How Does Politics Affect Economic Outcomes?
Insights from "New" Political Economy

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1. Introduction

The question of how politics affects economic outcomes has been asked probably as long as people have been interested in economics itself. From Adam Smith's *Wealth of Nations* in 1776 (if not earlier) until at least John Stuart Mill's *Principles of Political Economy* in 1848, what we now call "economics" was in fact generally referred to as "political economy." This terminology in large part reflected the belief that the fields of economics and politics were not really separable. This was more than an administrative classification of disciplines; it arose from the widespread view that political factors are crucial in determining economic outcomes. Hence, as a discipline economics historically viewed political forces not only as influencing economic outcomes, but often as a determining influence.

With the division of economics and political science into distinct disciplines, economists abstracted from political and institutional factors. The desire for methodological progress and for a more rigorous basis for economic analysis were important motivations in this separation. The development of neoclassical economics stressed optimization by consumers and firms subject to well-defined constraints and a market environment, deliberately downplaying more amorphous political factors. Those determinants of economic outcomes easily formalized in this choice-theoretic framework were stressed in the development of neoclassical economics; those not easily formalized were seen as largely the province of other disciplines.

The connection between politics and economics is now once again in the forefront of research among both economists and political scientists. This research covers not only formal models of the effect of political decisionmaking on economic outcomes, but also the use of the analytical tools of economics to analyze political processes themselves. The "new" political economy is not however just a resurrection of an earlier approach to economics. Though characterized by a strong interest in the question of how politics affects economic outcomes, the new political economy is defined more by its way of approaching this question. Specifically, it is defined in large part by its use of the formal and technical tools of modern economic analysis to look at the importance of politics for economics and, as mentioned, to study political decisionmaking itself. Modern economic analysis is used not just in the formal sense of a mathematical approach; it is also conceptual, viewing political phenomena in terms of optimization, incentives, constraints, *et cetera*. Hence, what really distinguishes the new political economy is not so much the volume, but the sort of research being done.

In this short essay I provide a particular perspective on the field. I will concentrate on the new political economy approach to studying thee effect of politics on economic outcomes, rather than on the use of tools of economic analysis to study politics itself. The essay is *not* meant to be a literature survey, but simply an exposition of a number of key points and concepts. Hence, the stress will be on illustrating these concepts clearly, rather than on highlighting specific contributions. Not surprisingly, the essay will draw heavily on my recent textbook on political economy.1. I make no apology for the possibly subjective nature of the essay, assuming that I was asked to write this essay in part because of my views on the area.

2. Heterogeneity of Interests as the Key Concept

What is the new political economy? To define it as the study of the interaction of politics and economics gives no real sense of what is being studied. It is like describing the taste of French cooking by saying it results from the interaction of France and cooking, a definition that misses the real flavor that makes good French cooking so special.

Asking how politics affects economic outcomes suggests that one must begin with being more precise about what is meant by the term "politics." "Politics" may be defined as the study of *power* and *authority*, and the exercise of power and authority. I take "power" to mean the ability of an individual (or group) to achieve outcomes which

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1 Drazen, *Political Economy in Macroeconomics*, Princeton, NJ: Princeton University Press, 2000.

reflect his objectives.2 Similarly, authority refers to an individual or a group making decisions for others with their explicit or tacit permission.

What is most important for our purposes in these definitions is what is implicit and taken for granted. Questions of power and authority are relevant only when there is *heterogeneity of interests*, that is, a *conflict* of interests between economic actors in a society. If there were no heterogeneity or conflict of interests, there would be no political problem. The central "political" question is thus how a society makes collective policy decisions when individual members have conflicting interests, and the question in the title becomes how does the nature of collective decisionmaking in the face of heterogeneity of interests affect economic outcomes. To summarize: *The key driving force in political economy is heterogeneity and conflict of interests. The "effect of politics on economics" reflects the implications of these conflicts and of how they are resolved for economic outcomes***.**

This may seem obvious, and perhaps it should. However, the centrality of heterogeneity is not always fully realized, with things like the sequential nature of the policy-making process being sometimes argued as key to political economy.

