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GENERAL INTRODUCTION

Until about 200 years ago, almost everyone faced the prospect of an incredibly poor life with essentially no prospects for growth. Per capita income during the first millennium, for example, was constant at about US$500 (in today's dollars!). And most of the next century saw little in the way of expanded opportunities. Indeed, until the early 1800s, average per capita income was only a couple of hundred dollars higher, and the average growth rate increased to just above zero.

Why have societies so consistently failed to generate high standards of living and why, even today, do so many societies live far from the frontier of the developed world's economic possibilities? No question may be more important for social science to answer.

This series of edited volumes brings together literatures from politics, law and economics that, when considered together, can help scholars, policymakers and business professionals make progress on this dilemma, and do so in a manner that is theoretically sound, empirically relevant and socially feasible. From an engineering viewpoint, the question of how to grow an economy appears rather simple – unleash innovative efforts so that individuals can expand consumption possibilities from limited resources. But this process is not always a smooth one and even when business cycles are small and infrequent, a growing economy can create resistance from those who find it hard to adjust to constantly changing opportunities in a dynamic economy.

By lowering the cost for individuals to discover economic opportunities, measure the attributes of goods and services and enforce terms of trade, laws can help societies productively address such obstacles. As history has shown, however, making such laws is fundamentally hard. Indeed, more often than not, laws emerge from a political process that looks more like a zero- or negative-sum game than a mutually agreeable effort to expand general economic opportunities.

This introduction presents a brief sketch of some of the theoretical perspectives that underlie political economy, while the four volumes in this series address these issues from the ground up. The first two volumes are aimed at letting readers see the fundamental constraints that political processes impose on legal frameworks. Volume III, then reviews important contributions to the theories of economic growth and fluctuations, as well as theories of how those macroeconomic outcomes relate to politico-legal foundations. Finally, Volume IV takes a 'micro-governance' approach to the problem, looking at how corporate law and intra-firm politics influences business performance, which in turn forms an intermediate base for the macroeconomic aggregates by which social welfare is often measured.

A theme of the articles collected in these volumes is that the purpose of *political economy* is to provide a theoretical framework for designing human institutions. One of the themes that we develop is that the theoretical work asserting that markets optimally aggregate preferences needs to be generalized to extend preference-based theories to include belief formation. A consequence of this change is that the theory is no longer purely axiomatic, but draws on insights about human behaviour from other disciplines and empirical analysis of the role institutions play in determining beliefs.

In our view what gives political economy a degree of coherence is precisely that it is an attempt to construct a general theory of human behaviour. That is to say, the theory is a conceptual framework through which to analyse the interplay and consequences of human incentives within institutions. This may explain why, long before rational choice theory migrated from economics into political science, it had been used by the Marquis de Condorcet in late eighteenth-century France to provide a framework for the design of good government and society.[1] A universal theory of human behaviour should be equally applicable in either politics or economics. To assess the merits of political economy, then, requires an understanding of how it has evolved, regardless of which discipline served as the site of the various stages of its evolution. We shall argue that the primary motivation for practitioners of political economy, in the course of its evolution since the 1950s, has been to create an integrated, empirical theory of market and polity that would serve the normative purpose of designing good institutions. It has become increasingly obvious that to create such a theory, it is necessary to understand how individuals form beliefs about empirical reality and how they act in response to both their normative preferences and their beliefs. As this theory evolved, it led to changes in our understanding of how to devise good political and economic institutions, inasmuch as the economists' equation of good with Pareto optimal no longer appeared adequate. Given that people's beliefs – their empirical models of the world, their private information and so on – vary so much, the aggregation of people's preferences (or values) so as to achieve Pareto optimality could no longer be the normative basis for design. This realization has led to a return to Condorcet's original desire to evaluate human institutions as devices both to aggregate preferences and integrate beliefs.

We shall discuss in some detail below how only one component of Condorcet's concern, namely preference aggregation, was developed by economists, and particularly Kenneth Arrow (1951), in laying the foundation for a rational choice theory of political economy. Whereas the work in the tradition of Downs (1957) and Olson (1965) had the virtue of simplicity in construction and prediction, the more recent efforts have shown that the predictions of these preference-based models were not corroborated, in general, in the behaviour of real polities.

In the rest of this introduction we shall consider the various attempts to construct a closed (or consistent) preference-based theory of human behaviour in both economics and politics and show, in each case, why there were logical reasons to extend the theory beyond preferences to beliefs. As the discussion proceeds, we hope to make it clear why the normative economic criterion of Pareto optimality began to appear less appropriate than the Condorcetian criterion of truth. We use 'truth' as shorthand for the property of a human institution to efficiently aggregate the dispersed information held by its individual members.

