Chapter 6

NORMATIVE
POLITICAL-ECONOMIC
ANALYSIS

6.1 Introduction

How does one evaluate the economic efficiency of a political-economic equilibrium? What is the relationship between the underlying institutional structure, and in particular the constitutional order, and the efficiency of the resulting political-economic equilibrium? These are the focal problems addressed in the following inquiry into the foundations of normative political-economic analysis. Besides the general interest in evaluating political-economic equilibria, valid answers to the questions posited above are also prerequisites for prescription.

Any attempt at evaluating political-economic equilibria must commence with the choice of appropriate evaluation criteria. The principal criterion adopted in the present analysis is the one often used in cost-benefit analysis (e.g., Mishan 1976), and policy analysis (e.g., Just et al. 1982 and Gardner 1987a). Essentially, this evaluation approach expresses the effects of public intervention in terms of consumer surpluses, producers surpluses, ”willingness to pay” measures along with public expenditure.

As the theory presently expounded focuses exclusively on equilibrium states of the system, the analysis is strictly static. Despite its great importance, no evaluation of political-
Two fundamental questions must be addressed in any normative analysis:

(i) Is the political-economic equilibrium policy regime and values of the policy instruments socially optimal, and what are the social gains and/or losses due to the intervention?

(ii) Are the political and economic transaction costs under the political-economic equilibrium minimal?

Both problems arise under any type of policy intervention, but the first is more prominent under quantitative policies while the second is particularly important under structural policies. According to Tinbergen (1956), quantitative policies regard the economic structure as given and the principal political problem is to select the policy regime and values of quantitative policy instruments that solve the underlying political-economic problem; that is, to obtain the desired policy target. Note that in the context of a quantitative policy the term "policy regime" refers to the combination of policy instruments employed in the intervention. A structural policy, on the other hand, seeks to alter the economic structure itself; that is, to modify the various institutions (laws, property rights, modes of organization, commonly accepted contractual arrangements, etc.). Both quantitative and structural policies significantly affect the political-economic equilibrium. We are also interested in the possible tradeoffs between the transaction costs and other social gains and losses associated with the selected policy.

Attempts at evaluation must also contend with a fundamental observational issue. That is, if one can observe the market behavior of all participating agents so that the demand and supply relations are in principle known, then various economic surplus concepts can be derived and used in the normative analysis. Under these circumstances market performance may be predicted and evaluated even before the political-economic equilibrium is established.

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1 An attempt at developing a dynamic theory of political-economic processes is made in Chapter 5. The attempt strongly suggests a crucial interrelationship between the political economy's dynamic behavior and its economic efficiency.
However, owing to observational difficulties and revelation problems, changes in the “willingness to pay” for public goods as well as changes in economic and political transaction face more difficult assessment problems, and often one must observe the new political economic equilibrium before the evaluation of system performance is possible.

In this chapter, the choice of evaluation criteria is first considered, and an exploration of the efficiency conditions is subsequently undertaken. In this setting, the conditions of particular interest are those that the political economy must satisfy for an equilibrium to be efficient. Given the present political power theoretic approach, such efficiency conditions are intimately related to the characteristics of the political structure. The derived efficiency conditions are, therefore, stated in terms of the political-economic structure. The problems of evaluating economic and political transaction costs are also explored.

6.2 Evaluation Criteria of Social Benefits and Costs

The effects of policy intervention are many and varied; to simplify, an evaluation criterion that will serve as a common measuring rod of the social welfare implications of all such effects is required. The criterion should evaluate the allocative efficiency of the political economic equilibrium and express it in comparable units, preferably monetary units. One criterion was actually developed and used in benefit-cost analyses of public projects in particular and more generally in the evaluation of public policies. The criterion assigns monetary values to the divergencies from the non-intervention equilibrium brought about by public intervention; benefits are expressed as positive deviations while social welfare losses (or costs) are assigned negative values. Alternative intervention options may then be ranked according to their respective net benefits. In evaluating changes in quantities traded and in market prices of private goods, benefits and costs are ordinarily obtained as net consumer and producer surpluses; public expenditures are regarded as costs incurred by taxpayers, or as opportunity costs of foregone public goods to potential users. Harberger (1964) employed this criterion in
assessing social deadweight losses brought about by government intervention ("Harberger’s triangles"). The value of public goods not traded in the market is obtained as the sum of individuals’ "willingness to pay" for these goods. Indirect costs and benefits entailed by the intervention should also be included in the calculus. Thus, nominal government expenditures as such undervalue the real social cost of the intervention since the tax excess burden is not reflected in nominal government expenditures. Of course, the tax excess burden should be added to nominal expenditures.

