

I. From Philosophy and Economics to Constitutional Political Economy

- A. In the late nineteenth century, social science started to become more specialized and separate departments for the study of economics, political science, and sociology became commonplace in academia.
- The fields of political science, economics, sociology, and psychology emerged as separate areas of research and university departments specializing in these research programs emerged as well--which tended to affirm the invisible lines separating the new fields of research.
 - Economists after that partitioning of social science focused more narrowly on markets and economic development.
 - Normative and positive analysis became more separate, in part because the insights of "positivist philosophy" were internalized by the profession.
- B. Economists have long been interested in public policy questions.
- In fact, it can be argued that economics as a field emerged as a method for persuading others about the merits of liberal policy reforms in the eighteenth and nineteenth centuries.
 - Utilitarians, for example, wrote economic text books at the same time that they lobbied for policy reforms.
 - The English strand of the "marginal revolution" was launched by utilitarians.
 - During the nineteenth century, there was not much distinction between positive and normative analysis, nor was there much distinction between economic, political, and legal analysis.
 - Policies were analyzed for their impacts (positive analysis)
 - And, many suggestions for reform were offered--often based on utilitarian analysis (e.g. social welfare functions).
 - Reforms included all manner of laws, not simply ones affecting regulation and trade--including proposals for new election laws and other constitutional reforms.
 - After the fields of social science separated, economists remained interested in public policy issues, but the politics behind public policy became a topic for political scientists rather than economists, and the constitutions behind politics became a subject for law professors.
 - One could see this effect in textbooks and in research.
 - Specialization continued to increase and sub-fields of economics and the other fields emerged.
- C. For most of the twentieth century, most public finance, environmental economics, and macroeconomic text books and research assumed that public policies were "exogenous" (beyond their models and analysis) rather than part of the subject.
- Text books in all these fields often criticized contemporary public policies and made suggestions about how those policies can be improved.
 - Taxation was criticized from the perspective of optimal tax theory
 - Externality problems were pointed out and possible solutions proposed.
 - However, with minor exceptions, they did not discuss why those policies have or have not been adopted.
- D. During the late 1940s and 1950s, a small group of economists began to use rational choice models to analyze how public policies come to be adopted in democracies.
- Duncan Black (1948, 1958) and Howard Bowen (1943) were the first economists to analyze voting with rational choice models.
 - Subsequent contributions in the 1950s include papers and books by Kenneth Arrow (1951), James Buchanan (1949, 1954), Anthony Downs (1957, 1960), and Charles Tiebout (1956).
 - In the 1960s, interest group models of the selection of public policy were developed by Olson (1965) and Stigler (1971), and analysis of political agency problems was begun [Niskanen (1968)].

- a. The classic works of public choice are largely from the first three decades of public choice research:
- Duncan Black's *Theory of Committees and Elections*
 - Kenneth Arrow's *Social Choice and Individual Values*
 - Anthony Downs's *Economic Theory of Political Action in a Democracy*
 - William Riker's *Democracy in the United States*
 - James Buchanan and Gordon Tullock's *Calculus of Consent*
 - Mancur Olson's *Logic of Collective Action*.
- b. Other near classics from the 1970s and early 1980s include:
- William Niskanen's *Bureaucracy and Representative Government*
 - Susan Rose Ackerman's *Corruption*
 - Mancur Olson's *The Rise and Decline of Nations*,
- iv. Much of that work was considered to be political science rather than economics by other economists.
- Mainstream political scientists regarded "rational choice" politics, for the most part, considered public choice research to be part of economics, rather than political science.
 - It was not until the 1990s the public choice research came to be regarded as part of economics by economists, and even now public choice, rational choice politics, and constitutional political economy are somewhat controversial areas of research.
- v. For the most part, political science had been empirical (inductive) rather than theoretical (deductive) after the field emerged in the late nineteenth century.
- The work of William Riker (1962, 1968) arguably was most important.
 - This was followed by many political scientists including Steven Brams (1973, 2005), Bernard Grofman (1973, 1984, 1999), Barry Weingast (1979, 1989, 2009), and Elinor Ostrom (1986, 1990, 2009), who won the Nobel prize in Economics in 2009.
- vi. Fellow travelers from sociology and philosophy included James Coleman (1966, 1988) and John Rawls (1955, 1971).
- E. Of course, public choice research was not entirely discounted by mainstream economists, political scientists, sociologists, and philosophers.
- a. Their research attracted considerable interest.
 - b. Indeed, Arrow, Stigler, Becker, Buchanan, and Ostrom eventually won Nobel prizes partially or entirely (in Buchanan's case) for their pioneering contributions to "rational choice politics" or "public choice."
 - c. (Arrow in 1972, Stigler in 1982, Buchanan in 1986, Becker in 1992, and Ostrom in 2007).
- F. As the analysis of the effects of voting rules was worked out, the importance of voting rules became obvious. And, as the possibilities for "voting with one's feet" were analyzed (Tiebout 1956), the degree to which governments were centralized were analyzed. Both could affect public policies and through those effects, affect economic activity.
- G. The fields of political economy and constitutional political economy began to reemerge.

II. Constitutional Political Economy

A. What might be called neoclassical constitutional political economy emerged at about the same time as the interest group literature.

- i. In many respects it was a natural extension of the elections literature.
- ii. If elections matter, then voting rules must matter.
- iii. And, because voting rules are chosen in some way, how they are chosen must matter as well.
- iv. Constitutional political economy explores how "constitutions" (broadly construed) affect public policies through effects on the processes through which policy choices are made and how the persons participating in those processes are selected.

- With respect to the latter, persons of authority may be elected, indirectly elected, appointed be elected officials, or appointed by unelected officials.
- B. Although constitutional research is an ancient sub-field of political science--dating back to Aristotle and beyond--very little of it was grounded in rational choice models.
- C. Buchanan and Tullock wrote a path-breaking book in 1962 on the manner in which various elements of constitutional design tend to affect public policies.
- It explored the effects of different voting rules on outcome.
 - It explored the effects of bicameralism. on public policies
 - It explored the effects of federalism on public policies.
 - And it provided new critiques of welfare economics as it existed at that time--critiques that would be later referred to as "contractarian critiques."
- i. Their work demonstrated that constitutions could be fruitfully analyzed with rational choice models.
- ii. The book clearly demonstrated that constitutions "matter"because they affected public policy choices and thereby affect both future economic and political activities.
- For example, if policy choices were generally with respect to changes in some status quo, fewer new policies are adopted under super majority rule than under majority rule.
 - Indirect forms of democracy can reduce the link between voters and policies. For example if candidates are elected to office with 50% of the vote and 50% of the representative elected are enough to adopt a new policy--only 25% of voters would necessarily approve of the policies adopted.
- D. The field of CPE extends well beyond the formal government documents that are referred to as "constitutions."
- i. Every group requires a process for making collective decisions.
- ii. The process adopted--dictatorship, majority rule, consensus--operate as a group's constitution.
- Nearly every firm and club has standing formal and informal decisionmaking rules.
 - That is to say, they have charters or constitutions.
 - This is surprising even true of pirate ships (Leeson 2007/09)
- iii. Because group decision making is ancient, there is a sense in which constitutional political economy is an ancient field of study.
- Every family, band, tribe, town, city, state, country, alliance, etc. uses some form of collective decision making to choose particular courses of action.
 - And obviously, since they do not know ex ante the best way of doing so they have to think about and evaluate the alternative decision making rules that they are aware of.
 - By doing so, the groups are engaged in constitution choice and constitutional political economy.
- E. The use of methodological individualism and rational choice models as the basis for analysis was new and generated a variety of new insight about both the effects of constitutoins and the many interdependenc-ies between political and economic systems.
- i. Methodological individualism attemptps to characterize all social phenomena as consequences of individual decisions.
- ii. There are several rationales for this methodology.
- A group of individuals does not share the fundamental hardware of choice, a central nervous system, essentially by definition.
 - So, group decision making cannot be fully induced by inherited biological traits and necessities--although human nature clearly helps human beings organize themselves and the environment around them.
 - Humans, for example, are better at creating organizations, at communicating, at analyzing the world, and accumulating knowledge than other species.

