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A TRANSACTION COST THEORY OF POLITICS

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ABSTRACT

This essay first specifies and describes the behavioral and information cost assumptions that underlie instrumental rationality and the consequent a-institutional world of neoclassical theory and contrasts these assumptions to those that underpin a theory of institutions and transaction costs. It then explores the characteristics of political markets, characterizing the costs of transacting in political markets and the role of ideology in shaping political choices. Finally, it explores the implications of a transaction cost framework for the performance of polities and economies over time.

KEY WORDS • institutions • instrumental rationality • path dependence • transaction costs

Rational choice models in politics have applied the basic assumptions of neoclassical economic theory to politics. Those assumptions include instrumental rationality and the notion (usually implicit) of efficient markets.[1] I believe that the uncritical acceptance of both of these assumptions has led political theory astray. A transaction cost theory of politics is built on the assumptions of costly information, of subjective models on the part of the actors to explain their environment, and of imperfect enforcement of agreements. Choices employing such models result in high political transaction costs that make political markets very imperfect. I believe that modifying the standard rational choice model by incorporating into it transaction cost theory can substantially increase the explanatory power of the model and make more sense out of the political markets we observe.

In this essay I first specify and describe the behavioral and information cost assumptions that underlie instrumental rationality and the consequent a-institutional world of neoclassical theory, and contrast those assumptions with those that underpin a theory of institutions and transaction costs. I then explore the characteristics of political markets. I can then characterize the costs of transacting in political markets and the role of ideology in shaping political choices. Finally, I explore the implications of a trans-

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1. For a recent explicit argument that makes this claim see Wittman (1989).

action cost framework for the performance of polities and economies over time.

I

Instrumental rationality means that the actors either have correct models by which to interpret the world around them or receive information feedback that will lead them to revise and correct their initially incorrect theories. Actors and their organizations that fail to arrive at correct theories will perish in the competitive markets that characterize societies. Herbert Simon has accurately summarized the implications of instrumental rationality as follows:

> If we accept values as given and constant, if we postulate an objective description of the world as it really is, and if we assume that the decisionmaker's computational powers are unlimited, then two important consequences follow. First we do not need to distinguish between the real world and the decisionmaker's perception of it: he or she perceives the world as it really is. Second we can predict the choices that will be made by a rational decisionmaker entirely from our knowledge of the real world and without a knowledge of the decisionmaker's perceptions or mode of calculation (we do, of course, have to know his or her utility function) (Simon, 1986: S210).

The best characterization of the instrumental rationality approach applied to politics is Becker's model of political competition (1983). The model strips the decision-making process of explicit actors and institutions (voters, legislators, legislatures, decision rules) but not of transaction costs (since both free riding and deadweight losses are included in the model). The game is one of income redistribution in which subsidies to one group are matched by taxes paid by other groups but, since there are deadweight costs, the taxes rise more rapidly than the subsidies. In consequence redistribution will be limited since the costs to the taxed will rise more rapidly than the benefits to the subsidized. The beauty of Becker's model is that it brings into stark relief the assumptions driving the results (as do, indeed, all good neoclassical models). The two key assumptions driving the results are that the players (in this instance those that are taxed) can identify accurately the source of their income loss (those that are subsidized) and that they have equal access to the decision-making process.

Certainly the unambiguous identification of the source of taxation is easy in Becker's model since all that is going on is a redistribution game. And, to the extent that political policies are of this type the taxed may indeed be aware of who is responsible for their income loss. Since transfer payments are responsible for a major share of the growth of modern government this model focuses on an important type of legislation in which there is relatively low cost information about incidence.

