor and increase their payoffs. On the other, it can lead to less effort being put in on land as landlords find it difficult to use eviction incentives. At the same time, long-term investment in the land can be more attractive. The overall impact can only be established with careful empirical analysis. (See, for example, Banerjee and Ghatak (1996)).

Even if the effects of policy in one location is clear, the issue of portability arises. Is there some special factor at work in one location where policy incidence is studied that makes it difficult to generalize its impact elsewhere. A good illustration of this is the widespread discussion of the portability of the lessons from the Grameen bank to other contexts.

Measuring some policy effects is particularly problematic in the case of true policy innovations. Consider for example, the difficulty of estimating the impact of schemes to promote the use of IT technologies where there is little benchmark against which to measure the effects.

Against the background of changing technologies and opportunities, there is constant scope for innovation in policy with the impact of policy generally

being imperfectly known. In some cases, this may lead government to perform their own policy experiments – phasing in a policy in one region before extending it to a national level.

A key feature of academic life is that new ideas are subject to careful peer review and heavily scrutinized. The whole tenure structure encourages the young to pick holes in conventional wisdom.

Of course, scrutiny of policy is much more than economic analysis. The role of policy oriented scientific research is a case in point. Consider, for example, the effort that is going into establishing the safety of genetically modified crops and how the competing findings lead to debates that are central to public policy. The implications for human welfare of these efforts is potentially immense.

The value of policy competition is the value of bringing knowledge into the policy arena. If something of social importance is learned and has implications for policy design, then policy competition is the process by which the better alternative is pitted as against its predecessor, much like a new product is put into the market against its incumbents.

### **3 The Process of Policy Competition**

The notion of better policy is not straightforward. There are some policies that everyone agrees are better than others – political scientists call these valence issues (following Stokes (1963)). In the limit, these are policy outcomes that are Pareto ranked. However, it is unusual to find such policy alternatives in the world. When there are gainers and losers associated with policies, it is less clear what the right criteria should be. Coate (2000) has proposed an efficiency test for policy whereby a policy is acceptable only if there is no other policy that achieves the same outcome with less efficiency cost.

Different models of political competition have been put forward to capture these different views. The famous Downsian model can be viewed predominantly as model for determining distribution rather than efficiency. A variety of models have also emphasized reasons why political competition may have important efficiency roles. A good starting point are models of imperfect information – where the citizens cannot observe some aspects of the action chosen by incumbents or some important characteristics of incumbents. A good example is Coate and Morris (1995).

Since the consequences of many policies is uncertain, the process of experimentation is important. There is a potential benefit if the policy is widely adopted and a cost to the adopter if the policy is not as good as it was hoped. Thus, the process of policy adoption is analogous to the process of adopting new technologies of uncertain benefits. Experimentation has a value and it is important that policy actors appropriately weigh the costs and benefits of doing so.

In spite of the vast and growing political economy literature, little has been written on policy experimentation. In a world of multiple jurisdictions, the issue of policy adoption has a number of further aspects as policy experimentation in one region may yield benefits in another. This creates an externality between adoption decisions and possible gains from cooperation.

With non-cooperative behavior, there is no particular reason to expect the experimentation decisions of different jurisdictions to be optimal from the point of view of the whole group. This may lead either to excessive adoption of policies that are dominated. There is the possibility of inefficient herding as in Banerjee (1992).

Having experimented with a policy change, there is also the need for policy evaluation. If bad policies are to be dispensed with and good ones promoted, then there is a need for a process of credible demonstration and information flow. Both the incentive to experiment and the evaluation of policy require the development of particular political institutions.

## **4 Institutions of Policy Competition**

This section discusses the main institutions that are essential for effective policy competition.

### **4.1 A context for policy experimentation**

Decentralization may be important here. In a famous quote, Supreme Court Justice Brandeis noted that “It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country”. Thus, he views the possibility of policy experimentation as a benefit of federalism. This idea is developed further in Strumpf (2000). Moreover, this may also create competitive pressure for policy reform.

There are at least two reasons why multiple jurisdictions have an incentive to compete. The classical argument is due to Tiebout (1956) who observed that in a world of multiple jurisdictions, individuals may move to those that are more efficiently run and that provide the bundle of goods and services that citizens' desire. Besley and Case (1995a) observe that another advantage of multiple jurisdictions is that political competition is enhanced as voters compare the policy alternatives available in different jurisdictions. This induces a kind of yardstick competition among jurisdictional units.