- Moreover, for the economists taking up CPE analysis, the rational choice models of economics and game theory were part of their "tool bags."
- F. There evolutionary pressures that tend to "select for" collective decision making processes that increase both individual and group survival and attractiveness.
- i. "Collective enterprises" are very useful to humans and so evolution favors the subset of human characteristics that make such organizations possible and effective--if not fully so.
 - a. Continued affiliation with such groups is largely voluntary, in the sense that exit is normally possible.
 - b. Exit tends to be costly in large part because of advantages of continued association with one's current group (family, club, tribe, community, etc.).
 - c. Groups with efficiency increasing constitutions thus tend to have a survivorship advantage over those with less efficient constitutions--efficiency means their effectiveness at making choices that improve survival prospects.
- G. Collective decision making rules are clearly an important part of the productivity (survival advantage) of groups. Without some method of choice, a group will have a difficult time solving public goods and externality problems.
- i. It is arguably the ability to solve these and similar "team production" problems that makes organized groups more viable than unorganized ones.
 - ii. A group that could not formally or informally make decisions, would not have an advantage over individual decision makers, because it would not realize economies of scale, produce public goods, solve coordination problems, etc.. (A group that could never make a decision about a restaurant or method of hunting would starve.) .
 - iii. Note that "group management" need not be particularly active. Often establishing and enforcing rules (as with a civil law code) is sufficient to solve a broad range of problems--including the one pointed out by Hobbes.
- H. Because decision making methods and rules for living in a community can be revised both whole cloth and at the margin, there is good reason to believe that the ones that have "stood the test of time" are in some sense efficient.
- i. One can use rational choice models to explore both the properties of existing institutions and to suggest and test possible reforms.
 - ii. As a consequence, the "technology" of collective decisionmaking tends to improve through time.
 - iii. Although it certainly does not look perfect, it has doubtless improved greatly, allowing both better decisions by a group of given size and also decisions by larger groups to be made and implemented.
 - iv. Governance has been evolving for far longer than written language has been--that is to say, for as long as groups have existed.
- I. There are survival advantages to being affiliated with groups, and insofar as groups "do things together," they have always required methods for collective decision making.
- i. Diamond (1999) and others suggest that until about ten thousand years ago most people on earth associated with one another in relatively small groups (a few dozen people), who used a form of consensus based decision making.
 - ii. However, as towns and cities formed to take advantage of specialization and trade, the groups became larger and other collective decisionmaking procedures (including the "king and council" form) came to be widely used.

III. A Digression on a Few Ancient and Contemporary Theories of Governance and of the Origin of Government

- A. Practical theories of governance and the state are ancient, and thus political science is among the oldest fields in social science.
- Academic analysis of governments is also quite old, although less so than government itself.

B. To illustrate that academics have long studied these kinds of questions consider the following quotes from important analytical political theorists.

i. Confucius on Government (Analects, 500 BCE)

- Lead them by means of regulations and keep order among them through punishments, and the people will evade them and will lack any sense of shame. Lead them through moral force (de) and keep order among them through rites, and they will have a sense of shame and will also correct themselves.
- Zigong asked about government. The Master said, “Sufficient food, sufficient military force, the confidence of the people.” Zigong said, “If one had, unavoidably, to dispense with one of these three, which of them should go first?” The Master said, “Get rid of the military.” Zigong said, “If one had, unavoidably, to dispense with one of the remaining two, which should go first?” The Master said, “Dispense with the food. Since ancient times there has always been death, but without confidence a people cannot stand.”

ii. Aristotle: On the origin of the state (the Politics, 350 BC)

- “Now, that man is more of a political animal than bees or any other gregarious animals is evident. Nature, as we often say, makes nothing in vain, and man is the only animal whom she has endowed with the gift of speech. And whereas mere voice is but an indication of pleasure or pain, and is therefore found in other animals (for their nature attains to the perception of pleasure and pain and the intimation of them to one another, and no further), the power of speech is intended to set forth the expedient and inexpedient, and therefore likewise the just and the unjust. And it is a characteristic of man that he alone has any sense of good and evil, of just and unjust, and the like, and the association of living beings who have this sense makes a family and a state.
- Further, the state is by nature clearly prior to the family and to the individual, since the whole is of necessity prior to the part ...
- The proof that the state is a creation of nature and prior to the individual is that the individual, when isolated, is not self-sufficing; and

therefore he is like a part in relation to the whole. But he who is unable to live in society, or who has no need because he is sufficient for himself, must be either a beast or a god: he is no part of a state. A social instinct is implanted in all men by nature, and yet he who first founded the state was the greatest of benefactors. For man, when perfected, is the best of animals, but, when separated from law and justice, he is the worst of all; since armed injustice is the more dangerous, and he is equipped at birth with arms, meant to be used by intelligence and virtue, which he may use for the worst ends. Wherefore, if he have not virtue, he is the most unholy and the most savage of animals, and the most full of lust and gluttony. But justice is the bond of men in states

iii. Aristotle on democracy (the Politics, 350 BC):

- The basis of a democratic state is liberty; which, according to the common opinion of men, can only be enjoyed in such a state; this they affirm to be the great end of every democracy. One principle of liberty is for all to rule and be ruled in turn, and indeed democratic justice is the application of numerical not proportionate equality; whence it follows that the majority must be supreme, and that whatever the majority approve must be the end and the just.
- Every citizen, it is said, must have equality, and therefore in a democracy the poor have more power than the rich, because there are more of them, and the will of the majority is supreme. This, then, is one note of liberty which all democrats affirm to be the principle of their state.
- Another is that a man should live as he likes. This, they say, is the privilege of a freeman, since, on the other hand, not to live as a man likes is the mark of a slave. This is the second characteristic of democracy, whence has arisen the claim of men to be ruled by none, if possible, or, if this is impossible, to rule and be ruled in turns; and so it contributes to the freedom based upon equality.

