I. Introduction.

A. The analysis to this point has largely taken political institutions as given. That is to say, it has been assumed that voting rules, the bureaucracy, laws limiting the scope of government policies, and the consequent plethora of politically active interest groups have all been taken to be exogenous.

B. On the other hand, we have implicitly done a bit of constitutional political economy insofar as one could interpret the various sections of the course as examinations of consequences of *different forms of governance.*

   i. The pure election models could be interpreted as polities where all matters of importance are determined by refferendum (or at least by contractually bound representatives) and where interest group activities were illegal or very circumscribed.

    a. Issues regarding the existance of electoral equilibria and/or how those equilibria might be affected by different voters, cultures, institutions and voting rules are all topics of Constitutional Political Economy.

    b. Recall Weingast and Shepsle's institutionally induced equilibrium paper.

   ii. One could interpret the Becker model and the bureaucracy models as ones where political institutions allowed or solicited input from various organizations and groups regarding policies that were of special interest to them.

   iii. The combined model would thus be an intermediate case, where both elections and politically active groups play a role in the development of public policies.

   iv. The positive consequences of these institutions, as well as the normative implications of the operation of these institutions are all topics in what has been called Constitutional Political Economy

C. The field is both very old and very new.

   i. Aristotle's *Politics* spends considerable time analyzing the relative performance of alternative methods of organizing government (deomocracy, oligarchies, and monarchies).

   ii. Obviously, Madison and the other contributors to the american constitution and subsequent constitutions elsewhere have all wrestled with the relative merits (from various points of view) of alternative methods of organizing government.

   iii. Modern analytical analysis began with Buchanan and Tullock's *Calculus of Consent* (1962) where they explicitly attempt to analyze the logical foundations of constitutional democracy. Subsequent work by Buchanan was largely focused on further economic, political, and philosophical analysis of what he calls the "constitutional" perspective.

   iv. Many other public choice/rational politics analyses of constitutional issues have taken place during the perods following the *Calculus of Consent.* (See for example the syllabus for a sample of these.) In 1990 a the journal of *Constitutional Political Economy* was begun by the Center for Study of Public Choice. It is now published by Kluwer.

   v. Most recently, Dennis Mueller has written a book that also engages explicitly in constitutional analysis: *Constitutional Democracy* (1996).

D. Interest in the properties of alternative constitions or alternative collections of economic and political rules has intesified partly as a result of the demise of the Soviet Union and the consequent democratization of much of Africa and South America. In Europe there has been an actively debate over the proper constitutions for a "European Union." Obviously, *CPE* is for these societies a pressing practical concern not an abstract exercise of interest only to political philosophers.

II. Normative CPE Approaches

A. The central normative question addressed in CPE requires assessing the *relative* merits of alternative institutions.

   i. Characterizing "efficient" or "good" or "effective" institutions clearly required both a positive analysis of the manner in which particular types of government may be expected to operate, and some normative theory to assess the relative merits of the outcomes (processes, etc.) likely to obtain from those governments.

   ii. The former is partly can be addressed with a positive economic and public choice analysis of the operation of specific governmental institutions. Many of the tools and procedures used in previous parts of the course can be used for this purpose.

   iii. The normative analysis is not as straightforward because people are more likely to disagree about how to "measure" the desirability of a particular form of government than about the real consequences of such governments.

   iv. For example: (i) Should one mainly focus on the process used to make policy chocies, or on the consequences of those choices. (ii) Should one focus on the effects of these policies or processes under best, average, or worse case scenarios? (iii) Should one focus on the consequences on the poorest, richest, median, mean or all persons affected by governmental policies? (iv) Who counts and who does not? Should international externaliteis be considered?

   v. Clearly one can apply essentially the same tools and methods that we used to evaluate particular public policies to the examine the relative value of institutions

B. Paretian

   i. Clearly, one can use the Pareto norms to assess the relative merits of actual or hypothetical institutions. Institution A is Pareto Superior to Institutions B *iff* at least one person perfers institution A to Institution B and no one strictly prefers B to A. If there are no hypothetical or real institutions that are Pareto superio to A, then A is a Pareto efficient or optimal institution

ii. The same problems that we have with the Paeto criteria for policy are obviously present here as well. There may be "too many" Pareto Efficient institutional arrangements. For both a dictatorhip and a democracy might be regarded as Pareto optimal becaue the dictator will be made worse off by a move to democracy, and the median voter made worse off by a move from democracy to dictatorship. (Is every institution Pareto efficient?)