Given the necessity of conflict of interests for there to be a political economy problem, one is led to ask: what are important types of heterogeneity for political economy? It is useful to consider two basic types of heterogeneity. The first reflects underlying heterogeneity of actors "coming into" the political arena, implying they have different policy preferences. They may simply have different tastes over goods, broadly defined, or different relative factor endowments. They may find themselves in different situations not easily summarized in terms of tastes or endowments that lead them to prefer different policies. Or, they may just differ in how they think the world works, and hence what policies would best achieve a given aim. In short, individuals are heterogeneous in a number of dimensions, leading them to prefer different policies *ex ante*. We summarize this with the term **ex-ante heterogeneity.**

There is another central type of heterogeneity. Even when political-economic actors have the same "primitives" -- endowments, preferences, *etc*. -- there will generally still be a conflict of interests. Actors may all equally value a good, but there is conflict because its distribution (if it is private) or the distribution of the costs of providing it (if it is public) is determined by a collective choice. Economic policies generally have distributional implications. Therefore, when a policy does (or *can*) have distributional consequences, self-interested "representative" agents will be in conflict over distribution. Since "distribution" can also refer to conflicts arising from *ex ante* heterogeneity of factor endowments, we use the general term **ex-post heterogeneity** for this type of heterogeneity.

Ex-post heterogeneity is important not only in questions of income redistribution, but also in understanding the political aspects of some "representative" agent problems, problems where it might initially appear that heterogeneity plays no substantial role. Consider, for example, imperfect credibility of policy due to the possibility of "time inconsistency". Time inconsistency is said to arise if the optimal policy chosen at t_1 for date t_1 differs from the optimal policy for t_1 which was chosen at $t_0 < t_1$, even though technology, preferences, and information are the same at the two dates. Time inconsistency refers to more than a policymaker announcing a policy for t_1 at t_0 and then enacting a different policy at t_1 if it suits his own interests. Time inconsistency is especially interesting because it can arise even when the planner is maximizing the welfare of a "representative individual". Hence, heterogeneity would appear to play no role. However, as I argue in Drazen (2000, chapter 4), this is not correct. In representative individual models individuals are identical *ex ante*, but there may nonetheless be *ex post* conflict of interests. I demonstrate that problems of time inconsistency arise in such models only when there is an important *ex-post* heterogeneity.

One may argue that heterogeneity of interests is also central to much of economics. Markets are driven by heterogeneity as well, heterogeneity of tastes, of endowments, and of expectations. Why not therefore argue that heterogeneity is the basis not only of the field of political economy, but also of market economics itself? The argument on the importance of heterogeneity for political economy may be summarized in two statements. First, heterogeneity or conflict of interests is necessary for there to be political constraints. Second, the effect of politics on economics follows from the mechanisms by which these conflicts are resolved. The first point is clear -- heterogeneity is a *necessary* condition. It can be read as saying only that without heterogeneity, there would be nothing to study. It is the second which is really our focus. Heterogeneity is also necessary for there to be markets,

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2 Weber, M., (1947), *The Theory of Social and Economic Organization*, translated by A.M. Henderson and T. Parsons, New York: Oxford University Press, p. 152.

but heterogeneity of interests play out quite differently when addressed through the market than through the political process. For example, the effect of heterogeneity of abilities on distribution of income mediated simply through the market will be quite different than the income distribution which would result when individuals can lobby for transfers, based on their endowed abilities. How much different will depend on the political mechanism by which tax-and-transfer policy is decided. Moreover, there are numerous issues where individuals have a heterogeneity of interests where the market mechanism either cannot be used or simply is not used to determine outcomes, the political choice mechanism being used instead.