iv. On the nature of anarchy: from Thomas **Hobbes**, *Leviathan* (1651)

- "Whatsoever therefore is consequent to time of Warre, where every man is Enemy to every man; the same is consequent to the time wherein men live without other security than what their own strength,

and invention shall furnish them withal. **In such condition .. the live of man [will be] solitary, poor, nasty, brutish and short.**

v. On the nature of anarchy: From John Locke (Second Treatise on Government 1689)

- O understand political power right, and derive it from its original, we must consider, what state all men are naturally in, and that is, a state of perfect freedom to order their actions, and dispose of their possessions and persons, as they think fit, within the bounds of the law of nature, without asking leave, or depending upon the will of any other man.
- And that all men may be restrained from invading others rights, and from doing hurt to one another, and the law of nature be observed, which willeth the peace and preservation of all mankind, the execution of the law of nature is, in that state, put into every man's hands, whereby every one has a right to punish the transgressors of that law to such a degree, as may hinder its violation: for the law of nature would, as all other laws that concern men in this world 'be in vain, if there were no body that in the state of nature had a power to execute that law, and thereby preserve the innocent and restrain offenders.
- And thus the commonwealth comes by a power to set down what punishment shall belong to the several transgressions which they think worthy of it, committed amongst the members of that society, (which is the power of making laws) as well as it has the power to punish any injury done unto any of its members, by any one that is not of it, (which is the power of war and peace;) and all this for the preservation of the property of all the members of that society, as far as is possible. But though every man who has entered into civil society, and is become a member of any commonwealth, has thereby quitted his power to punish offences, against the law of nature, in prosecution of his own private judgment, yet with the judgment of offences, which he has given up to the legislative in all cases, where he can appeal to the magistrate, he has given a right to the commonwealth to employ his force, for the execution of the judgments of the common-wealth,

vi. From John Locke, *First Tract on Government* (1689)

- “‘Tis not without reason that tyranny and anarchy are judged the smartest scourges [that] can fall upon mankind, the plea of authority usually backing the one, and of liberty inducing the other...All the remedy that can be found is when the prince makes the good of the people the measure of his injunctions, and the people...pay a ready and entire obedience.”

C. Quotes from two of the founding Public Choice scholars are included below to show that the same issues are still being examined. The “correct” answers to many fundamental questions remain controversial.

i. From Mancur Olson, "Anarchy, Autocracy and Democracy" (1991)

- "The conqueror of a well defined territory has an encompassing interest in that domain given by the share of any increase in the territorial income that he collects in taxes. This encompassing interest gives him an incentive to maintain law and order and to encourage creativity and production in his domain. Much of the economic progress since the discovery of settled agriculture is explained by this "incentive."

ii. From James Buchanan, *Limits to Liberty*, 1975.

- "The state serves a double role, that of enforcing constitutional order and that of providing "public goods." This duality generates its own confusions and misunderstandings. "Law," in itself, is a "public good," with all the familiar problems in securing voluntary compliance. Enforcement is essential, but the unwillingness of those who abide by law to punish those who violate it, and to do so effectively, must portend erosion and ultimate destruction of the order that we observe.
- These problems emerge in modern society even when government is ideally responsive to the demands of citizens. When government takes on an independent life of its own, when Leviathan lives and breathes, a whole set of additional control issues cone into being. "Ordered anarchy" remains the objective, but ordered by whom?
- Neither the state nor the savage is noble, and this reality must be squarely faced.

IV. Three Public Choice Theories of the Origin of the State

- A. One of the most unusual and controversial parts of CPE research concerns the origins of government or rule-making organizations with the power or authority to impose and enforce laws--including tax laws.
- B. There are two main explanations: what might be called the productive state and extractive state explanations.
- C. A productive state may emerge because there are survival advantages to being affiliated with groups, and insofar as groups "do things together," they have always required methods for collective decision making.
 - These advantages may explain the emergence of the formation of organizations that we refer to as governments. Such governments tend to be productive enterprises.
- D. On the other hand, governments may emerge because a group manages to solve Olsonian problems with respect the production of coercive power and other capacities for making credible threats and/or imposing laws on others. Such states tend to be extractive states.
- E. Historically, it seems likely that some states emerge to solve various social dilemmas and others emerge because of their ability to organize coercive force.
- F. Social evolution, in turn, may explain the kinds of institutions that both productive and extractive governments tend to use for selecting public policies.
 - Among these, the most commonplace are various implementations of what I refer to as the "king and council" template.
 - The king and council template is a divided form of government in which a king (executive, ceo, president etc) and a council (parliament, legislature, etc) jointly determine policy choices.
 - The balance of authority between the two "branches" of government differ widely among governments and through time--and may be adjusted through various kinds of "constitutional bargaining."

V. The Coercive/Extractive theory of the state (Montesquieu, Tullock, Olson, Acemoglu)

- A. The most widely held theories of the state tend to focus on extractive/coercive theories. These theories tend to focus on the organization of force.
- B. If mankind found itself in a state of Hobbesian anarchy, groups would naturally be formed for self defense and for conquest. (Montesquieu and Tullock).
 - i. In a given region, one group may be better organized than others and so gradually come to dominate all others.
 - Such a group may be said to be a territorial government when it can impose rules and taxes on others living in the territory.
 - ii. According to this theory, an authoritarian state emerges when one group conquers all those within a given territory.
- C. Common Problems and Solutions for Authoritarians
 - i. The first problems that have to be overcome by such conquering groups is the problem of organizing coercive force. There are all kinds of team production problems associated with such organizations.
 - ii. Once such groups emerge and conquer others, the next problem that must be overcome is to retain power or avoid overthrow.
 - iii. How one does this involves a number of strategies. [Tullock (1972, 1974, 2012) , Wintrobe (1990, 2000), Buena de Mesquita et al. (2005)].
- D. Tullock argues that ruling groups undertake common strategies to remain in authority. These include:
 - a. censorship
 - b. secret police
 - c. rewards for information
 - d. the rotation of rivals among offices (to minimize their base of support)