Assessing changes in transaction costs brought about by the intervention involves a far more complex and subtle phenomenon. Any real social system in which individual actors engage in exchange entails certain welfare losses referred to as transaction costs. Transaction costs are hard to define; but generally speaking, they refer to the differences between the value of individual utility levels attainable under the existing technology and resource availability constraints, and the value of utility levels actually achieved under the particular social organization. That is, the term "transaction costs" refers to the value of all departures from the "first best" resource utilization scheme due to system imperfections-a rather tautological description.\(^2\) Changes in social costs and benefits associated with variation in the quantities traded and market prices are not considered changes in transaction costs.

In the present context, the full range of transaction costs related issues is not pursued; rather, the analysis focuses on two distinct classes of transaction costs: (i) purely economic transaction costs that are significantly affected by structural policies; and (ii) costs entailed by the political-economic process itself, including costs originating from the corresponding informational and incentive structures. The first class of transaction costs is dealt with in Section 6.4 below, where the problem of evaluating structural policies is addressed. The second class of transaction costs are examined in this section.

Of the many possible categories of political-economic transaction costs we explore only

\(^2\)There exists at present a voluminous and rapidly expanding literature on transaction cost economics, sourced with Coase (1960) and Williamson (1975; 1979). The definition and role of transaction costs in shaping organizational forms are discussed in Zusman (1988: 68-72).
two generic types:

(i) Political-economic transaction costs incurred during the political process in which the policy regime is selected and the values of the instrumental variables are determined. These include bargaining costs, the cost of power, and policy decision costs.

(ii) Transaction costs incurred during the policy implementation phase. These comprise the cost of administering the policy program, the cost entailed by an imperfect information structure, and costs due to distorted incentive systems.

Bargaining costs arise during the policy formation phase as power groups with conflicting objectives seek an agreed upon policy that will serve each group’s interest. Agreement is reached through negotiation, bargaining, and mutual persuasion which are usually costly in terms of time invested, delayed action and impaired human relations. While the Nash-Harsanyi bargaining theory presupposes the dominance of cooperative solutions with conflict situations serving merely as unimplemented threats, casual empiricism strongly suggests that conflict situations do arise and threats are often carried out. Disparities in the parties’ perceptions of the conflict outcomes often precipitate costly tests of power. In general, bargaining costs are greater the more diverse the groups’ interests, the greater the stakes involved, and the less compromising are group leaders’ attitudes.

The cost of power, especially under disagreement, is partly embodied in the bargaining cost. But even in the cooperative solution when organized interest groups are engaged in reward rather than conflict strategies, society may incur net social losses. It would be wrong to regard the full cost of rewarding policymakers as net social costs, for these costs create benefits valued by political decision agents. As the latter are also members of society, reward values should be included in the social welfare calculus. Thus, in a configuration with a single center and $n$ organized interest groups, the quantity, $\sum_{i=1}^{n} s_i(c_i, \alpha_i) - \sum_{i=1}^{n} b_i c_i$ is maximized in the political-economic equilibrium.\(^3\)

\(^3\)where $s_i(\cdot)$ denotes the pressure function for interest group $i$, $c_i$ denotes the cost of power for interest group $i$, and $b_i$ denotes the weight attached to interest group $i$. 
The last type of political-economic transaction cost incurred at the policy formation phase is the policy decision cost. The term refers to resources expended on information gathering and calculating when reaching policy decisions as well as welfare losses due to mistaken choices. Though difficult to distinguish from the already-mentioned bargaining costs, decision costs constitute a separate and distinct cost category.

Two types of political-economic transaction costs predominate the policy implementation phase: (i) program administration costs; and (ii) rent-seeking costs. The composition and extent of the first category depend on the nature of the policy program. Of particular interest are the relationships between the policy choices, the administrative costs, and the rent-seeking costs. For example, policies requiring public intervention at the microeconomic level (e.g., supply control through production allotment, resource rationing by public authorities) will likely entail heavy administration costs, in contrast with macroeconomic policies (e.g., public control of the market rate of interest and foreign currency rate of exchange) where administration costs are relatively smaller in comparison to benefits. Similarly, policies creating strong incentives for non-compliance (e.g., high tax rates encourage tax evasion) require higher administration cost for monitoring and enforcement.