## **4.2 Institutions for policy debate**

Effective policy competition requires both that policy is effectively analyzed and that research findings are disseminated in an effective way. This requires a number of institutions. Policy is analyzed within governmental institutions such as government funded policy units as well as independent think tanks. The role of higher education institutions with a strong research tradition is also a vital part of the process of policy analysis and evaluation.

## **4.3 Open entry of policy**

A key feature of effective policy competition is that lessons find their way into policy reforms. Entrenched interests may stifle innovation if policy change is a threat to their hold over power. This may, therefore, reduce the incentive to generate policy evaluations. In a traditional Downsian model where parties compete to attract votes, there is maximal incentive to find solutions that appeal to voters. However, little is understood, even in this well-known framework on whether this process leads to correct incentives for policy experimentation and evaluation.

This may be related to the degree of political competition. In his commentary on the politics of the south in the U.S., one of the central tenets V.O. Key's view is that "the best government results when there is free and vigorous competition at the ballot box in contests in which genuine issues are defined and candidates take a stand." (Key (1950)). One issue is whether close political competition is associated with more responsive policy outcomes. This is argued by Holbrook and van Dunk (1993) who use data from the U.S. states.

## 5 Institutional Reform

The art of constructing an effective democratic system is, among others things, building institutions that constrain malevolent forces while promoting benevolent ones. This is usually achieved through a nexus of institutional choices. These have two broad aspects – (i) institutions that determine the design of electoral institutions, for example, who can stand for office, the nature of the electoral system etc. (ii) institutions for policy making including specific restrictions on actions, a system of vetoes etc.

The choice of these institutions is itself a subject of policy competition and there is little consensus on the “best” set of policy making institutions. It is even uncertain what the impact of some institutions is. For example, the effect of term limiting political actors is far from clear in theory or in practice. (See Besley and Case (1995b) for some analysis.)

However, there is a growing literature that tries to evaluate the effect of institutions on policy outcomes (see, for example, Besley and Case (2000) and Persson and Tabellini (2000)).) In the current context, this raises an issue of how effective policy competition can be promoted through effective institutional change. I will briefly suggest a few examples and the available evidence on them.

**Mandated representation:** One fear in many countries is that political representation is confined to particular elite groups. This can encourage entrenchment and policies that are designed to favor particular groups in societies. Some countries have, therefore, passed laws that mandate representation for disadvantage groups. A good example is from India where a number of seats are reserved for low caste groups. Pande (2000) argues persuasively that this has led to increased benefits for these groups.

**Single issue authorities:** Systems of representative democracy typically use general elections that decide on multiple issues simultaneously as their main democratic vehicle. In any given election, only a small subset of all the issues tend to be politically salient. This limits policy competition on the non-salient issues. In the U.S., a number of states use single issue authorities with direct elections. For example, some states directly elect their regulatory commissions. These can enhance policy competition by making the issue salient to voters. Besley and Coate (2000a) find evidence that states that elect their regulators have more pro-consumer outcomes. Issue salience can also be enhanced by the threat of citizen’s initiatives (Besley and Coate (2000b)).

**Mass Media:** Above, we alluded to the potential for the press to enhance policy competition by increasing the scrutiny of policies and enhancing flows of information about policy change across space. The press can also play a role in making government responsive to particular groups by making certain issues politically salient as in Besley and Burgess (2000) and Stromberg (2000). The virtues of press freedom in the context of famine relief policy have been argued for in Sen (1984).

**Civil Society:** Other aspects of civil society, broadly defined, are also an important part of effective policy competition. This includes the promotion of policy think-tanks and academic institutions that scrutinize policy.

## 6 In Defence of Democracy?

One of the most important dimensions of political development from the point of view of economic policy is developing the institutions that facilitate effective policy competition. There is analogy between liberal democracy and markets. Even though they fail in all sorts of ways, we have yet to devise a better method for the promotion of product market competition than the promotion of competitive markets. Liberal Democracy also has failings. However, it is probably the best mechanism that we know of for promoting effective policy competition.

The late twentieth century have seen two major institutional triumphs – broad based use of democracy as a political system and the market economy as an economic system. Both have triumphed despite the fact that there is no entirely persuasive argument that either is the best possible system for the functions that they perform.

The arguments that I have presented here cast a somewhat different light on the triumph of democracy, emphasizing its adaptability and robustness in the face of change, in particular its ability to generate policy competition. There is a parallel here between Hayek’s defence of the market against social planning. The difficulty of anticipating the future and the challenges that it will bring, nor even the lessons of the present, make it valuable to leave things open to each generation to change and adapt. The job of the founding fathers is only in part to engage in successful social engineering that binds the hands of the future. Like any responsible act of parenting, it must also ensure a context for the resolution of the challenges faced by those who come later.

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