- e. distribution of organizational “profits” among those whose support is most needed to retain power (See also North, Wallis, and Weingast, 2009, on this point.)
- i. After security of authority is assured, authoritarian regimes would next attempt to maximize the fruits (present value of the net benefits) of office.
- ii. Perhaps surprisingly, the ability of stable dictatorships to tax the residents of their territory gives them an “encompassing interest” in the economic development of their territory (Tullock, Olson)
- a. With this in mind, a court system may be established
- b. Roads and ports improved
- c. Education provided
- d. (Prosperity is a good thing for authoritarians as long as it does not increase prospects for an over throw.)
- iii. Mancur Olson (1993, 2000) demonstrated that a secure net revenue maximizing dictator has good reason to provide law and order, national defense, highways, and so forth.
- a. As a residual claimant on national output, a “**stationary bandit**” has an “encompassing interest” in the prosperity of his territory.
- In order to harvest taxes and other goods from “his garden,” the stationary bandit must protect it from others (from **roving bandits**).
- b. Olson also points out that roving bandits have no such incentive, because they “harvest” in an environment that closely resembles a prisoner’s dilemma game. What they fail to harvest is likely to be taken by the next roving bandit rather than used to produce next years tax base.
- E. Olson argues that this encompassing interest accounts for most of the emergence of civilization over the centuries.
- a. Differences in planning horizon (security) would induce more or less long term planning and so more or less rapid economic development.
- b. Tullock, in contrast, argues that rather than reinvest profits in their territories, less than perfectly secure dictators would invest outside the country, reducing a country’s long term growth rate. (capital flight)
- F. Tullock , Buena de Mesquita et al. and North et al. all argue that even authoritarian regimes need to have some minimum base of support to retain authority (Mequita terms such persons the “Selectric.”)
- i. Dictatorship tend to be extractive regimes, but the "fruits" of power are shared among top government officials (to solve incentive problems) and others whose support can be "purchased" at least cost.
- The result tends to be a highly unequal distribution of income and a somewhat broader foundation for rule than the goals of a single man or woman.
- ii. Tullock suggests that within a ruling group there is often a single decisive decisionmaker, who can be regarded as “the dictator,” but that dictatorships often have what might be called committee-based decision making institutions.

VI. The Contractarian Theory of the State: Productive States

- A. An alternative theory of the origins of the state also imagines the original setting being a Hobbesian jungle, but notes that groups may form voluntarily in such settings and form a government as a means of escaping from anarchy, producing public goods, solving externality problems, and so forth.
- i. Hobbes argued that this can lead to an authoritarian state, such as France was during his lifetime.
- ii. Others argued, that society can do better than that if it could develop an effective constitutional system.
- iii. The early constitutionalists (17th and 18th century) all believed that a government better than an authoritarian one could be achieved through appropriate constitutional designs (as with Locke and Montesquieu).
- B. The contractarian (social contract) theory of the state conceives of a **state as the result of a voluntary contract among equals**.
- i. States formed in this way are productive., rather than extractive--otherwise they would not have unanimous or near unanimous support..

- ii. Individuals create a governing organization as a method for overcoming the collective action problem associated with advancing common ends.
 - a. To make property and life more secure.
 - This requires national defense
 - and a legal system, with effective courts
 - iii. Such governments may also be formed to solve other public goods and externality problems.
 - iv. In such “contractarian” states, the **coercive means** used by the state to collect taxes, enforce laws, and assure national defense are all **grounded in voluntary agreement**, rather than imposed by outsiders.
 - v. There are many instances in which contract-based states have been formed.
 - Many towns in the "New England" colonies of North America were founded voluntarily and included a town charter that all residents had to sign.
 - Many alliances among towns and countries are formed voluntarily (with written charters or constitutions) to defend one another from conquering groups of the extractive state variety. Switzerland, the Netherlands, and the United States were initially defence alliances.
 - Some of the most powerful contemporary treaty organizations have also been formed voluntarily at the level of national governments and so could be regarded as contractarian or productive states (at least by their national governments and/or median voters).
- C. James Buchanan (1975) extended the social contract theory of Hobbes by applying modern tools of economic analysis and game theory to the analyze the kinds of governments one could imagine persons adopting voluntarily.
- i. His concept of social contracts is more optimistic than that of Hobbes in that he believes that leviathan can be constrained by a constitution.
 - a. Buchanan argues that there are often mutual gains that can be realized by agreeing to be "coerced" by a third party, which helps to explain the existence of both a rule-enforcing government and the tax collector.
 - b. In the absence of coercive methods, free rider problems would prevent the state (or a club) from advancing the interests of its citizens (members).
 - c. However, in settings in which persons are not initially more or less equal, the social contracts that emerge may violate contemporary norms for “good” governance.
 - ii. Buchanan often suggested that one **should focus on the process by which a state is formed** rather than its characteristics to appraise its legitimacy.
- VII. A Digression: Territorial Monopoly as a Foundation for Territorial Governance**
- A. An alternative explanation for the emergence of a state was proposed by Congleton in *Perfecting Parliament* (2011), chapter 4.
- i. In that chapter it is argued that the fact that many organizations can impose rules on “outsiders” and “insiders” makes the boundary between the insiders and outsiders less than perfectly sharp in practice, although that distinction is a useful one for many purposes.
 - For example, a commercial organization’s “customers” are not “insiders” in the sense used above, because they do not ordinarily participate in the firm’s team production, but they are nonetheless loosely affiliated with the organization and affect the organization’s viability.
 - Similar associations exist for a church’s congregation, the victims served by charitable organizations, and the alumni of colleges and similar organizations.
 - ii. Organizations can often impose rules on such affiliated persons, although within limits, as noted above.
 - In a setting in which customers may acquire the same services from a variety of organizations, their exit costs are low and the value of alternative sources of the services of interest are essentially equal.
 - In such cases, no organization can demand a higher price for its services than any other, whether in cash or kind. However, in cases in

which an organization provides an important, essentially unique service, a much higher price can be charged, that may well include cash and services to the firm.

► In such cases, customers must pay “the price” or do without.

B. Monopoly power potentially allows organizations to collect high fees, but also to impose rules and duties on their customers in exchange for the services provided.

- i. Here, one can imagine a water monopoly that controls the local irrigation network.
 - If a farmer wishes to have food on the table next year, he must have a reliable source of water and so is willing to pay a high price to the local water monopoly.
 - If prices become too high, the farmer may sell his land and move, although prices would have to be very high to induce abandonment of fertile farmland.
- ii. In such cases, the quality and extent of available substitutes plays a role that is very similar to exit costs.
- i. It bears noting that a monopoly price may involve more than a simply transfer money from customers to the organization’s treasury.
 - a. A monopolist that controls an important service is often able to earn additional profits by multipart prices that require both money and services from their customers.
 - b. For example, a water monopolist might set its prices in terms of money, farm output, hours of work, and deference to the organization’s leadership.
 - c. Such complex pricing can generate significant improvements in the well-being of the water monopolist over cash payments alone, because well-developed markets for other resources may not exist, or because some customer resources are worth more to the monopolist than to other organizations.
 - Deference, for example, is not a tradable good.
 - d. A farmer would not pay exorbitant prices for unimportant services, but some services are worth more their weight in gold.

C. There are many important services that can be monopolized by organizations in an insecure world without extensive trading networks.