C. Contractarian (psuedo Paretian) The contractarian approach(es) are very closely related to the Pareto norms. Essentially they are looking for institutions that could or could have been adopted voluntarily by those subject to those institutions or rules. That is to say, an institution is desireable if it is (or could have been) the result of a Pareto superior move. On the other hand, the notion of a voluntary contract differs slightly from that of a Pareto superior move insofar as every one has to agree that they will be at least as well off after accepting the contract, before a contract can be signed. (A Pareto superior move can be "retrospective" in that after a possibly involuntary contract takes place, the results are observed to make some better off and no one worse off.)

i. To a contractarian, agreement is the only index that we have to decide whether a policy or institution is a good one. (They resist making inter-personal comparisons of utility.)

ii. Explicit contracts: clearly any case where the direct participants in a government all sign a contract that establishes a government satisfies the contractarian norm. This would be true for example of the British Magna Carta and the Mayflower Compact might count as examples of this, but not the American Constitution insofar as many affected persons were opposed to it. (The latter was unanimously accepted by the states but by no state's voter's.)

iii. Implicit contracts: many other governments may be regarded to be the result of implicit contracts. The contracts may be implicit in two senses of the word. First they may be implicit because the details of the obligations are not spelled out (this is the usage in economics). Second they may be implicit insofar as many affected parties who did not sign the contract feel bound by it and would have signed if offerred the chance. (The current American Consitution probably almost qualifies as an implicit contract in both these senses of the word. People would not agree that it was the best constitution that could be drafted, but that it was better than nothing.)

iv. The veils of ignorance and/or uncertainty: Several persons who are regarded as modern social contractarians: Rawls, Buchanan, and Harsanyi; have argued that individuals would be more inclined to agree about a constitution (and/or other fundamental laws of the land) if they had to make a decision in a setting where they did not know the direct consequences of those institutions for themselves.

a. Under the Rawlsian veil, the typical individual is assumed not to be able to predict "who" he will be in the ensuing society. So the participant at the hypothetical constitutional convention has to imagine himself in each of the wide variety of positions that might arrise. In the end, Rawls argues that individuals will focus on the welfare of the worst-off person in society and attempt to maximize the value of that position. (A *maxi-min* strategy.)

b. A real veil of uncertainty assumed in the theories of Buchanan and Tullock in in Harsanyi. Here uncertainty about the personal consequences of the institutions being considered causes individuals to take a wider account of the possible implications of the institutions (consider their own personal circumstances if they are rich or poor, lucky or unlucky, etc.) in a manner which yields a choice calculus similar in many ways to that developed and made famouns by Rawls. B&T and H both regard the outcome to be one where expected values or at least expected (average) utility is maximized.

v. Virginia School origins of constitutional analysis are clear insofar as the first analytical work of any depth was developed by Buchanan and Tullock who were the leaders of the "Virginia school" for most of its existance. (The calculus of Consent was written at UVa in the late 50's and 60's, the Center for Study of Public Choice center was created at VPI in 1969/70 about ten years latter when both Buchanan and Tullock moved there from UVa (via Rice and UCLA). Of course they and the Center both moved to GMU in 1983/4.) Buchanan's Nobel prize was essentially for Constitutional Political Economy although other contributions are mentioned.

vi. Rediscovery by the "new" north-eastern PC literature: Bagwatti, Dixit

D. Utilitarian calculus can also be used to evaluate the relative merits of institutions. Often this is easier, but the calculus of the "veil" of ignorance is actually very similar to a Benthamite social welfare function

III. Illustration: The Generality Principle

A. In *Politics by Principle not Interest* (1998) Buchanan and Congleton argue that rules which constrain government to provide services more or less uniformly can sharply reduce both rent-seeking expenditures and usefully increase the stability of governmental policies.