A rent-seeking cost consists of resources expended by individual economic agents seeking to increase their share of politically-rationed rights to assets yielding government contrived rents. An import quota is a celebrated example explored by Krueger (1974). Similarly, production allotments and politically allocated resource utilization and trade rights entail rent-seeking behavior and cost. Rent-seeking costs include all social losses arising out of departures from the "first best" resource allocation induced by politically contrived rents. Because rent seeking often involves bribing and other illicit activities, the full social costs associated with rent seeking may appreciably exceed direct economic resource cost. The amount of rent-seeking cost produced in the political economy depends on the market structure for the politically contrived rent-bearing property rights. As Krueger had shown, under competitive market conditions, the social loss is equal to the total value of the politically
contrived rent which may indeed be considerable.\textsuperscript{4}

Controlling shipments across international borders is far less expensive than controlling domestic trade flows. Hence, the administrative cost of policing production quotas of domestically produced and consumed commodities may be comparatively high. Accordingly, total political-economic transaction costs in most policy programs, especially those involving micro-level quantitative control, are substantial and must be included in the policy evaluation calculus. Political-economic transaction costs are often important policy determinants as there often exist considerable potential tradeoffs between the political-economic transaction costs and other groups' policy objectives. Rent-seeking and administrative costs may be substantially reduced by selecting less stringent quantitative restrictions and lower rent-producing prices.

There is also the measurement problem. Program administration cost is easily quantified, but other types of political-economic transaction costs are difficult, and in some instances impossible, to evaluate objectively. To be sure, individual policymakers do form their own subjective estimates of the various costs, which they use in choosing among feasible policy options, but these estimates are never reported. In more empirical applications, policymakers' implicit cost estimates can only be extracted from observed policy choices.

It is important to recognize that the distinction between welfare losses due to a socially non-optimal policy regime and losses due to transaction costs is somewhat arbitrary. The distinction, however, is useful in order to facilitate the exposition and systematize the analysis but, in principle, optimal political intervention is the one minimizing total net social cost or maximizing net social benefit consisting of both types of costs and benefits. Furthermore, as the various organized groups do not ignore significant political and economic transaction costs in reaching the agreed upon policy, these cost components are also important elements of any positive political-economic theory.

A minimalist approach to the normative analysis of political-economic equilibria would

\textsuperscript{4}Krueger cited an estimated deadweight loss of 7.3 percent of GNP in India in 1964 due to import licenses. The corresponding loss in Turkey in 1968 was estimated at 15 percent of GNP (Krueger, 1974: 294).
view the redistribution of income to the beneficiaries of the program as politically determined and seek the policy program yielding the predetermined redistribution of income at the lowest social deadweight losses (inclusive of political-economic transaction costs). This approach is conducive to an evaluation criterion – the $T/S$ ratio, defined as (Becker, 1983; Gardner, 1983):

$$\frac{T}{S} \equiv \frac{\text{Net benefits transferred by the policy to target beneficiaries}}{\text{The net social cost entailed by the policy}}$$

Both $T$ and $S$ are expressed in monetary terms and may be derived as aggregates of economic surpluses, public expenditures, ”willingness to pay” measures and values of changes in relevant transaction costs. Policy programs can then be ranked according to their $T/S$ ratio; the higher the ratio the better.

As an illustration, consider the price subsidy policy regime depicted in Figure 6.1. This policy program transfers utility from taxpayers to consumers and producers. Consumers’ gain is represented by the area of the trapezoid $P_eEBP_c$, where $P_e$ is the equilibrium price and $P_c$ is the consumer’s price, and producers’ gain is represented by the area of the trapezoid $P_eEAP_p$, where $P_p$ is the producer’s price; the nominal cost to taxpayers is equal to the subsidy cost represented by the area of the rectangle $P_pABP_c$. But the full cost to taxpayers is greater than the subsidy cost and includes the tax excess burden, $\epsilon$ (subsidy cost); where $\epsilon$ denotes the marginal tax excess burden, approximately constant because the analyzed subsidy cost is small in comparison with total tax revenue in the economy. Ignoring all political-economic transaction costs (including the program administration cost), $T$ and $S$ follow immediately:

(6.1) \[ T = \text{Area of trapezoid } P_eEBP_c + \text{Area of trapezoid } P_eEAP_p \]

and
Figure 6.1: The political economy of a subsidized competitive commodity in a small importing country
(6.2) \[ S = (1 + \epsilon) \text{[Area of rectangle } P_pABP_c] \]

The area of the triangle $EAB$, Harberger’s deadweight loss triangle, represents the excess of nominal subsidy cost over the increases in the sum of consumers’ and producers’ surpluses. For this illustrative example, the $T/S$ ratio is obviously smaller than unity. More generally, apart from pure lump sum transfers, whenever an efficient non-intervention competitive market equilibrium is displaced by government intervention a social deadweight loss is incurred and the ratio $T/S$ is smaller than unity.

