Political Economy[a]

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The topic of this year's annual meeting, "*Political Economy*", has, at least, two dimensions. The first one is the new discussion of the role of government in a modern democratic market society. As I discussed two years ago at the same occasion, the great financial and economic crisis of the recent years lead us to reconsider this role. The second dimension is to what extent political processes are topics of economic analyses or, to state it somewhat differently, the relation between 'Economics' (Volkswirtschaftslehre) on the one and 'Political Economy' (Politische Ökonomie) on the other hand. Both topics are interrelated.

If we go back to the Classics, Economics was always understood as Political Economy, as can easily be seen from titles of famous contributions, be it, for example, *On the Principles of Political Economy and Taxation* by David Ricardo, or *Contribution to the Critique of Political Economy* by Karl Marx. This changed, however, in the 19th century in the area of Neoclassical Theory. Then, Physics and, in particular, classical mechanics became the role model of economic theory. This is, for example, very clearly expressed in Irving Fisher's dissertation submitted to Yale University in 1891. He contrasted the physical entities particle, power and energy, with the economic entities individual, marginal utility and utility.[1]

One consequence of this reorientation of Economics was that theories for the economic and the political subsystems of the society were strictly separated. Economics was considered being the theory analysing the economic subsystem, but not at all the political one. The political environment of the economic system was to be seen as data which the economic theorist had to take into account, but he was assumed to have no competence to analyse political processes. This was

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1 See also Walras (1874, p. 71). – On the impact of classical mechanics on neoclassical economic theory see, for example, Grattan-Guiness (2010).

seen as being the task of historical analysis. As WALTER EUCKEN stated in 1940 (p. 220): "Economic theory cannot show how these data come to exist", and he warned: "There must be a distinct frontier between what is to be taken as given and what not. Unless there is, and unless theoretical analysis keeps within this frontier, history and theory cannot be combined."

There were, of course, developments in economic theory that did not accept this separation, as, for example, Austrian Economics, the American Institutionalists or the German Historical Schools.[2] They did not, however, represent the mainstream, and at least the latter two did not have a strong theoretical foundation, at least as long as we interpret the term 'theory' in the way done by modern economics.

The first one who used modern (neoclassical) theory to analyse political processes was HAROLD HOTELLING, who applied in 1929 the model of economic competition to the competition between political parties in a two-party system, thus creating the famous median voter model. The second basic idea came from JOSEF A. SCHUMPETER. In his classical contribution, *Capitalism, Socialism and Democracy*, published in 1942, he applied the idea of economic entrepreneurship to the political sphere, thus introducing the idea that politicians are political entrepreneurs. Finally, in 1951, KENNETH ARROW, in his *Social Choice and Individual Values*, showed that there is no political aggregation mechanism which is (only) based on ordinal individual preferences and guarantees some basic democratic and rationality conditions. Thus, he questioned the idea of a social welfare function which might be maximised, even if only implicitly, by democratic procedures.

The real starting point of Modern Political Economy or, as it is often called, Public Choice, was, however, the dissertation of ANTHONY DOWNS about *An Economic Theory of Democracy*.[3] He took up ideas of HOTELLING and SCHUMPETER and developed in his dissertation, which was published in 1957, for the first time a full model of the political process based on the economic model of behaviour. In doing so, he further developed and popularised the median voter model. Even though it was already implicit in the works of his forerunners, he was also the first one to make it very clear that the behaviour of politicians should be analysed

2 On Austrian Economics see, for example, KIRZNER (1987), on American Institutionalism, the most prominent representative of which THORSTEIN VEBLEN was, see, for example, HAMILTON (1919), on the German Historical Schools, the most prominent representative of which GUSTAV SCHMOLLER was, see, for example, SENN (2006).

3 For an introduction into modern Public Choice Theory see, for example, MUELLER (1997, 2003).

along the same lines as the behaviour of all other individuals, in particular of economic agents, and that politicians as all others maximise their individual utility functions subject to constraints (and limited information). Like HOTELLING, he showed that the democratic process might (under some conditions) nevertheless lead to a social outcome which is to the advantage of many citizens. What ADAM SMITH (1776, p. 27) told us about the intentions and the social consequences of the behaviour of butchers, brewers and bakers, might similarly hold for the behaviour of politicians. There is, at least, no reason to assume that politicians behave fundamentally differently than other people; there is no reason to assume that they are better or worse than other human beings, also not with respect to moral behaviour. Politicians should definitely not be seen as being benevolent dictators maximising social welfare, but as citizens who, subject to specific constraints, maximise their individual welfare (and/or the welfare of their clientele).

Today, at least for economists, this seems to be rather trivial, but in 1957, this was really revolutionary. At the same time, totally independent of ANTHONY DOWNS, PHILLIP HERDER DORNEICH wrote a similar dissertation based on the same ideas and submitted it to the university of Freiburg in Germany. However, in order not to risk his academic career, his advisors suggested to publish his book under a pseudonym. Thus, it was published as *Politisches Modell zur Wirtschaftstheorie* in 1959 under the name of FRED O. HARDING.