- i. For example, suppose that a “protective wall cooperative” builds a protective wall around a plot of ground outside an existing village or a community that is available only to its members (subscribers).
 - a. This coop is clearly able to demand high membership fees in settings where external security risks are high and no other redoubts are available nearby.
 - b. It can also raise membership dues at times of unusually high risk. Indeed, at such times, potential members may be willing to pay essentially any price to join the club.
 - i. The implied offer is essentially “your money or your life,” although in this case, the coop clearly offers a service, rather than a threat.
 - However, the fact that the threat comes from “roving bandits” does not diminish the club’s bargaining power or its ability to impose rules on members and potential members.
 - In insecure times, the membership dues of such clubs can be as high as the wall is secure.
 - i. Monopoly power over a valuable service allows the organization to impose both high fees (taxes) and demanding rules on those who hope to gain access to the service.
- D. By controlling the magnitude and mix of payments required for access to its services, the governing body of organizations with monopolies over important services within a geographic area can exercise significant control over all who live there.
- Note that the ability of an organization to impose rules in such cases arises not through the exercise of military power (although some police power may be necessary to protect their claims to the irrigation network or wall), but rather through their ability to deny access to extremely valuable services.
 - If a person fails to pay, he or she might face starvation in the future or be banished from a redoubt or walled community, increasing their risks from roving bandits in both the short and long run.

- Moreover, more than one organization may be able to impose rules on outsiders in a given territory.
- E. The ability of organizations to impose rules on outsiders clearly varies with their monopoly power.
- i. Even firms in competitive markets often impose rules on their customers; for example, a grocery store will exclude unruly customers who impose negative externalities on other customers or significantly increase a firm's production costs by disturbing the arrangement of inventory on shelves or other displays.
 - ii. Such rules for customers, however, can be imposed only if they directly or indirectly benefit their customers. For example, shopping rules often allow firms to provide their services at lower costs to the customers.
 - Dress codes may create ambiance desired by a restaurant's customers.
 - Ease of substitution (exit), however, clearly limits the ability of rival organizations to impose rules on their customers.
 - McDonalds, for example, could not require all of its customers to wear tuxedos. Coercive proposals do not always yield additional net benefits for organizations or their customers.
- F. Historically, all three of these theories of the state may operate simultaneously. An invading army can be a very strong reason to join forces under a social compact.
- (Military alliances are often voluntary agreements by communities to repel an authoritarian invader or to secede from an authoritarian regime.)

VIII. How Constitutional Designs influence governance and policy choices.

- A. Given the two rough categories of governments, which are better thought of as end points of a spectrum of governmental types (productive and/or extractive), we next explore how policies differ in the two extreme cases of an extractive dictatorship and a productive liberal democracy.

- B. In the former case, it is assumed that a single person selects policies subject to economic and/or political constraints.
- C. In the latter case (liberal democracy), it is assumed that competitive elections determine policies--and that this process can be characterized with the median voter model.
- D. Note that in both cases, a single person can be said to select policies, but their interests are quite different for a number of reasons.

IX. Rational Choice and the Policies of a Secure Dictatorship

- A. Models of authoritarian regimes are of interest for several reasons. First, it is a relatively straightforward model of the state. Second, it represents a, more or less, worse-case theory of the state, but implies better public policies than might have been expected (indeed better than observed in most places). Third, until very recently, such governments have been the dominant form of large scale governance on the earth.
- Democracies have historically been a very small minority of the governments on earth.
- i. In spite of this, surprisingly little economic or public choice research has been undertaken on dictatorship.
 - (The books and papers of Gordon Tullock, Mancur Olson, and Ronald Wintrobe account for most of the rational-choice based literature on dictatorship before 2000.)
- B. The Olsonian model assumes that a dictator exists and analyzes the kinds of fiscal policies that a profit maximizing dictator would adopt.
- i. The assumed goal of the dictator is analogous to that of a slave holder in the old south, except that the plantation can not be sold.
 - ii. It turns out that a **revenue maximizing** dictator's interest in tax revenue leads him to provide public goods that increase national wealth (taxable wealth) and to tax at less than 100%.
 - iii. The latter implies that his subjects share in any prosperity induced by the dictator's public policies.

iv. And, moreover, insofar as the dictator can not fully capture the fruits of his subjects' labor, the "ruled" are made better off by the dictator, at least relative to what they would have realized under Hobbesian anarchy.

- That is to say, the conquered parties realize greater net of tax income than required for subsistence. (Of course, their alternative state might not have been the Hobbesian jungle.)
- (Note also that security interests may make a dictator less interested in advancing the interests of groups whose support is difficult to obtain at the margin or if he has a short time horizon.)

C. The simplest model is one where the dictator acts as an income maximizing Leviathan (as assumed in Brennan and Buchanan (1977), and in Olson and McGuire (1996).

i. A secure dictator, whose rule is unchallenged by potential rivals or invaders, will select tax and expenditure policies to maximize his income:

$$\blacktriangleright Y = tNy(G,t) - c(G)$$

ii. where y a function representing *average* or per capita national income and N is the number of subjects within the kingdom. Average income rises as G increases and falls as t increases. t is the tax rate and G is a national service that costs $c(G)$ to provide.

iii. First order conditions of ii characterize t^* and G^* for the dictator.

a. $Y_t = t + tN y_t = 0$ at t^* e. g. given G^* set t to maximize tax receipts

b. $Y_G = tNy_G - c_G = 0$ at G^* e. g. given t^* set G to maximize tax receipts

c. Because the tax base can be increased by services, and the dictator has an interest in the tax base, he can be said to have an encompassing interest in the wealth of his subjects. After all that is where his taxes come from.

iv. On the other hand, this is not a complete encompassing interest. Note that G tends to be *underprovided* by the dictator insofar as he receives less than the complete marginal benefit from the service. The national income maximizing level of government services requires

$$\blacktriangleright Ny_G - c_G = 0 \text{ not } tNy_G - c_G = 0$$

► the marginal benefits from government programs should be set equal to the marginal cost of G .

► (Note that a very similar model can be constructed for monopolist-based governance for services that increase the profitability of the service monopolized.)

► **Notice also that this model is very similar to the median voter models worked out in the previous part of the course. Such a model is developed below as well.**

D. Practice Problem(s)

i. It bears noting that two dictators can be worse than one.

ii. To see this consider the case of two toll collectors on the Rhine.

- Each knows that the shipping along the river increases as public services are provided and falls as tax rates (tolls) increase other things being equal.

- Let shipping be simply $S = K - b(t_1+t_2) + c(G_1 + G_2)$ and net tax revenue be $T_i = t_i S - c(G_i)$

- Holding public services constant ($G_i = k$) determine each river baron's optimal tariff rate. (Assume that neither river baron knows what the other is doing.)

iii. Compare this rate with that under a single ruler.

iv. Now, hold taxes constant, and determine the public service levels that will be forthcoming under the two vs. single river baron cases.

X. Elections and Electorally Determined Policies

A. One advantage of democracies over dictatorships is that it is easier to replace rulers who generally reduce the welfare of their citizens. (Popper 2000/2013).

B. Another advantage is that elections themselves tend to induce those competing for office to propose and implement policies that generate net benefits for a majority of the persons living in the country of interest.