But political markets are about much more than explicit redistribution. They are about the underlying rules that are the incentive structure of

an economy – property rights, contracting, and credible commitment. Understanding what is going on involves much more than information. It involves having theories to explain the consequences of policies that create or alter property rights, define international relations, determine price and employment fluctuations, and so forth. These political markets are characterized by imperfect information, subjective models, and high transaction costs. Moreover even in the case of transfer payments, the most clear-cut case for Becker's model, there are significant transaction costs, the affected parties are ill-informed, and it is not correct that all the affected parties have equal access to the decision-making process as Becker himself recognized in a subsequent essay (Becker, 1989). And, transfer payments aside, unabashed redistribution is rare precisely because of its transparency. Farm price support bills in the US polity that simply paid the farmer not to produce never succeeded for just the reason that they were too transparent. And most legislation is not of this type. In most legislation redistribution is either concealed or a by-product of other objectives. In either case not even the bill's author may know all the consequences; much less the constituents.

From the American colonists who thought that the policies of the British after 1763 were destroying the colonial economy, to the late nineteenth-century farmers who thought that farm distress was a result of railroads, grain elevators, monopolists and bankers, to the modern American sugar consumer who has the vaguest idea of the web of controls that determine the price of sugar and sugar substitutes (Krueger, 1988) the political market has been, and continues to be, one in which the actors have an imperfect understanding of the issues affecting them and equally in which the high costs of transacting prevent the achievement of efficient solutions.

What is missing in each of the above illustrations is an accurate understanding of the consequence of policies that is a *true* theory of the issues. In hindsight we know British policies were not ruining the colonies (indeed Canada did very well staying within the British system); that the farmer's distress would not have been significantly alleviated by the populist policies advocated by the farmer; and that the byzantine history of sugar controls has never been understood by either the US consumer, who has frequently paid more than twice the world price for sugar, or by the principal actors, who have frequently not completely comprehended the consequences of their own policies (in this instance the development and relative price of sugar substitutes).

The political market for sugar highlights the two key issues that are ignored in rational choice theory; imperfect models that guide our actions and high transaction costs that do not even vaguely lead in the direction of more efficient markets. Krueger's study of the political economy of sugar raises two questions.'First, how well did the representatives of the various interests . . . know their interests? Second was the collective outcome rational, in the sense that policies could have been devised that

rendered all concerned better off?' (1988: 38). Her detailed answer lists endless errors by the supposedly knowledgeable, interested and influential parties. Not only did the parties pursue mistaken policies; they also failed to undertake policies that would have clearly made them better off. And as for policies that would have led to Pareto-improving solutions, there is little indication of any movement in that direction. Instead each successive incremental alteration in policy produced new interest group pressures that inexorably led to further byzantine policies. Krueger concludes:

> First, when it was originally formulated in 1934, and then when it was reinstated in 1948, the intentions of its advocates bore little resemblance to the purposes to which it was put twenty or thirty years later. Second, it seems highly unlikely that the electorate would support a program that provided payments of over $136,000 per farm were that figure highly publicized. Third, at least some of the supporters of the sugar program over the years – importers and refiners of raw sugar and the beet mill owners who went bankrupt at the very least – would not have been so enthusiastic had they known the outcome (1988: 54).

The two underlying sources of the byzantine sugar market policies are that the actors do not understand completely the consequences of their actions and that the particular institutions of the political market raised transaction costs that make efficient solutions impossible. In this section we have looked at the first issue – instrumental rationality. I now turn to the second issue, the costs of transacting in political markets, and then put the two together to explore the overall characteristics of political systems.

II

The most efficient political market extant is the legislature in a political democracy – in this case the US Congress. In order to understand the characteristics of this market it is essential to examine the institutional matrix that determines the transaction costs in it. In a modern representative democracy, the institutional structure is devised to facilitate (given relative bargaining strengths) the exchange between interest groups.[2] This

2. The development of political theory in the last 25 years has drawn from economic theory. The developments began in an a-institutional setting, in which the model was one that paralleled the a-institutional model of economics. But the result, in terms of the formal theory, was that no stable equilibrium would evolve and that *cycling* would be a continuous pattern of political systems (at least in two party, nonideological models). However, this formal finding was at odds with empirical and descriptive studies that provided no evidence of such dis-equilibrating characteristics, and it remained to take a further step in political theory to explore the nature of the institutional structure that provided for the evolution of equilibrium states in the political system. For a description of this evolution and a model of structure-induced equilibrium, see Shepsle (1986). However, while the new political economy has introduced institutions into the analysis, its practitioners have frequently (albeit implicitly) maintained the instrumental rationality assumption. There are no institutions in neoclassical economic theory because the instrumental rationality postulate renders them superfluous. Once one introduces institutions into the model a necessary corollary is a recognition that instrumental rationality is not the correct behavioral assumption.