B. The intuition behind their argument can be illustrated with the following game matrix which resembles a PD game but which is interpreted in a quite different manner in their analysis.

C.

	Coalition B Transfer to B	Do Not Transfer to B
Coalition A — Transfer to A	-1, -1	1, -2
Do Not Transfer to A	-2, 1	0, 0

D. The individual cells of the game represent different policies or social states that can be chosen by which ever party comes to power.

  i. Note that Coalition a will chose the lower left hand cell if it comes to power and Coalition B will choose the upper right hand cell.

  ii. That is to say, coalitional democracy has a predisposition to transfer wealth from those outside the dominant coalition to those inside the dominant coalition.

E. If these coalitions are somewhat unstable, then as power shifted back and forth between them, policy outcomes would oscillate between the lower left hand outcomes and the upper right hand outcomes.

  i. Note that if this rotation was fairly even, that the average payoff to being able to discriminate would be -0.5 for each coalition, e. g. (0.5)(1 - 2).

  ii. Moreover, each coalition has in incentive to spend considerable resources to try to avoid being the minority coalition (their personal wealth increases by 3 units if they can move from the minority to the majority position), thus considerable majoritarian rent seeking expenditures might take place

F. Together, these two effects suggest that each coalition would benefit if somehow they could escape from this game.

  i. One possibility might be that they would try to eliminate future elections.

G. Another possibility of greater interest to Buchanan and Congleton is that they could adopt a constitutional rule which "eliminates the off diagonals possibilities" by forbidding discriminatory transfers.

  i. Note that in this case, both coalitions would face choices along "the diagonal."

ii. And, moreover, note that each group now prefers the same policy. (Here no transfers.)

iii. Stability exists, and the particular form of stability is Pareto Superior to the original setting where the constitution allows discriminatory transfers to take place.

H. (In their book, BC apply their analysis to a broad range of policies to show that this "generality" line of argument can be applied to a wide range of modern public policies.)

IV. Federalism

A. There are many economic an political cases that can be made to support Federalism as a competitive form of government. Consider the following one based on reducing rent-seeking and other types of political conflict.

B. A simple rent seeking game: Suppose that ethnic group "A's" probability of securing a transfer, T, via the contest of interest is approximately equal to the ratio of their efforts, E^A, to all others, E^O, $P^A = E^A / (E^A + E^O)$.

  i. Suppose further that the cost of each unit of political effort is simply C. In this case, A's expected net benefit, N^e, from engaging in political activity is simply the expected transfer less the cost of the effort undertaken.

$$N^e = P^A T - E^A C \qquad (2)$$

  ii. Differentiating with respect to E^A and setting the result equal to zero, allows (ethnic) group A's political profit maximizing investment in rent-seeking to be characterized as:

$$[- E^O / (E^A + E^O)^2]T - C = 0$$

or

$$E^A = - E^O + [TE^O/C]^{½} \qquad (3)$$

  iii. Now, consider the very tractable equilibrium that emerges if there are K-1 other equally well organized and effective groups participating in the political influence game of interest. At the symmetric equilibrium all groups make the same investment in rent-seeking activities, so $E^o = (K-1) E^A$. Substituting into equation 3 and solving for E, allows the Nash equilibrium political effort of each group to be determined:

$$E = (1-1/K) T / KC \qquad (4.1)$$

and total rent-seeking cost, $\mathcal{R}$, across all K groups is:

$$\mathcal{R} = KEC = (1-1/K)\ T \tag{4.2}$$

C. Note that both single group investments (4.1) and the total amount invested among all groups (4.2) increase as the political prize (T) increases. Note also that as the number of groups, K, gets large, the total amount invested approaches T, the total value of the transfer sought. That is to say, a multi-national state in which ethnic or nationalist groups seek transfers or favorable regulations from government tends to waste more and more scarce economic resources in political conflict.