- C. A lean model of policy formation in a democracy implies that the policies adopted tend to be those which maximize the welfare of the median voter.
- D. A model comparable to the dictatorship model developed above can be constructed where a “ruler” is elected:
- i. Suppose that the median voter is restricted to similar fiscal policies: proportional taxes and public goods and is interested in maximizing his own after tax income.
 - ii. What would be the median voter’s ideal combination of taxes and government services?
 - iii. Since the median voter can not keep net tax receipts, she faces a balanced budget constraint and her tax rates vary with the government services provided and the size of the tax base.
 - ▶ Let $c(G)$ be the cost of the government service(s) and $y(G,t)$ be the average income associated with service level G and tax rate t .
 - ▶ Given a balanced budget constraint and a proportional tax system, the tax rate can be determined as follows:
 - ▶ $c(G) = tNy(G,t)$ which implies that $t \approx c/Ny$
 - iv. The median voter's after income is similar to that of the average voter's income although not identical unless the distribution of income is symmetric.
 - v. Let $v(G,t)$ be the median voter’s pretax income.
 - (Note that $v(G,t)$ is implicitly a "reaction" function that describes how job opportunities or wage rates are affected by government policies and how her family income is then affected by the leisure-labor choice made.)
 - vi. The median voter's after tax income is:
 - $V = (1-t)v(G,t)$ which given the balanced budget constraint is
 - $V = (1-c/Ny) v(G,t)$ or
 - $V = v(G,t) - (c/N) (v/y)$
 - vii. Differentiating yields:

- $v_G - c_G/N (v/y) - (c)[v_G/y - vy_G/y^2] = 0$

- and $v_t - (c/N) [v_t/y - vy_t/y^2] = 0$

viii. An interesting **special case** of the median voter model is that where the median voter's income is the same as average income: $v=y$.

a. In that case, $V = v(G,t) - (c(G)/N)$.

b. If the median voter maximizes her own income, the median voter sets G such that $Ny_G = c_G$

- This sets G^* to **maximize** national income

- Note that the result is better than that of leviathan above.

c. Selecting the t that **minimizes** tax burden of providing G^* requires that $v_t = (c/N)$ with $t^*Ny = c(G^*)$

ix. This is one case where democracy will have broad appeal.

E. The general sense that we in the West have that democracies are superior to dictatorships should be apparent in policies.

- i. One can observe, for example, that the Western democracies have been wealthier places than anywhere else for the past century or two.

- ii. Thus, in spite of all of their flaws, Western liberal constitutional designs must be doing something right--they must be inducing policies that advance the interest of most persons living in those countries.

XI. More Sophisticated Constitutional Designs: Institutions for Constraining a Leviathan: Beyond Hobbes

A. It is possible that a group of individuals would agree to use a dictatorial (one man rule) collective decision making procedure--especially in times of war (supreme commander) or on occasions when that person could be removed from “office” very easily (as with a CEO or town manager). Hobbes suggests this solution as an escape from the endless war that he believes would otherwise be associated with anarchy.

B. On the other hand, if a group decides to use one man decision making for ordinary collective decision making, it is clear that they would prefer that the ruler abide by a variety of constraints, as noted by Buchanan (1975) and Buchanan and Brennan (1977). For example:

- i. Some method of aligning the interests of the ruler and the ruled might be adopted. (Elections)
 - ii. There might be guarantees of property rights and due protection. (Rule of Law)
 - iii. The domain of policy might be constrained. (Civil and Political Rights)
 - iv. Only tax instruments with a relatively high deadweight loss might be permitted, or veto power over such policies may be retained. (Referenda)
 - v. Alternatively, the authority to make public policy may be divided between a king and a council or parliament. (This was true of most early constitutional monarchies in medieval Europe and east Asia.)
 - vi. The king and council is a very widely used template for governance and one that allows governmental authority to be distributed in a number of ways: from authoritarian regimes in which the king dominates policy formation to parliamentary regimes in which the council dominates.
- C. Many of the features of modern states with elected governments can be thought of as the result of constitutional bargaining and bargains reached over the centuries.
- i. Constitutional law and constitutional theory, however, is far older than contemporary constitutions.
 - ii. Settle agriculture began more than ten thousand years ago.
 - iii. Simple written descriptions of government emerged shortly after writing, as with the prologue to the legal code of the Hammurabi (1750 bce).
 - Many of the Classical Greek city states often had formal constitutions.
 - Aristotle's the *Politics* (330 BCE) began the academic analysis of constitutions. It includes a broad overview of the relative merits of those constitutions.
 - iv. European constitutionalism arguably emerged in the sixteenth and seventeenth centuries, as with the Dutch Republic and Cromwell's constitution following the English civil War.
 - v. The oldest written constitution in force is presently the US constitution which is just over 200 years old.
- D. The Constitutional designers of the United States created a very new form of large scale government, based on elections, rights, the separation of powers and federalism.
- i. In less revolutionary states, such as England, Sweden, Norway, Denmark, and so forth, their contemporary constitutions emerged gradually through constitutional bargaining and reform in the nineteenth and early twentieth centuries.
 - ii. Nearly all contemporary governments have written constitutions.
- ## XII. Institutional Designs and Corruption: Competitive Process, and Competitive Waste
- A. The analysis of rent-seeking losses undertaken in the previous lecture block should make it clear that the main losses of rent seeking activities arise for three reasons:
- The **process used to influence policy is costly**. The resources invested in the contest have an opportunity cost. (They could have been used to produce new goods and services, rather than to reduce net benefits or redistribute existing resources.)
- There is an externality among players**, in that as each player increases his or her investment the expected net prize (returns) diminish for other players.
- ▶ It is the competitive nature of the contest that produces both the investments and the rent-seeking costs.
- The **assumed rent seeking activities do not themselves create value** in excess of their opportunity cost
- ▶ Normally, spillover effects on those outside the contest are ignored except in applied research.
 - ▶ In principle, however, such contests can have positive or negative externalities, as noted above.
- i. Much of the rent-seeking literature stresses the redistributive consequences of such political games.

The rent-seeking literature suggests that the efforts of interest groups may not only produce inefficient public policies, but wastes resources doing so.

It also possible, as noted above, that lobbying (rent-seeking) may also improve public policies, as for example when barriers to trade are reduced or eliminated, infrastructure is improved, etc.

Costly forms of competition in markets are not necessarily “efficient” and have to be analyzed on a case by case basis. Resources may be “over invested” in R&D for example.)

- ▶ Price competition in markets, however, is essentially costless and produces external benefits for consumers.
 - ▶ So, “rent-seeking” in markets may increase rather than reduce social net benefits.
 - ▶ (Buchanan 1980, for example, distinguishes between profit-seeking and rent-seeking activities.)
- ii. The extent of the dead weight losses from rent seeking are determined by the rules of the rent seeking game.