3. The Political "Bias" in Outcomes

In asking the question of how politics affects economic outcomes, we must ask "relative to what?" In a world without political conflicts, that is, where all individuals have identical interests both *ex ante* and *ex post*, there would be no disagreement over policies or outcomes, so the textbook paradigm of a "social planner" choosing policy to maximize the welfare of a representative individual is fully appropriate. This approach contains an implicit, but crucial assumption when applied to policy choice, namely, that once the optimal policy is found, it will be implemented. The problem of policy choice is thus simply a technical or computational one.

Our interest in the question "how does politics affect economic outcomes?" stems from the observation that actual policies are often quite different from "optimal" policies. The latter are defined as those chosen subject to technical and informational, but not political, constraints, as defined above. Hence, we further refine our basic question to ask how the mechanisms that societies use in choosing policies in the face of conflicts of interest may explain the choice of policies (and thus economic outcomes) that differ from optimal policies, and the outcomes those policies would imply. A key focus of political economy is this divergence.

One must be careful in interpreting this point. The statement that policy choices in the real world differ from what a textbook social planner would choose because "politics" intervenes may sound a bit too familiar, at least to economists. It sounds like a standard, simplistic criticism that neoclassical economics naively ignores politics in its analysis of economic policymaking. One may then be tempted to interpret the above point as indicating that academic economics has simply caught up with the real world.

However, new political economy is characterized by far more than the view that the mechanisms for making collective choices may "bias" outcomes relative to the textbook social planner. Central to new political economy is the restriction that individual behavior is modeled as optimizing wherever possible. In contrast, the underlying premise in the everyday view that economic analysis ignores politics is that rational choice models cannot explain economic outcomes. A moment's reflection should convince the reader about how diametrically opposed to one another are these two views. Hence, though collective decisions may be non-optimal from a societal point of view, the individual behavior that lead to them is not necessarily either irrational nor non-optimal. We summarize this discussion as: *The mechanisms that societies use in choosing policies in the face of conflicts of interest will imply that the result will often be quite different than what a benign social planner would choose. A key focus of political economy is not simply in explaining this divergence, but in showing how non-optimal policies in the aggregate are consistent with individual optimization.*

The stress on formal models of optimization in political economy mentioned in the introduction and, moreover, on applying tools of maximization to the study of political processes is an immediate corollary of this point.

4. A Very Simple Example

To illustrate some of these points quickly, consider a group of people who decide to go to a movie together. Different tastes about movies represents *ex-ante* heterogeneity, and the members of the group must find some way to make a collective choice. Once they have settled on a movie, there may still be a conflict over things that people value (or dislike) equally, such as who goes to get popcorn. This represents what I have termed *ex-post* heterogeneity. The group may settle their conflicts of interest by employing different choice mechanisms, such as: voting; deciding to rotate the choice of movie among people if the group gets together regularly; or, the most stubborn holding out for his preferred choice. Difficulties in resolving conflicts may lead to an undesirable outcome, such as missing a movie altogether if consensus comes too late. In contrast, standard welfare economics handles the problem of collective choice when there are many agents with different preferences by considering a social planner maximizing a weighted sum of individual utilities (a social welfare function), where the weight on each type is *exogenously* given.

One may find the use of such an example amusing. First of all, the two sorts of conflict of interests are easily recognizable, but the social planner is not. Who is this social planner who is making collective consumption decisions for the group? What relation does the social planner's problem with an exogenous weight on different individuals have to the problem of making a group decision when people have different preferences? The short answer is very little. This is not because the multi-agent welfare economics problem is poorly formed, but because it misses key issues we associate with conflicts of interest. How in fact are conflicts of interest resolved? What implications does the need to resolve conflicts (and the way they are resolved) have for economic outcomes? Deriving the optimal policy once society has chosen how to weight the preferences of different people doesn't treat these problems.[3]

One may also be amused by the simplicity of the example, but that is part of the whole point. If we consider a small group deciding on a movie or on who goes to get popcorn, coming to a joint decision is generally not too difficult, but the problem they face is a political one in microcosm. When we consider a society as a whole making collective economic choices, the political problem of resolving conflicts of interests is not so simple, and the economic implications of how the conflicts are resolved are far larger.