The earliest effort in this direction was Condorcet's demonstration that, among a jury judging the innocence or guilt of a defendant, a majority vote will more often be correct than the response of an average juror. As the size of the jury, or society, becomes very large, the probability that the majority will be right approaches unity. This theorem seems to justify democratic procedures for belief aggregation (of a certain kind) as optimal.

As political economy has evolved, it has been obliged to become less axiomatic in structure. Indeed, the increasing emphasis on beliefs suggests that it will, of necessity, have to draw on insights from other behavioural sciences, including anthropology, linguistics and psychology. Since the theory also includes the role of institutions in determining human choice, it is likely that there will be continuing interaction between empirical and theoretical research on this topic. Let us amplify these remarks by briefly discussing how the rational actor theory employed by economists in the 1950s was later obliged to address larger questions of social choice that were anticipated by Condorcet.

Neoclassical economic theory can be viewed as the analysis of human incentives in a particular restricted context of fixed resources, private goods and a given technology. As such, it is a theory of preference aggregation. The work of Arrow and Debreu (1954) did assert, however, that, in this restricted context, the competitive price equilibrium would be Pareto optimal. In discussions of market behaviour, economists often go on to assert (a claim that, as far as we know, is unproven) that only a competitive market can efficiently aggregate the diverse beliefs of the members of a heterogeneous economy. If this were true, then non-market, planned economies would be inadequate to the task of integrating the dispersed information that underlies these divergent beliefs.

Since the difference between preferences and beliefs is important, but subtle, it is worthwhile briefly discussing how market institutions do aggregate beliefs. Foreign exchange markets, futures markets, financial markets and so forth may seem to be driven by the preferences of buyers or sellers, but in truth the motivations of the agents are derived from their own private information and their expectations of commodity price movements. Rational expectations, or the convergence of agents' expectational beliefs, can be thought of as the appropriate type of truth in markets. However, this convergence in beliefs need not occur.

Thus, in an attempt to develop the analysis of human incentives, rational actor theory has been forced to go well beyond the preference-based study of private-goods markets. The intimate connection between preferences and beliefs has necessitated an attempt to reconstitute a general theory of rationality; this is exactly what game theory is about. Moreover, some goods are public, and jointly produced and consumed. Some such public goods (like technological innovation) may be produced and consumed within the economic system, but others, such as national defence and domestic security, are more traditionally created through the political system.

Since one method of political choice is by some form of democracy, the need to extend the theory to public goods translates into a requirement to analyse democratic polities to determine not only preferences for such goods, but the incentives to produce them, given people's beliefs about others' willingness to pay for them. It should be noted here that the distinguishing feature of rational choice theory in its market-based form was its emphasis on the connection between preferences, equilibrium and optimality. The attempt to enlarge the domain of the theory from economics to political economy retained these key concepts. Moreover, the non-market institutions that constrain human behaviour are obviously important for the way individuals construct their preferences and beliefs, and for the methods by which these are aggregated. The need to examine this question has become more important in the last few years, as research has attempted to model different political institutions. The general theme underlying this research has been, we believe, a desire to determine whether or not democratic political institutions are compatible, in some sense, with market efficiency.

A very extensive public choice literature, particularly in the 1970s and 1980s, argued that democratic political choice was not compatible with market efficiency. The various arguments are too numerous to list here, but in general they asserted that democratic polities created the context for political rent-seeking that constrained economic growth. Indeed, political representatives were viewed as creating rents for themselves, with the consequence that government growth was accompanied by deleterious economic consequences. The debate is, of course, still being carried on, and it underlies many of the tensions that exist between the Anglo-Saxon polities of the United Kingdom and the United States and the member states of the European Union. The debate is even more intense in the United States, between Republicans who intend to reduce the size of government and Democrats who believe that government should ameliorate the effect of the market.

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The public choice literature, while influenced by theoretical, rational choice models, was also directed at explaining empirical facts. This mix of theoretical and empirical reasoning we shall term positive theory. Since positive theory attempts to explain facts of the world, it must address questions of empirical corroboration or falsification.

Early positive attempts to apply economic theory were based on a model of market behaviour that assumed that agents are completely characterized by their preferences, and that they respond non-strategically to prices. To some degree the inferences of this model have been corroborated in relatively simple situations. However, this preference-based theory has had little success in either modelling choice under strong uncertainty (see Denzau and North 1994) or explaining large-scale economic change over time (see North *et al.* 2009).