In the meantime, things have changed dramatically. In 1972, WILLIAM B. NORHAUS proposed the first full model of the political business cycle. This model has three ingredients: A vote function, which makes the electoral success depending on the development of unemployment and inflation, a behavioural assumption about the government that it maximises its vote share in order to insure re-election, and a Phillips-curve to represent the trade-off between inflation and unemployment. Using this model, he showed that governments have incentives to create business cycles, even if the economic system is stable, i.e. that there are no cycles inherent in it. This is in stark contrast to all previous business cycle literature where the assumption was that the government intends to stabilise the economic development, and the only discussion was whether it was able to do so or not.

This simple model is, for example, also one of the starting points for the discussion about the time inconsistency of monetary policy. In the Nordhaus model, voters/consumers are permanently fooled: expected consistently differs from actual inflation.[4] This strongly contrasts to the rational expectations hypothesis

4 See for this KIRCHGÄSSNER (1983).

incorporated in modern macroeconomics. A second generation of models of political business cycles has taken this into account: models of 'rational' political business cycles have been developed, thus, reconciling political business cycle with modern macroeconomic theory.[5] Consequently, the text book of TORSTEN PERSSON and GUIDO TABELLINI (2000) about *Political Economics* reads, to a large part, like a textbook of modern macroeconomic theory. Thus, in this respect, Modern Political Economy has been fully integrated into the mainstream of Modern Economic Theory. A good indicator for this is that today important contributions to modern Political Economy come from the famous Economic Departments of Harvard, MIT and LSE.[6]

This is, of course, not the only example where modern political economy became – more or less – mainstream. Constitutional Economics, starting with the seminal contribution *The Calculus of Consent* by JAMES M. BUCHANAN and GORDON TOLLUCK in 1961 is today integrated in modern institutional economics,[7] and the idea of rent seeking, going back to GORDON TULLOCK (1967), is also fully integrated. What started in Virginia by the Public Choice School is today greatly acknowledged. Insofar, standard Economics is nowadays much closer to the traditional concept of Political Economy as it was 50 years ago. And not only Economics and Political Science were influenced by this development: MANCOR OLSON's *Theory of Interest Groups* was also highly influential not only in Political Science, but also in Sociology.[8]

There is, however, also another aspect which should be taken into account. Using the model of the benevolent dictator, traditional economic theory, in particular traditional Public Finance, pointed to "market failure" in various areas. These failures have been interpreted as justifications for government interventions, with goods or services being produced in the public sector, for instance, or with some sectors of the economy being heavily regulated. Given the fact that governments are not benevolent dictators but have their own political objectives, the development of Public Choice rightly pointed to the fact that there exists also "government failure". Many of those developing Public Choice theory even believed that only the latter is relevant. Thus, in their opinion, nearly everything

5 See, for example, the model presented in ALESINA and ROSENTHAL (1995).

6 See, for example, the discussion about institutional and geographic preconditions for economic growth, surveyed in FELD and KIRCHGÄSSNER (2008).

7 The basic ideas of Constitutional Economics go back to KNUT WICKSELL (1896), who's work had a great impact on JAMES BUCHANAN. See for this, for example, BUCHANAN (1987).

8 See for this, for example, BARON and HANNAN (1994, pp. 1130ff.). For its impact on Political Science see ALT (1999). – Another major early contribution is "*The Theory of Committees and Elections*" of DUNCAN BLACK (1958). See for this also GROFMAN (2002).

could and should be done by markets. As we have seen during the great financial and economic crisis of the recent years, this turned out to be a serious fallacy.

Therefore, the acknowledgment of government failure should not make us blind for the existence of market failure. Political Economy has to take both into account. This becomes obvious if we consider today's discussion about the appropriate regulation of Banks which, due to the extreme 'too big to fail' problematic, is of particular interest in Switzerland. Governments might, in their own interests, have a tendency to over-regulate the Banking-Sector. Representative of Banks, on the other hand side, in their attempts to increase profits and knowing that they are too big to fail and, therefore, having an implicit insurance by the government, go into rent-seeking in order to restrict regulations by the government and/or the Central Bank as far as possible. Thus, the current game between regulatory authorities and commercial banks might be a rather good object of future politico-economic analyses.

But, as will be seen at this congress, there are also other fields for fruitful politico-economic analyses. The fact that Modern Political Economy is, to a large extent, today fully integrated in mainstream Economics does not imply that there is no need for further development in Political Economy. Take, just as one example, Public Finance. If you go to the leading journals in this field you will still find at lot of papers where it is assumed that the government maximises a social welfare function, thus, ignoring the more than 50 years old insights of Kenneth Arrow and Anthony Downs. Such models are hardly useful, for example, to analyse the development of public debt. Modern Political Economy, on the other hand, taking into account that governments might have a tendency to have too large deficits, shows how political institutions like debt brakes can counteract this tendency of government behaviour and – hopefully – lead to sustainable public finances.[9]

There are other aspects of Modern Political Economy which will be discussed at this meeting as well. They can, of course, only show a small part of its developments. Nevertheless, I hope that this congress will on the one hand give you some impression about what Modern Political Economy is today and on the other hand show that there are still many open areas for future fruitful research. Thus, I hope that you will all benefit from this annual meeting.

9 Buchanan and Wagner (1977, 1978) pointed to the fact that democratic governments, following the Keynesian advice of anticyclical business cycle policy, have a strong incentive to increase public debt. On the effects of debt brakes in Switzerland, see, for example, Feld and Kirchgässner (2008a).

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