B. The rules of rent-seeking contests can be interpreted as institutions.

- i. For example, the distributional rules, the process of making decisions about who will receive the prize can all be considered to be political institutions in the usual context of a rent-seeking contest (e.g. lobbying or elections).
- ii. These institutions substantially determine the rates of return from alternative forms of influence.
- ▶ Institutions, thereby, *implicitly* determine the type of activities that must be undertaken by potential rent seekers, and the extent to which persons are free to compete in a particular contest.
 - ▶ The rules of the game thereby encourage the use of particular rent-seeking techniques.
 - ▶ These may, in some cases, induce forms of competition that benefit third parties outside of the contest. (Awarding the king's daughter to the Knight that wins an entertaining tournament.)

iii. The rules also determine who is eligible to participate in a given rent-seeking contest.

- ▶ In many cases, the extent of dissipation will increase as the number of competitors increases.
- ▶ Eligibility, also tends to determine who can win contests. Such rules can, for example, protect elite claims to the fruits of government regulations and positions.

C. Some of the main results from the theoretical literature are:

- i. Losses from games where the rents are shared are below those in games where the rents all go to a single victorious group or individual (Congleton 1980, Long and Vousen 1987).
- ▶ Stochastic payoffs have similar effects, as in the usual lottery representation of rent-seeking contests.
- ii. The losses from rent-seeking games tend to be smaller in cases in which majority rule is used to determine winners (Congleton 1980, 1984).
- iii. The logic of rent-seeking contests applies to nongovernmental settings as well as governmental ones.
- ▶ See various works by Robert Frank, including his book on positional games and winner take all games. See also Congleton (1989) and Glazer and Konrad (1996).
 - ▶ Bhagwati (1982) tried to rename such activities: Directly UnProductive Efforts: DUPE.
 - ▶ (Indeed, one can argue that much of modern contest theory consists of extensions of various rent-seeking models.)
- iv. Note that a good deal of market competition can also be regarded as a contest for rents (e.g. profits) in which the rules of the game are such that the efforts of competing firms tend to benefit consumers.
- ▶ Thus, the resource intensive parts of competitive markets that are largely neglected in mainstream neoclassical models (which tend to focus narrowly on price competition) may be examples of contests that dissipate profits for firms, but which produce considerable external benefits for consumers.

- ▶ Similar claims might be made regarding the academic competition--insofar as it adds (at least occasionally) useful information and knowledge to society's stockpile.
- D. Congleton and Lee (2009) note that rent-seeking contests can be constructed for the purposes of raising state revenue (or elite government official income). Insofar as the problems noted by Hillman and Katz (1987) are avoided, the rent-seeking contests adopted will take account of their burden on society and effects on rates of innovation.
- ▶ Well informed rent-extracting governments that are able to overcome problems of corruption will construct rent-seeking contests that produce revenue similar to what would be obtained from an efficient Ramsay tax system
 - ▶ (Rates will be set somewhat higher than optimal for growth in cases in which elites can take some of the revenue for personal income.)
 - ▶ (The Congleton and Lee model of government is an extended form of the Olson-Buchanan&Brennan's Leviathan model.)

XIII. Agency Problems: the Problem of Bureaucracy

- A. Many of the problems associated with interest group occur because bureaucrats are not perfect agents of the government, whether an authoritarian regime or a democracy.
- i. Analysis of these agency problems have a long history in public choice analysis, beginning with Niskanen's (1971) simple budget maximizing model of a bureaucrat.
 - Note that this model was developed a decade before the agency problem literature emerged in microeconomics. (Jensen and Meckling (1979), Fama 1980).
 - ii. Issues associated with Niskanen's model are also present in other private organizations as well, although they are arguably more difficult to solve in governments than in private firms and also arguably have greater effects on social net benefits or aggregate utility.

- iii. Niskanen's model, for example, implies that government bureaus all tend to be too large, because of bureaucratic efforts to maximize their individual budgets.
- B. In addition, bureaucratic decisions may be influenced by rent seekers and may themselves be rent seekers with respect to government.
- C. An important issue is the extent to which governments can properly align the interests of bureaucrats with those of the government, whether autocratic or democratic.
- i. It is in this area that the study of political agency problems becomes part of Constitutional Political Economy.
 - ii. Partial solutions often involve standing procedures for recruiting and paying individual bureaucrats.
 - iii. Other solutions involve the manner in which bureaucratic decisions are made and constraints on the extent to which such processes determine laws or regulations. Such procedures and constraints are also institutional and so constitutional in the sense used here.
 - iv. Rules on corruption and gift giving and receiving also tend to limit the effects of rent seeking and corruption on public policy--although it does not completely eliminate such problems.

XIV. Beyond the Theoretical Basics: Evidence of the Effects of Institutions on Economic Development

- A. During the late 1990s, the focus of constitutional political economy research tended to shift from theory to empirical research. This is not to say that theoretical and conceptual research did not continue (as with Buchanan and Congleton 1998), but the most cited work started to be empirical rather than theoretical. The focus of attention also shifted from Western democracies with stable constitutions to developing countries where constitutional experimentation was more commonplace. The latter facilitated the econometric tests of the effects of constitution--albeit when constitutions shift relatively frequently the decision procedures of governments tend to be more "ad hoc" and less constitutional