Under conditions yielding an inefficient non-intervention market equilibrium, public intervention may actually yield a $T/S$ ratio greater than one, as is illustrated by the tariff imposed on a single imported commodity in a large importing country. This case is portrayed in Figure 6.2. The curves $D(P)$ and $S(P)$, respectively, are the domestic demand and supply curves in the importing country, while the curve $D(P) - S(P)$ is the corresponding domestic excess demand function. The curve $S_{rw}(P_w)$ is the excess supply schedule of the rest of the world when no tariff is imposed ($t = 0$) and $S'_{rw}(P)$ is the excess supply function of the rest of the world taking into account the tariff (i.e., $P = P_w + t$). Zero shipping costs are presumed.

The non-intervention (i.e., $t = 0$) equilibrium is given by the intersection of the $S_{rw}(P_w)$ curve with the domestic excess demand curve, $D(P) - S(P)$. The equilibrium price, $P(0) = P_w(0)$, satisfies the equality $S_{rw}(P_w) = D(P) - S(P)$; the quantity demanded domestically is $Q^D(0)$; the quantity supplied domestically is $Q^S(0)$ and the quantity imported is $M(0)$. When a tariff of $t$ dollars per unit of imported commodity is levied, the equilibrium is shifted to the intersection of $S'_{rw}(P)$ with the new equilibrium $S'_{rw}(P) = D(P) - S(P)$. In the equilibrium with a tariff $t$, the domestic price is $P(t) = P_w(t) + t$; the quantity demanded domestically is $Q^D(t)$ (where $Q^D(t) < Q^D(0)$), while the quantity supplied domestically is...
where \( Q^S(t) > Q^S(0) \); the quantity imported is \( M(t) \), \( (M(t) < M(0)) \). Since \( P(t) > P(0) \), the increase in domestic producers’ surplus is represented by Area \( A \), while domestic consumers surplus is reduced by Area \( A + B + C + D \); total tariff revenue is represented by Area \( C + F = tM(t) \). Note that the tariff revenue allows the fiscal authorities to reduce other taxes and, thereby, lower overall tax excess burden by Area \( C + F \).\(^5\) Hence, the tariff policy portrayed in Figure 6.2. involves transfers from consumers and producers in the "rest of the world" to domestic producers and taxpayers.

However, only the domestic interests are measured and changes in foreigners’ welfare are ignored.\(^6\) Let \( G \) denote the program administration cost and ignore all other political-economic transaction costs, then under the tariff policy regime,

\[
T = \text{Area } [A] + (1 + \epsilon) \text{Area } [C + F]
\]

and

\[
S = \text{Area } [A + B + C + D] + (1 + \epsilon)G
\]

Hence, if Area \( [B + C + D] + (1 + \epsilon)G < (1 + \epsilon) \{ \text{Area } [C + F] \} \), then the \( T/S \) ratio exceeds unity. As the net loss of welfare by various groups in the rest of the world is not included in the welfare calculus, the \( T/S \) ratio is greater than unity. This is also why under such circumstances, an optimal tariff rate is positive. The non-intervention equilibrium illustrated in Figure 6.2 is considered inefficient only from the narrow self-centered domestic point of view.

It is worth noting that in the case of market failure, when the non-intervention equilibrium

\(^5\)Since the social deadweight losses created by the tariff are explicitly taken into account, the savings in tax excess burden due to a reduction in other taxes are fully accounted for.

\(^6\)The effects on foreigners’ welfare are considered only when such effects provoke retaliation by the trading partners which may affect the well-being of domestic groups; and only the latter effects are included in the cost-benefit calculus.
Figure 6.2: The political economy of tariffs in a large importing country

Note:
\[ M(0) = Q^D(0) - Q^S(0) \]
\[ M(t) = Q^D(t) - Q^S(t) \]
is by definition inefficient, public intervention yields smaller net social losses and even benefits (in which case $S < 0$). In the former case, the $T/S$ ratio tends to be large, while in the latter case the $T/S$ ratio should be replaced by another efficiency criterion, viz. net social benefits. The ranking of policy programs according to this criterion is straightforward.\footnote{For more on the incidence and efficiency of different public policies, see Alston and James (2002).}

Finally, it should be noted that the proposed allocative efficiency evaluation criterion, completely ignores distributional effects and no distinction is made as to the identity of the person valuing the cost or benefit; that is "a dollar is a dollar is a dollar." This is, clearly, a narrow view of the social value of a policy program, but a useful one, nonetheless. In a fuller normative analysis, pure allocative efficiency criteria should be augmented by appropriate income distribution indices.