political structure reflects concentrations of voters with specific interests in particular locations. Thus in the United States polity, there are elderly in Florida and Arizona, miners in Pennsylvania and West Virginia, artichoke growers in California, automobile manufacturers in Michigan, etc. Because there are multiple interest groups and these interest groups are reflected by legislators who have a concentration of only a few interest groups in their districts, no particular interest group that a legislator may represent can form a majority. Therefore, legislators cannot succeed acting alone, but must make agreements with other legislators, with different interests.

What kind of institutions will evolve from such exchange relationships between legislators reflecting multiple interest groups? Previous work, beginning with Buchanan and Tullock (1962), focused on *vote-trading* or log-rolling. While a step forward in recognizing the way by which legislators can strike bargains that facilitate exchange, such an approach is too simple to solve fundamental problems involved in legislative exchange. It assumes that all bills and payoffs are known in advance, and it has a timeless dimension to it. But in fact a variety of exchanges arise in which today's legislation can only be enacted by commitments made for a future date. In order to lower the costs of exchange, it was necessary to devise a set of institutional arrangements that would allow for exchange over space and time. Note the parallels with economic exchange. In each case the problem is to measure and enforce the exchange of rights.

How does credible commitment evolve to enable agreements to be reached when the payoffs are in the future and on completely different issues? Self-enforcement is important in such exchange and in repeat dealings a reputation is a valuable asset. But as in economic exchange, the costs of measurement and enforcement, discovering who is cheating whom, when free-riding will occur, and who should bear the cost of punishing *defectors* make self-enforcement ineffective in many situations. Hence political institutions constitute *ex ante* agreements about co-operation among politicians. They reduce uncertainty by creating a stable structure of exchange. The result is a complicated system of committee structure, consisting of both formal rules and informal methods of organization. Its evolution in the American Congress is described in a study of the structure by Barry Weingast and William Marshall entitled 'The Industrial Organization of Congress' (1988). In the conclusion of their essay, Weingast and Marshall specify the kind of structure that evolved.

> Instead of trading votes, legislators exchanged special rights affording the holder of these rights additional influence over well-defined policy jurisdictions. This influence stems from the property rights established over the agenda mechanisms, that is the means by which alternatives arise for votes. The extra influence over particular policies institutionalizes a specific pattern of trades. When the holders of seats on committees are precisely those individuals who had bid for votes on these issues in a market for votes, policy choice under the committee system parallels that under a more explicit exchange system. Because the exchange is institutionalized, it need not be renego-

tiated each new legislative session, and it is subject to fewer enforcement problems (1988: 157).

The foregoing description illustrates the way a set of institutions facilitate political exchange. The US Congress has relatively low cost transacting (and therefore is relatively efficient) as a result of an elaborate institutional structure that facilitates exchanges over time and makes possible credible commitment. But while the institutional structure has enabled a small legislative body to have relatively low cost exchange this consequence does not mean that the overall political market is efficient; only that the institutional framework of the legislature facilitates low cost exchange. The efficiency of the overall political market is measured by how well the market approximates a zero transaction cost result.

An efficient political market would be one in which constituents could accurately evaluate the policies pursued by competing candidates in terms of the net effect upon their well-being; only legislation (or regulation) that maximized the aggregate income of the affected parties to the exchange would be enacted; and compensation to those adversely affected would insure that no party was injured by the action.

To achieve such results constituents and legislators would need to possess true models that allowed them to accurately evaluate the gains and losses of alternative policies, legislators would have to vote in the constituents' interests – that is the vote of each legislator would be weighted by the net gains or losses of the constituents, and losers would be compensated such as to make the exchange worthwhile to them – all at a transaction cost that still resulted in the highest net aggregate gain.