More importantly, the attempt to use rational actor theory as a basis for macroeconomics has not been particularly successful. Although macroeconomics purports to describe the real economic world, it often appears to be a tower of Babel, populated by Keynesians, monetarists, supply-siders and so on. On the other hand, most macroeconomists would accept, in general terms, the postulates of microeconomic theory, and the notion of rationality in particular. The empirical weakness of microeconomics has not led economists to reject this theory, but rather has led them to attempt to develop more complex models of rationality (Camerer 2003). As we have suggested above, the imperative for game theory has been to extend simple models based on preferences so that agents' beliefs are made more explicit.

Is political science more like macroeconomics or microeconomics? Political science is driven by the age-old problem of how we are to be governed. The Founding Fathers and particularly the authors of *The Federalist*, were concerned precisely with the normative problem of the proper form of government. We would go so far as to suggest that Hamilton and the other Federalists were rational choice theorists of a kind. To substantiate this we might mention the recent observation of Gordon Wood that the Federalist notion of government rested completely 'on the assumption that most people were self-interested and absorbed in their private affairs' (1991: 264). Of course, the Founding Fathers did not engage in empirical political science, as we would understand the term empirical today. Nonetheless, they were men of practical reason who made intelligent guesses about the way self-interested individuals were likely to behave under different systems of government. For example, Madison argued in *Federalist X* that

> the greater number of citizens and extent of territory may be brought within the compass of Republican, than of Democratic Government; and it is this circumstance principally which renders factious combinations less to be dreaded in the former, than in the latter.
>
> ([1787], 1999: 166)

Not only does Madison essentially apply a Condorcetian[2] form of argument in *Federalist X*, but he distinguishes between opinions (i.e. beliefs) and passions (i.e. preferences).

If we distinguish the normative political theory of the Founders from the current study of American, comparative and international politics, and if we call the latter political science as opposed to political theory, then it is true that political science is now predominantly empirical, just as macroeconomics is. This by no means entails that empirical political science is epistemologically superior in any way to political theory (whether normative or rational choice). Our own view is that if political science focuses principally on empirical relationships rather than on the evaluation and design of government, then it is seriously wanting. We can regard social choice theory as an attempt to construct a normative basis for social decision-making that extends the rationality postulates of microeconomics.

Notes

1 The period 1759 to 1788 saw the publication of major works on 'social design' in Britain and the United States as well as France. These include Adam Smith ([1759] 1984; [1776] 1981), Condorcet ([1785] 1994; [1795] 1955) and Madison in *The Federal Papers* (1787).

2 As mentioned above, Condorcet's Jury Theorem asserts that a jury, using majority rule, is more likely to make a correct decision than a typical juror.

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INTRODUCTION

Part 1 Social choice

Microeconomics adopts the postulate that individual preferences are consistent. However, a variety of consistency axioms can be adopted. The most restrictive one, common in microeconomics, is that each individual's preference can be represented by a (numerical) utility function. This strong assumption implies that both strict preference and indifference are transitive: if *a* and *b* are equally preferable, as are *b* and *c*, then so are *a* and *c*. The standard example of non-transitive indifference, however, is a cup of coffee with no sugar, which is indifferent compared to a cup with a single grain of sugar, to one with two grains and so on, but not to one with a thousand grains. A weaker consistency assumption is that of the transitivity of strict preference, but not of indifference. Even weaker is the assumption of acyclicity: if *a* is strictly preferred to *b*, *b* is strictly preferred to *c*, *c* to *d* and so on to *x*, then *x* cannot be strictly preferred to *a*. Acyclicity guarantees that an individual may always make a choice, that is, select an alternative, such that if *a* is chosen, none of the other alternatives can be preferred to *a*.

Arrow's famous *possibility theorem* (Arrow, 1951) was concerned with the normative task of aggregating such transitive individual preferences into a transitive social preference. The theorem showed that a *necessary* condition for this to be possible, no matter what the individual preferences were, was that the social rule was *dictatorial*. The first two papers in Volume I, by Amartya Sen and Prasanta Pattanaik (Chapter 1) and Mark Satterthwaite (Chapter 2) explore the ramifications and extensions of Arrow's Theorem. The papers by Kenneth Arrow (Chapter 3) and Ken Binmore (Chapters 4 and 5) explore the normative ramifications of social choice.