### 6.3 Political-Economic Efficiency Conditions

What are the conditions for an economically efficient equilibrium policy regime and values of the policy instruments? It is heuristically arguable that departures from the following conditions are highly likely to induce economically inefficient policy choices.

(a) All individual actors whose well-being is influenced by the choice of policy instruments should be represented in the political process. Thus, when net government revenue is affected by the selected policy regime and values of the policy instruments, such choices may affect taxation rates; and taxpayers should, therefore, be represented in the political process. Note that taxpayers who ordinarily constitute a politically inert interest group may, in fact, be represented in the political process by a fiscal authority whose policy objective function is to minimize net government deficit.\footnote{The very existence of a fiscal authority aiming at minimizing the fiscal deficit is, in itself, an indication that taxes must be limited in order to avoid taxpayers’ potential adverse responses. Under such circumstances, taxpayers may still be viewed as an unorganized but responsive interest group in general, although in many specific cases they are practically inert.}

(b) All organized groups’ policy objective functions should fully and faithfully reflect the group members’ preferences over the policy space, $X_0$. In other words, policy effects should
be fully internalized. To the extent that an organized group policy objective function also reflects the preferences of unorganized individuals, this condition also applies to such groups.

(c) The weights attached to the organized groups’ policy objective functions should be equal (i.e., in the governance function, $W$, (see chapter 4, section 4.4): $b_1 = b_2 = ... = b_n = 1$ and $B_i = B_j = B_k = B$ for all $i$, $j$, and $k$). Depending on one’s preferred interpretation of the weights, condition (c) may imply equal distribution of power or permissible side payments. The latter interpretation can be obtained from the Appendix to Chapter 4 by noting that under permissible side payments, $s_{ij}(c_i^j, \alpha_i^j) = c_i^j$ and $s_{kj}(c_k^j, \alpha_k^j) = c_k^j$. By implication, the gains from a cooperative political-economic equilibrium relative to a conflict situation are then equal for all organized groups.

Two principal types of serious distortions, or externalities, are likely to occur in political-economic systems: (i) group members’ interests may be distorted in the political process; and (ii) groups may regard certain aspects of the system as collective goods/bads from whose effects no one can be excluded. Such groups are likely to ignore important aggregate system aspects while framing their policy objective functions.

The former distortion derives from intra-group political relations which tend to emphasize group leaders’ interests – essentially a principal agency problem (see Chapter 7). Empirical evidence on the existence of such distortions in real political-economic systems are reported in chapter 19.

The latter distortion may be viewed as an Olsonian ”logic of collective action” operating through the political process. It is a pervasive distortion which seriously afflicts political economies featuring choices of time profiles of policy instruments (Zusman and Rausser, 1990; Rausser and Zusman, 1991; 1992; see also Chapter 15).

The sufficiency of the economic efficiency conditions (a) through (c) may be illustrated by a simple example consisting of a market for a subsidized commodity. The example is presented graphically in Figure 6.1 above. The economic structure comprises the supply and demand relations described in Figure 6.1. by the curves $SS'$ and $DD'$, respectively. A third
structural relation is the price-subsidy equation:

\[ P_p = P_c + s \]

where \( P_p \) denotes producers’ price, \( P_c \) denotes consumer price, and \( s \) is subsidy per commodity unit. The three economic structural relations together determine the endogenous variables, \( P_p, P_c \) and \( q \) for a given subsidy level, \( s \). Thus, \( P_c = P_c(s), P_p = P_p(s), \) and \( q = q(s) \), where \( q \) denotes the quantity supplied.

The group configuration is assumed to consist of a policymaking center or government (indexed by \( i = 0 \)) and two organized interest groups: consumers (\( i = 1 \)) and producers (\( i = 2 \)). Regarding the zero subsidy equilibrium, \( E \), as the reference state, the government wishes to minimize the subsidy cost represented in Figure 6.1 by the area of the rectangle, \( P_p A B P_c \); consumers are interested in maximal consumer surplus represented in Figure 6.1 by the area of the trapezoid \( P_c E B P_c \), while producers seek to maximize the producer surplus represented in Figure 6.1 by the area of the trapezoid \( P_p E A P_p \).