It is possible that the intermediate steps by the legislator – voting what he/she perceives as in the constituents' interest and having the vote crudely weighted by the perceived net gain or loss to the constituents – are sometimes approximated by the complex legislative structure described above. But look at the rest of the requirements for efficient political markets.

1. How does the constituent know his/her interests? What will the competing candidates really do? Not even the candidates know the variety of issues they will be called upon to legislate which will directly and indirectly affect the constituents' welfare. And even if they did they would have to know the effect on constituents' welfare – easy, perhaps, in the cases of obvious redistribution or bills directly influencing income and employment in a district, but simply unknowable for a large proportion of the bills. And as for the constituents, they would have to know the consequences of the multitude of bills enacted by the representative and the effect on the individual's pocket book.

2. How closely does the institutional structure of the legislature approximate the zero transaction cost model? I have asserted above that the legislative body is characterized by low cost transacting. This assertion is true, as compared to a totalitarian polity; but the cost is far from the zero

transaction cost model, as the substantial literature of the new political economy dealing with strategic voting (for example, Denzau et al., 1985) and pork barrel legislation will attest. The fact of the matter is that the institutions of representative government create a mixed set of incentive signals which make possible low-cost exchange among legislators but also provide the incentives for strategic voting and pork barrel legislation.

3. How close are intentions to outcomes? The models that guide the legislators are one source of error. Legislators simply do not possess the information of the theoretical models to achieve the desired outcomes, as I have discussed above. But there is more to the issue than that. The legislation is enacted and implemented by an agent whose own utility function is going to directly affect the actual results. The endless studies made of the carrying out and enforcement of legislation make clear the wide discrepancy between formal enactment and actual outcomes. Airline deregulation in the United States, for example, illustrates the unanticipated outcome of policies reflecting both the imperfect models in the minds of the legislators and the fact that implementation is in the hands of agents. The Department of Transportation's approval of mergers of airlines, for example, wiped out a good deal of competition created by deregulation and led to results at variance with intentions (Morrison and Winston, 1989). The department policy was formulated on the basis of the theory of contestable markets developed by economists and was clearly erroneous in its application to airline mergers.[3]

Imperfect models of the complex environment that the politician (and constituent) is attempting to order, the institutional inability to get credible commitment between principal and agent (voter and legislator; legislator and implementors of policies), the high cost of information, and the low payoff to the individual constituent of acquiring information all conspire to make political markets inherently very imperfect.

Surely this conclusion should not be surprising if we would take off the blinders imposed by our theoretical preconceptions. After all the basic separation between polity and economy has always, even amongst the most confirmed libertarians, left a residual of activities to be undertaken by government because of the inherent difficulty that arose from the public good attributes, free riding and costly information of certain types of activity. We do not expect a random sample of issues to become *public*. Those that can be readily handled by individual or small group bargaining don't need to be placed on the public agenda. What remains for the public agenda are those with the attributes described above or those in which

3. 'Charles Rule, a top official in the Antitrust Division of the Justice Department in 1986 explained in an interview where the Department of Transportation reasoning had gone wrong. The problem Rule said, lay in the Transportation Department's religious adherence to the "economic theory of contestable markets" – the economic theory that underlies deregulation' (*St Louis Post Dispatch*, 27 March 1990).

some groups do not like the market outcome and have enhanced bargaining power in the polity to achieve their objectives. Necessarily bargaining strength and the incidence of transaction costs are not the same in the polity as in the economy, otherwise, it would not be worthwhile for groups to shift the issues to the political arena. Thus the selection process is one in which the high transaction cost issues gravitate to the polity. Now it is true that in the past three centuries we have evolved political and economic institutions to reduce some of the imperfections described in the preceding paragraph (see, for example, North and Weingast, 1989). But it is the contention of this essay that we would get much farther in modeling political markets if we would build our models on a transaction cost framework. Where would that lead?