The idea that the political process may *bias* the result away from a socially preferred solution has at least two aspects to it. First, society as a whole may have preferences over efficient outcomes, but the outcome emerging from the political process, even if efficient, may be different from what society finds optimal. Second, and more important, the political process by which economic policy is chosen will generally absorb resources in one way or another, leading to an economically inefficient outcome.

5. Reform as a Political Economy Problem

These same points can be illustrated by a far less whimsical example. Consider an economy experiencing hyperinflation, where there is agreement that hyperinflation imposes very large costs on all members of society. From a purely economic point of view, hyperinflation is actually an easy problem to solve. Extremely high rates of inflation reflect extremely high rates of money growth, which in turn often reflect fiscal imbalances. As many countries have found, reducing large and persistent budget deficits quickly cures hyperinflation. Having this information, a welfare-maximizing social planner would cut the government budget deficit to eliminate high money growth and thus high inflation.

What we observe in fact is that in many high inflation economies, where it is agreed that deficit reduction is a necessary component of an inflation stabilization program, deficit reduction is long delayed while inflation accelerates. Not only is it agreed what steps must be taken to end hyperinflation, but it is also agreed that the longer these steps are delayed, the higher the cost of cutting the deficit and reducing money growth which is necessary to end hyperinflation. How can one explain the delay?

Ending hyperinflation is not a technical problem; it is often a political one. Reduced to its basics, it is often a problem of *ex-post heterogeneity* – who will bear the burden of deficit reduction? Everyone wants someone else to bear the burden. The political problem of deciding how to allocate this burden often leads to long delays in reducing hyperinflation, with severe economic consequences.

If this were the sole insight of political economy into the problem of ending hyperinflation, the man on the street might say, "Fair enough, but isn't this intuitive if we look at how the world works." To use our earlier terminology, have economists simply caught up to the real world? A political economy analysis shows formally how such a socially undesirable outcome can be consistent with individual optimization, using a formal game-theoretic model known as the War of Attrition (see Drazen, 2000, chapters 9 and 10). In general, the war of attrition considers dynamic models of supplying a public good, here, hyperinflation stabilization. For example, taxes are raised and hyperinflation ended only when some group "concedes" and agrees to a sufficiently higher tax burden such that a comprehensive deficit reduction program becomes politically feasible. Concession comes only when this group decides it is optimal to wait no longer, but this may take time. At each instant in time, each group refuses to agree to pay higher taxes to lower the deficit as long as the gain from waiting (the probability that another group will

[3] In multi-agent welfare economics, the focus is on the technical problem of solving for an optimum policy given the exogenously specified weights. The political problem may be seen as deciding on those weights themselves, which is a very different issue.

"concede" multiplied by the gain being relatively lightly taxed in the deficit reduction program) exceeds the cost of waiting (the loss from living another instant in the hyperinflationary economy). Formalization allows us to ask questions such as: how much would an acceleration of inflation hasten the expected date of stabilization; could very high inflation so hasten concession that it may improve welfare over the long run; *et cetera*.

The problem of inflation stabilization as a war of attrition provides but one example of how political economy models are useful in understanding the dynamics of economic reform. Not only are there several possible general approaches to understanding delay in adoption (or outright non-adoption) of clearly superior economic policies in any given application, but there are many applications of such models, to issues such as deregulation, tax reform, transition economies, and so on. When one asks why aren't sorely needed reforms adopted in an economy, political explanations loom large. Understanding how individually rational politico-economic decisions can lead to this result is crucial in designing better policies, policies that consider not only economic optimality but political feasibility as well.

6. Conclusions

The purpose of this essay was to give a very brief introduction to (perhaps more accurately, a small taste of) new political economy. As indicated, there was no attempt at comprehensiveness; instead I focused on my view of some general issues to give a sense of a general approach to political economy. There is so much work in the area that even starting to fill in the details would take a book. And, that's only a start.