Hence,

\[(6.5a) \quad u_0(s) = -sq(s)\]

\[(6.5b) \quad u_1(s) = [q(0) + q(s)] [P_c(0) + P_c(s)]\]

\[(6.5c) \quad u_2(s) = [q(0) + q(s)] [P_p(s) - P_p(0)] / 2\]

Note that when excess tax burden and political-economic transaction costs are ignored, the area of the triangle \( ABE \) represents the subsidy deadweight loss. The political-economic equilibrium level of subsidy is the one maximizing the policy governance function:

\[ W(s) = u_0(s) + b_1 u_1(s) + b_2 u_2(s), \]

where \( b_1 \geq 0 \) and \( b_2 \geq 0 \) are the weights associated with the consumer and producer groups,
respectively.

When power is equally distributed (or side payments are allowed), i.e., \( b_1 = b_2 = 1 \), then \( W(s) \) is plainly the net social surplus; it is equal to the negative value of the area of the triangle \( ABE \) in Figure 6.1. Hence, \( s^0 = 0 \) is the political-economic equilibrium solution; that is,

\[
\max_{s} [u_0(s) + u_1(s) + u_2(s)] \Rightarrow s = 0
\]

The economically efficient solution occurs because taxpayers, the only politically inert interest group, are represented by the policymaking center (condition (a)); the policy objective functions faithfully represent the groups’ preferences with respect to subsidy levels (condition (b)), and political power is equally distributed (condition (c)). It is easy to see that departures from these conditions will yield non-optimal equilibrium subsidy levels – although the possibility of mutually compensating deviations, however unlikely, cannot be ruled out. However, since the probability measure of mutually compensating deviations from sufficient conditions (a) through (c) is practically negligible, these conditions are "almost always" necessary. That is, conditions (a) through (c) are necessary except for cases whose probability measure is zero.

Having analyzed the economic efficiency of political-economic equilibria for group configurations composed of organized groups alone, we wish now to explore the welfare implications of extending the configurations to include unorganized groups.

It is immediately obvious that the inclusion of a politically inert interest group without representation in the political process, violates economic efficiency condition (a) and is as a result conducive to economic inefficiency. Including an unorganized but responsive group creates a different situation, because the effects of the unorganized group’s reaction function on the participating organized groups become crucial. Accordingly, we now add one more necessary condition for the economic efficiency of the political-equilibrium, namely:
(d) If the group configuration of the political economy includes an unorganized but responsive interest group, then the total impact of the unorganized group’s reaction function on the participating organized groups should additively and faithfully reflect the unorganized but responsive group members’ policy preferences. If the group configuration includes several unorganized but responsive interest groups, then this condition must hold for each and every such group. Moreover, the weight associated with each groups’ preferences in the policy governance function should be uniform across groups. Thus, let the effects of the unorganized groups’ reaction function be as formulated in Equation (4.20) and let

\[
\hat{u}_i(x_0) = u_i(x_0) + \sum_{k=1}^{K} r_{ik} u_k(x_0) \quad i = 0, 1, 2, \ldots, n
\]

where the \( r_{ik} \)'s are constant coefficients.

Then, a necessary condition for the efficiency of the resulting political-economic equilibrium is that

\[
\sum_{i=0}^{n} r_{ik} = 1 \quad \text{for} \quad k = 1, 2, \ldots, K
\]

This is because by efficiency condition (c), \( b_i = 1 \) for all \( i \), and the efficient policy governance function should be

\[
W(x_0) = \sum_{i=0}^{n} \hat{u}_i(x_0) b_i = \sum_{i=0}^{n} \hat{u}_i(x_0)
\]
and by (6.6) and (6.7) one gets from (6.8)

\[
W(x_0) = \sum_{i=0}^{n} \left[ u_i(x_0) + \sum_{k=1}^{K} r_{ik} u_k(x_0) \right] 
= \sum_{i=0}^{n} u_i(x_0) + \sum_{k=1}^{K} \sum_{i=0}^{n} r_{ik} u_k(x_0) 
= \sum_{i=0}^{n} u_i(x_0) + \sum_{k=1}^{K} u_k(x_0)
\]

and efficiency condition (d) is satisfied.

It is unlikely that condition (d) is precisely satisfied. However, it is not unreasonable to expect that responsive unorganized groups will likely improve political-economic performance over pure inertia.

Conditions (a) through (d) are necessary except for cases whose probability measure is zero. In practical terms, departures from conditions (a) through (d), will almost always produce inefficient political-economic equilibria. The set of almost always necessary conditions for political-economic efficiency thus provides standards for the normative evaluation of political economies. Since these conditions are often violated, economic inefficiencies are pervasive in political economies; the attendant social costs depend, of course, on the nature and size of the departures from optimality.