III

Transaction costs are the costs of measuring and enforcing agreements. In economies, what are measured are the valuable attributes of goods and services or the performance of agents; enforcement consists of the costs associated with realizing the terms of exchange. Measurement consists of the physical and property right dimensions to goods and services and the performance characteristics of agents. While measurement can frequently be costly, the physical dimensions have objective characteristics (size, weight, color, etc.) and the property rights dimensions are defined in legal terms. Competition plays a critical role in reducing enforcement costs. The judicial system provides coercive enforcement. Even so economic markets throughout history and in the present world are frequently very imperfect, beset by high transaction costs and defined by institutions that produce incentives that work against economic efficiency. Indeed, creating institutions that provide low costs of transacting in economic markets is the key issue to creating productive economies.

Political markets are far more prone to inefficiency. The reason is straightforward. It is extraordinarily difficult to measure what is being exchanged in political markets and in consequence to enforce agreements. What is being exchanged are promises for votes. The observable dimensions of the promises are agreements between constituents and their representatives (in a democracy), between the representatives, between representatives and the executive, etc. The agreements result in legislative enactments, regulations, executive decrees, etc. that presumably embody the interests of the principals. How does one measure the coincidence of the promises with subsequent enactments? This coincidence can be relatively unambiguously defined within the institutional structure of legislatures as described above. But as between constituents and legislators and legislators and agents enacting the policies, the measurement and enforcement costs are beset by difficulties. The powerful role played by

competition in the economic market place is far less effective in this case. The weapon of the consituent is periodic elections at which the representative can be held accountable and the opposition candidate has the incentive to promulgate his/her deficiencies. But, as noted above, even the elaborate institutional framework of political democracy makes that a very dull instrument.

We begin our modeling of political markets with the relationship between constituent and legislator. For a variety of simple, easy-to-measure, and important-to-constituent-well-being policies, something like the rational choice model of the new political economy has explanatory value. Transfer payments fit this criterion very well. They require simple information that has the attribute of low cost measurement. But beyond these straightforward bills, ideological stereotyping takes over.

Ideologies underlie the subjective model that individuals possess to explain the world around them. They possess an essential normative element. That is ideologies explain both the way the world is and the way it ought to be. While the subjective models may be, and usually are, a hodge-podge of beliefs, myths, *sound* theories and dogmas they usually have elements of an organized structure that make the models an economizing device for receiving and interpreting information. The organized structure *plays* upon the normative element in individual preferences to rally supporters in favor of common causes. Legislative candidates sell themselves to constituents on the basis both of the individual issues important to candidates and ideological frameworks that appeal to these normative preferences. The most obvious organized stereotypes in democratic societies are liberal or conservative stereotypes although in many Third World countries other stereotypes – usually with important religious symbolism – frequently prevail. But everywhere the organized stereotypes are designed to appeal to constituent preferences and prejudices.

The relationship between the interests of constituents and the stereotyped ideologies that influence their choice of representatives only tenuously, even at the abstract level, portray the extent to which such stereotypes in fact do produce outcomes which favor the interests of those consituents. In terms of the actual policies that the representative votes for and the way they are implemented, the results can bear little resemblance to any modeling of an efficient political market.

While it is clear that organized stereotype ideologies can be, and frequently are, cynical devices by which legislative candidates try to attract votes, the legislators equally possess their own subjective models (frequently the same organized stereotype ideologies as many of their constituents) and act upon them (Kalt and Zuppan, 1984). The lengthy, inconclusive debate about whether or not legislators vote their constituent interests assumes they both know what those interests are.

A transaction cost framework to politics would build on two ingredients missing or slighted in rational choice models: the subjective models of

the actors and the transaction costs that arise from the specific political institutions that underlie political exchange in different polities. The first ingredient influences the second. That is, if the actors had *true* models there would still be transaction costs, but they would be very different and much lower than were the subjective model imperfect. In addition different institutional frameworks will result in different costs of political exchange. Political scientists have focused on exchange in democratic polities and this essay has attempted to demonstrate how imperfect even those political markets are. But it is political markets in non-democratic polities that urgently need such transaction cost analysis. The far greater imperfections of such markets in communist and Third World countries are the root cause of their poor economic performance since it is polities which devise and enforce the property rights that are the incentive structure of economies.