- B. In this concluding section of CPE, a series of very short overviews of a series of influential empirical papers is provided.
- C. Tullock and Grier (1989, JME) "We find that coefficient values vary widely across identifiable groups of countries, with evidence supporting the convergence hypothesis apparent only in the OECD country sample. Among other results, we find that the growth of government consumption is significantly negatively correlated with the economic growth in three of four subsamples, including the OECD, and that political repression is negatively correlated with growth in Africa and Central and South America."
- D. Congleton (1992, REStat) "This paper models the selection of environmental policies under authoritarian and democratic regimes, and tests the hypothesis that political institutions systematically affect the enactment of environmental regulations. The results support the contention that political institutional arrangements, rather than resource endowments, largely determine policies concerning environmental regulation."
- E. Olson (1993, APSR) "Under anarchy, uncoordinated competitive theft by "roving bandits" destroys the incentive to invest and produce, leaving little for either the population or the bandits. Both can be better off if a bandit sets himself up as a dictator—a "stationary bandit" who monopolizes and rationalizes theft in the form of taxes. A secure autocrat has an encompassing interest in his domain that leads him to provide a peaceful order and other public goods that increase productivity. Whenever an autocrat expects a brief tenure, it pays him to confiscate those assets whose tax yield over his tenure is less than their total value. This incentive plus the inherent uncertainty of succession in dictatorships imply that autocracies will rarely have good economic performance for more than a generation. The conditions necessary for a lasting democracy are the same necessary for the security of property and contract rights that generates economic growth."
- F. Knack and Keefer (1995, Ec&Pol) "The impact of property rights on economic growth is examined using indicators provided by country risk evaluators to potential foreign investors. Indicators include evaluations of contract enforceability and risk of expropriation. Using these variables, property rights are found to have a greater impact on investment and growth than has previously been found for proxies such as the Gastil indices of liberties, and frequencies of revolutions, coups and political assassinations. Rates of convergence to U.S.-level incomes increase notably when these property rights variables are included in growth regressions. These results are robust to the inclusion of measures of factor accumulation and of economic policy."
- G. Persson and Tabellini (2003) / Replication and Extension by Blume et al (2009, PC) "Persson and Tabellini (The Economic Effects of Constitutions, The MIT Press, Cambridge, 2003) show that presidential regimes and majoritarian election systems have important economic effects. Here, the number of countries is expanded and more recent data is used. In replicating and extending their analyses, we find that the effect of presidential regimes vanishes almost entirely. With regard to electoral systems, the original results are largely confirmed: majoritarian (as opposed to proportional) electoral systems lead to lower government expenditure, lower levels of rent seeking but also lower output per worker. The institutional details, such as the proportion of candidates that are not elected on party lists and district size, are particularly important."
- H. Rodrik et al (2004, J of Ec Growth) "We estimate the respective contributions of institutions, geography, and trade in determining income levels around the world, using recently developed instrumental variables for institutions and trade. Our results indicate that the quality of institutions "trumps" everything else. Once institutions are controlled for, conventional measures of geography have at best weak direct effects on incomes, although they have a strong indirect effect by influencing the quality of institutions. Similarly, once institutions are controlled for, trade is almost always insignificant, and often enters the income equation with the "wrong" (i.e., negative) sign. We relate our results to recent literature, and where differences exist, trace their origins to choices on samples, specification, and instrumentation."
- I. Doucouliagos and Ulubasoglu (2008, AJPS) "Despite a sizeable theoretical and empirical literature, no firm conclusions have been drawn regarding the impact of political democracy on economic growth. This article challenges the consensus of an inconclusive

relationship through a quantitative assessment of the democracy-growth literature. It applies meta-regression analysis to the population of 483 estimates derived from 84 studies on democracy and growth. Using traditional meta-analysis estimators, the bootstrap, and Fixed and Random Effects meta-regression models, it derives several robust conclusions. Taking all the available published evidence together, it concludes that democracy does not have a direct impact on economic growth. However, democracy has robust, significant, and positive indirect effects through higher human capital, lower inflation, lower political instability, and higher levels of economic freedom. Democracies may also be associated with larger governments and less free international trade. There also appear to be country- and region-specific democracy-growth effects. Overall, democracy's net effect on the economy does not seem to be detrimental."

XV. Other Policy Relevant differences between dictators and democracies

- A. Differences in the types of interest groups:
 - i. Dictatorships tend to suppress groups that lobby for large scale political reforms including those that reduce rates of extraction. They are more open to groups that lobby for economic privileges (e.g. rent seeking).
- B. Democracies on the other hand have interest groups that do both. Public interest groups may discourage the creation of special privileges and thereby reduce losses from rent seeking and corruption of both the Harberger and Tullock variety.
 - i. To the extent that democracies have less rent seeking than dictatorships (because of more anti-corruption regulations etc), they will tend to be relatively wealthier. (Aidt 2009)
- C. Differences in the prevailing ideology
 - i. Dictatorships often promote ideologies that provide rationalizations for their hold on power. Examples include the divine right of kings, the theories of "centralized democracy" used in communist regimes, and hierarchical theories of human nature and ability.

- ii. Democracies in contrast often are based on ideologies that may be called "liberal" in the 19th century sense of the word. They tend to support open competitive systems of economics and politics. To the extent that open competitive economies tend to be more productive than ones based on crony capitalism, such democracies will end to be more prosperous than the typical dictatorship.
 - iii. Levels of trust may differ significantly between the two regime types, in part because laws are less arbitrary and more aligned with general interests in democracies than in dictatorship. Trust (and trustworthiness) tends to reduce transactions costs in markets and also with respect to politics and public policies. For example, there tends to be less cheating on taxes (higher tax morale) in countries where the revenues generated are thought likely to be spent to advance shared interests (Feld and Frey 2002).
- D. However, what matters most for differences in their economic development is the policies chosen and the manner in which they are enforced rather than the type of government. Only to the extent that democracies adopt systematically "better" policies would we expect to see systematic differences in income and growth. There are many studies that show this effect, and so there is some evidence that the typical median voter (thanks to the Condorcet Jury theorem and some of the factors mentioned above) chooses better policies than even a very talented dictator. (See for example Doucouliagos and Ulubasoglu (2006, 2008).

XVI. Appendix: On the Practical Necessity of CPE

- A. In principle, every time a group of individuals undertakes a joint enterprise of some kind: choose a restaurant, play a game, create a firm, lobby for a particular public policy, found a state, they engage in public choice, or collective decision making. Every *group* requires some formal or informal method of making decisions.
 - i. In small groups, the decision rule may be a matter of unanimous agreement. A dinner party may hunt for a consensus restaurant which all might consider "acceptable."

- a. In some cases, as where one person of the dinner party is considered and expert, the collective decision made be made by one person, a “dictator.”
 - b. In larger groups, decisions may be made by casting and counting votes. A restaurant could be chosen by majority rule.
 - c. In still larger groups, or regarding more complex decisions, the groups may create a formal institution for making collective decisions, as a firm makes a variety of decisions that affects all with “rights” to the company’s output.
 - ii. To the extent that the decision making method is a formal and durable procedure for making group decisions, it may be regarded as grounded on a *constitution*.
 - iii. Within economics, most firms are not dictatorships of a single entrepreneur but often complex organizations in which a wide range of collective choices are made, some of which but not all are vote driven as with votes of shareholders and decisions by boards of directors and other committees within the organization.
 - iv. Even markets may be regarded as a possible procedure for making group decisions regarding the allocation of resources, the prices paid for goods and services, and the right to transfer ownership rights via production and sale.
- B. To the extent that procedures for making collective decisions remain in place, they may be regarded as "constitutional" in nature. That as to say, the procedures for making policy choices can be regarded as the **Rules of the Game**, or when applied to governance as the **Rules for Making (lower level) Rules**.
- i. Durable procedures for making decisions do not have to be written down to satisfy this condition.
 - a. It is sufficient that the basic pattern of "rule making" or "collective choice" is itself determined by rules that remain unchanged during day-to-day collective decision making.
 - b. A constitution, written or unwritten, that was not durable would not be a constitution in this sense of “the rules of the game.”
 - ii. Constitutions affect collective decisions (e.g. public policies) by affecting the kinds of political equilibria that tend to emerge in a given society.
- C. “Constitutional” choices are commonplace for small organizations and that constitutional reforms are fairly common within larger ones.
- i. Every time a group agrees to a durable group decision process, a constitution has been chosen.
 - ii. Every time a core procedure for making public policies is modified, a constitutional reform takes place. Political constitutions are chosen far less frequently than they are reformed. (Indeed, reforms are more common than most constitutional histories suggest.)