### 6.4 Evaluation of Structural Policies

The normative political-economic analysis has hitherto focused on policies categorized by Tinbergen (1956) as "quantitative policies.” However, in contrast to quantitative policy, structural policy fundamentally affects economic transaction costs in the economy. Evaluation of political-economic equilibria involving structural policies thus faces a particularly difficult problem. At issue are the identification and quantification of the social benefits and costs produced in the political-economic equilibrium involving a structural policy.
Consider the general case where the selected policy redistributes property rights and/or imposes constraints on permissible contractual arrangements (e.g. land reforms, resource rationing regulations, rent control laws, corporate laws). Intuitively, transfer of property rights shifts income from old owners to new ones; but how does it affect the allocative efficiency of the political-economic equilibrium?

According to neo micro-classical theory, zero transaction costs, convex production technologies, and the absence of externalities, ensure that the competitive market equilibrium is both efficient and invariant under redistribution of property rights (up to mild income effects). However, once transaction costs are introduced, the equilibrium resource allocation varies when the distribution of property rights varies; and furthermore, total transaction costs vary as well. Hence, changes in social losses due to transaction costs must be considered in any evaluation of a political-economic equilibrium involving changes in the assignment of property rights.

But how does one identify and quantify the changes in transaction costs in consequence of changes in the distribution of property rights? On a priori grounds, it can be showed that shifting property rights from resource owners to resource users is bound to reduce transaction cost; and in general any change in property rights lowering the volume of transactions will, ceteris paribus, lower total transaction costs.

To see this, notice that any transfer of property rights – from those who in the ensuing competitive equilibrium will be resource owners to those who will be resource users – reduces transaction costs; that is because the transfer of resources is an exchange maximizing the net value of output, by moving the resources from their owners to those having a comparative advantage in the use of those resources. Clearly, current resource owners are not likely to voluntarily give up their property rights in income-producing resources, and the very fact that in recent times they have not used their resources themselves indicates that they lack a comparative advantage as users.

On the other hand, those who have used the resource despite their higher cost are more
likely to enjoy a comparative advantage in resource use. Consequently, transferring the property rights from current owners to the actual users is likely to minimize transaction cost due to the smaller volume of transactions in property rights. Also, any reduction in the volume of transactions implies a saving in the costs of those transactions which are no more performed.

The *ex ante* valuation of the change ordinarily requires some prior information, which may or may not be derived from observed pre-redistribution behavior. Some information may become available only after the redistribution of property rights, when the new equilibrium has been established. Such information permits *ex post*, but not *ex ante* evaluations. Thus, resource prices and production technology employed by producers prior to a shift in the assignment of property rights is, in principle, knowable along with the pattern of resource hiring. This information may be used in estimating ex ante transaction costs associated with the then existing transactions. In some cases this information may be employed in predicting changes in production and resource utilization patterns. However, if the change involves a previously unobserved production technology and resource hiring patterns, then it may be impossible to predict changes in transaction costs, although these may be estimated ex post.

Consider, next, a structural policy imposing constraints on the choice of contractual arrangements (e.g., rent contracts control). It is presupposed that such constraints do not reduce the parties’ uncertainty, and that neither do they contribute to the reduction of bargaining costs or to a more efficient adjudication of contractual disputes.\(^9\) Neither do they eliminate interim contractual externalities.\(^10\) Then, given a complete and effective system of property rights, and assuming the complete absence of inter-contractual externalities, the

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9Public authorities actually impose many statutory constraints on contractual choices which do contribute to economic efficiency by narrowing down bargaining spaces, reducing the parties’ uncertainty and supporting contracts through effective adjudication of contractual disputes.

10The term, inter-contractual externality, refers to a situation where decisions taken in one contract (contract *A*, say) affect the well-being and/or behavior of some parties in another contract (contract *B*, say). None of the parties to contract *B* is identical with any party to contract *A*, so that no party to contract *A* is directly affected by the effects of its own decisions on the parties to contract *B*. An externality relation is thus created. Many such externalities exist and the phenomena may entail severe social losses which are widely spread in real economies.
unconstrained equilibrium collection of contracts is economically efficient, which also implies the minimization of transaction costs. Hence, effectively restricting contractual choice will likely lower the economic efficiency of the equilibrium collection of contracts, provided, of course, that such constraints do not contribute sufficiently to the elimination of existing intercontractual externalities.