IV

But if imperfect models are to explain the environment and high transaction costs are to characterize political markets, just what shapes the evolution of polities? The answer is that the institutional framework of a polity (and economy) is characterized by increasing returns so that incremental change is heavily weighted in favor of policies consistent with the basic institutional framework. This path-dependent argument requires elaboration.[4]

The institutional framework is a composite of rules, informal constraints (norms of behavior and conventions) and their enforcement characteristics. Together they define the humanly devised constraints that shape human interaction. They are the rules of the game and therefore define the way the game is played. The consequent organizations that arise will reflect the opportunities available in that institutional setting. That is the institutional constraints together with the traditional constraints (income, technology) define the potential wealth maximizing opportunities of entrepreneurs (political or economic) of organizations. If the constraints result in the highest payoffs in the polity/economy being criminal activity, or the payoff to the firm is highest from sabotaging or burning down a competitor, or to a regulatory agency from granting monopoly franchises, then we can expect that the organization will be shaped to maximize at those margins. On the other hand if the payoffs come from productivity enhancing activities, then economic growth will result. In either case the entrepreneur and his or her organization will invest in acquiring knowledge, coordination and *learning by doing* skills in order to enhance the profitable potential. As the organization evolves to capture the potential returns it

4. This argument is elaborated at length in North (1990).

will gradually alter the institutional constraints themselves in such a way as to reinforce the initial direction of their effort. It will do so either indirectly, via the interaction between maximizing behavior and its effect on gradually eroding or modifying informal constraints; or directly, via investing in altering formal rules.

In either case the change is an incremental process, the result of thousands of individual decisions by organizations and their entrepreneurs which cumulatively are altering the institutional framework over time. The symbiotic relationship between institutions and the consequent organizations shape the direction of political/economic change. The result is a set of reinforcing mechanisms, such as network externalities, which bias incremental costs and benefits in favor of those that are broadly consistent with the institutional framework. In consequence choices that would run counter to the institutional framework are typically unprofitable.

Thus short-run profitable opportunities cumulatively create the long-run path of change. But as the foregoing sections have emphasized, the long-run consequences are often unintended, for two reasons. First, the entrepreneurs are seldom interested in the larger (and external to them) consequences, but the direction of their investment influences the extent to which there is investment in adding to or disseminating the stock of knowledge, encouraging or discouraging factor mobility, etc. Second, there is a significant difference between intended outcomes and actual outcomes.

But while individual outcomes will frequently diverge from intentions for all the reasons discussed above, the overall direction of the polity or economy is difficult to reverse. Democratic polities with a long heritage of representative government are not easily overturned; economies with a tradition of productivity increase do not easily get reversed. On the other hand it is difficult to get stagnant economies to grow and polities with no tradition of democratic norms tend to be politically unstable.

The path of institutional change that determines the long-run evolution of economies is shaped by constraints derived from the past and the (frequently unanticipated) consequences of the innumerable incremental choices of entrepreneurs which continually modify those constraints. Path dependence means that history matters, that it is a consequence of incremental change and that it can account for the divergent paths of economies.

Now given the tendency of polities to produce inefficient property rights, economic decline or stagnation can persist since there will not typically develop a feedback that will create organizations with the incentives to invest in productive activity. That is, the organizations that are created by a set of property rights that reward redistributive rather than productive activity will become more efficient at such activities and will foster political organizations with similar objectives. The overall institutional matrix will always be a *mixed bag* including some organizations that will promote

productive activity, but if redistributive organizations predominate the polity will have evolved an institutional structure to facilitate those particular types of exchanges. Such a path is hard to reverse, as Latin American economic history will attest. Indeed the persistence of *inefficient* paths is far more characteristic of economic history than are paths of economic growth.

A transaction cost approach to politics offers the promise both of a better analytical understanding of the political choices made at an instant of time and an explanation for the differential performance of polities and economies over time. It does so because the level of transaction costs is a function of the institutions (and technology) employed. And not only do institutions define the incentive structure at a moment of time; their evolution shapes the long run path of political/economic change.

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