D. To assess the merits of Federalism as a device to reduce rent seeking by ethnic or other natural groups, consider first the extreme perfectly competitive case in which the cost of moving between local governmental jurisdictions is zero. That is to say, suppose people can costlessly relocate from one political jurisdiction to another, e. g. M = 0.

  i. Note that anyone who finds himself to be a member of an unfavored group would simply relocate to another community where his own ethnic group is favored or at least not relatively disadvantaged.

  ii. Members of "favored' groups that are not equally favored in their current locations would migrate to the locality where they might best profit from local discrimination.

  iii. Thus, Tiebout-type competitive equilibrium in a federal multinational state with local favoritism is characterized by many essentially *ethnically pure* local governments producing various local government services at least cost.   Obviously, favoritism can have only very limited effects on the distribution of wealth within such an equilibrium.

  a. Complete sorting implies that *all* bureaucratic services will be monopolized by a dominant ethnic group.

  b. However, complete sorting also implies that *all* those seeking services will be members of the same ethnic group.

E. Now consider, the level of resources that will be invested in political conflict within a country with L equal sized autonomous local governments. Suppose that their are N^L residents in each district and that moving between districts costs M^L while moving between countries costs M^C, with $M^C > M^L$.

  i. The greatest transfer that can be financed from a single local or national citizen is his opportunity cost of moving: M^L for local governments and M^C for national governments. Consequently, the maximal transfer that can be undertaken by a local government is $M^L N^L$.

  ii. Suppose that K local interest groups participate in a maximal local rent-seeking for this transfer which has the same format as the national game previously

analyzed.   From equation 4.2 above, we know that local political conflict will consume :

$$\mathcal{R}^L = (1-1/K)\ M^L N^L \tag{5}$$

  a. In the perfectly competitive federal environment, each community is homogeneous so K = 1, and no ethnic rent-seeking takes place.

  b. In the case of interest here, the number of ethnic rivals in a local jurisdiction, K^L, is greater than 1, but is smaller than the number of groups in the country, K^C, as a whole to the extent that some sorting of groups has taken place under federalism.

  c. Given, $K^L < K^C$, it is clear that fewer resource will be invested in political conflict locally than nationally whenever the same political prize is at issue.

  iii. On the other hand, national transfers can be much greater than that of any single local jurisdiction because national population is greater than local population and, perhaps most significantly, moving costs are greater.

  iv. Maximal national transfers can be represented as $LN^L M^C$. Resources devoted to political conflict to receive such a maximal national transfer would be:

$$\mathcal{R}^C = (1-1/K^C)\ LN^L M^C \tag{6}$$

  v. This is clearly much greater than the resources devoted to political conflict in any single local jurisdiction, and, of greater relevance for the present analysis, exceeds that of all L jurisdictions combined.   The latter can be written as:

$$L\mathcal{R}^L = (1-1/K^L)\ LN^L M^L \tag{7}$$

  vi. Comparing equations 6 and 7, it is clearly the case that ethnic based political conflict is smaller in a decentralized federal system for two reasons. First, greater mobility implies a smaller political prize to be competed for, $M^C > M^L$. Second, greater ethnic homogeneity implies that fewer competitors in the political game, $K^C \geq K^L$. Together these imply that maximal rent seeking costs fall unambiguously as programs are moved from the central government to local governments.

V. Cultural Norms and Constitutional Design

A. Cultural norms can similarly affect the kind of policies that will be adopted in a society insofar as those norms affect preferences over public policies.

B. For example, if transfers are believed to be a form of theft, then many will who might receive them will vote against such polices on moral grounds.

  i. (We do observe farmers voting against farm programs and educators employed by the state voting in favor of vouchers.)

  ii. Penalties imposed on drug sales versus other "economic" crimes provide evidence that "sin" is often subject to very stringent taxes.

    iii. Norms of Honesty and a Work Ethic naturally reduces monitoring costs in politics as well as in the private sector.

VI. Review of Positive CPE questions

A. Democracy versus Dictatorship

B. Voting Rules

C. Constraining Democratic Choices

D. Federalism: How Decentralized Should Government Be

VII. Review of Some Empirical CPE results

A. On state and local public finance: Crain and Miller

B. On international growth rates: Grier and Tullock

C. There are a wide variety of Constitution arrangements that can be shown to affect the performance of government.

D. We have already discussed several of ways in which institutions can affect one important aspect of political processes.   Several institutional arrangements will increase the likelihood that political processes have an equilibrium: bicameralism, various agenda control restrictions, etc.