Note, too, that a restrictive policy which also eliminates entirely the inter-contractual externalities also removes all social losses entailed by these externalities. To the extent that such social losses are sufficiently large, the efficiency of the equilibrium collection of contracts may actually increase. Note, too, that no participant in the equilibrium collection of contracts has any incentive to minimize the negative effects of the inter-contractual externalities for this participant will have to bear the full cost of its actions, without fully capturing the resulting social benefits. This is because, by definition, all relevant effects are external to all participating parties.

Only effective state intervention can achieve this, if at all. Hence, when removable intercontractual externalities do no exist, any restrictive public intervention is bound to be inefficient.

Given the above conditions for economic efficiency, one should not be at all surprised by the failure of many legal constraints on contractual choice (e.g. legal constraints on rental contracts, legal constraints on the rate of interest in credit contracts).

How can one evaluate the loss of allocative efficiency due to the restrictions imposed on the permissible set of contracts? Supposedly, this could be achieved by comparing the equilibrium collection of contracts in the absence of publicly imposed constraints with the equilibrium collection obtained under the restrictive policy. This would not be a simple task, but, in principle, it is doable.
6.5 Conclusion

Normative political-economic analysis is concerned with the evaluation of the allocative efficiency of the political-economic equilibrium. Even though it is obtained as a maximum of a weighted sum of the organized interest groups’ and policymaking centers policy objective functions, a political-economic equilibrium is not necessarily efficient. Furthermore, any attempt at evaluation must deal with a great variety of elements impinging on the efficiency problem.

A criterion which would reduce all diverse efficiency aspects to a common denominator is required. It turned out that the criterion generally employed in policy evaluation and benefit-cost analyses of public projects fits best the prerequisites of normative political-economic analysis. This criterion may be interpreted as the sum of all individuals’ “willingness to pay.” The criterion, in effect, adds up the valuations by many diverse individuals; the underlying assumption being that an effect valued at one dollar by one individual is socially equivalent to an effect valued by another individual at one dollar. Distributional aspects are, consequently, ignored altogether. Costs and benefits associated with a political-economic equilibrium were classified into three principal categories: economic surpluses, political-economic transaction costs, and purely economic transaction costs. Social benefits and costs in all categories are measured relative to the non-intervention equilibrium.

It was also possible to establish four sufficient and almost always necessary conditions for the efficiency of a political-economic equilibrium. The conditions refer to the underlying political power structure. Hitherto, the normative analysis has been focused on policy evaluation, largely avoiding prescriptive statements. Yet, normative prescriptions are suggested as by-products of the foregoing analysis. Furthermore, in the context of endogenous policy formation, prescriptive statements necessarily refer to constitutional and institutional choices expected to produce conditions (a) through (d) (Rausser and Zusman, 1992). The scope for policy recommendations is rather narrow, for policies as such are endogenously determined. Yet, as real political-economic systems do not always function perfectly, it is
not unlikely that a currently adopted policy may be improved by designing another, more
efficient policy, that also serves as a solution to the prevailing political-economic bargaining
game. Arguably, the resulting improvement is of limited necessity.

Efficiency conditions (a) through (d) clearly suggest that the political-economic equilib-
rium is not necessarily efficient. Since the efficiency conditions are quite restrictive, and as
political-economic transaction costs are practically unavoidable, one expects many political-
economic equilibria to be inefficient. While government action may be called for in cases of
severe market failure, the present theory implies that such intervention will actually come
about whenever it is in the interest of a sufficiently powerful group or coalition of groups.
Hence, unless constitutionally prohibited, governmental intervention occurs as soon as such a
group, or coalition, emerges – a development that may have nothing to do with market failure.
Because government intervention usually entails deadweight social losses the redistributive
objectives of the powerful are often conducive to sub-optimal political-economic resource
allocation. Since a political-economic status quo ordinarily consists of a political-economic
equilibrium corresponding to an unbalanced power structure, such a state is economically
inefficient.

In Chapter 5 it is argued that such a political structure is locally stable. However,
as economic inefficiencies persist, the legitimate base of power of the status quo forces is
progressively eroded, eventually leading to a political crisis and policy reforms.

Finally, it should be reemphasized that policy is made under a great deal of ignorance
and uncertainty through a conflict-ridden, highly frictional, process. Consequently, errors
abound and potential policy improvements are conceivable even under the prevailing power
structure. Thus, provided individual policy preferences are faithfully reflected by the various
policy objective functions, the maximization of W in itself will likely yield possible policy
improvements, given the prevailing power structure. Such policy improvements also have
the added advantage of being politically more acceptable.