Table 1 sets out one view of the relationships between the various branches of economics, political economy, and politics that we shall develop in the other volumes. As the table suggests, rational choice theory as applied to politics is only one among a number of different research activities, all characterized by their varying degrees of emphasis on the normative, the theoretical, the positive and the empirical.[1] The table is also meant to emphasize the close connections between game theory and the adjacent theoretical and positive subfields.

Table 1 A classification of economic and political theories

	Economics	*Political Economy*	*Politics*
Normative	Welfare economics	Social choice	Normative political theory
Theoretical	Market (equilibrium)	Game theory	Rational choice theory
Positive	Public economics	Public choice	Theory of institutions
Empirical	Macroeconomics	Institutional political science	Political economy

Market theory utilizes the idea of equilibrium to relate economic parameters (resources, preferences, technology) to an outcome or choice. Welfare economics and public economics (research fields that are subsidiary to market theory) are designed to address normative and positive aspects of the relationship between government behaviour and the economy. Public economics deals with the appropriate relationship between government and the economy, while macroeconomics covers the empirical aspect of this relationship.

In an attempt to provide a formal basis for public finance and government, the economist must determine whether the domain of market theory can be enlarged to include non-market phenomena, such as preferences for public goods. Arrow took the first step in this programme by asking if the preferences of the individuals making up a society could be aggregated to construct a measure of social welfare. Although his social choice theory addressed certain concerns that economists regard as essential, including the compatibility of the market and democracy, nothing about that theory restricts it to either welfare economics or political theory. Still, for an economist, the question of the compatibility of the market and democracy must be expressed in a formal language that is general enough to include economic theory.

Economic theory *circa* 1954 used assumptions on the preferences and resources of individuals to demonstrate the existence of a market equilibrium. To enlarge its theoretical language so as to model democracy, the nature of citizen preference was extended from private goods to public goods. However, the fundamental concept of preference had to be retained. Since the question involved the degree to which the market equilibrium result could be generalized, it was necessary to pose it in terms of the existence (or otherwise) of equilibrium.

While economic theory concentrates on preferences, it usually adopts the postulate that individuals' behaviour will be given by their choices (if such exist). Where the outcomes are uncertain, or involve risk, behavioural predictions may associate a list of probabilities with the final eventualities. Theorists often assume that preferences under risk behave as if they were weighted by these probabilities. Yet it is entirely possible that real individual preferences in the presence of risk may fail acyclicity, leading to apparently irrational or inconsistent behaviour (Kahneman and Tversky 1979). In our view the postulate of acyclic consistency is reasonable in the absence of risk, but is less tenable in its presence.

Rationality postulates combine with various structural assumptions about the nature of the economic system to yield an economic equilibrium that is Pareto optimal in the sense that no other allocation of resources is preferred unanimously. In the absence of a price mechanism, as in politics, rational choice theorists utilized the notion of the 'core'. An outcome is in the core if no coalition of agents is able and willing to bring about a different state. The concept of a core was devised, in part, to cover situations involving public goods.

The genius of Arrow's result is that it suggests that, in general, a social utility function cannot be defined, negating the assumption that individual preferences could be aggregated so as to describe an optimal provision of public goods. In a sense, Arrow showed that the assumptions economists typically employ in modelling individual behaviour are unlikely to hold where public goods are concerned. For while it is reasonable to assume that individuals prefer more rather than less of a private good, it is entirely possible that among them, individuals can have extremely complex preferences in the public domain. More of my public good may be more of your public bad. While we may want extensive military expenditure, you may loathe the military and prefer good schools, parks, environmental protection and so forth. Since there is no obvious a priori restriction on the possible set of public preferences that individuals may have, Arrow adopted the unrestricted domain assumption. That assumption allows each individual to have any preference, as long as it satisfies transitivity of both strict preference and indifference. Under this assumption, the only social rule that satisfies the unanimity condition must be dictatorial. More generally, any social utility that can be used to make social choices based on individual preferences must necessarily be dictatorial.

If preferences could be equated with utilities, then social utility could be obtained simply by summing individual utilities. But economists believe in general that interpersonal comparisons of utility are scientifically meaningless, since it is impossible to extract the information required to construct such comparisons. Certainly markets and voting mechanisms, when viewed as methods of preference aggregation, do not provide the means of obtaining such information. However, if markets and polities are modelled as devices for aggregating both preferences and beliefs, then it is possible that the negative inferences of the Arrow impossibility theorem could be avoided. As Arrow (1986) himself observed, before this could be attempted, it would be necessary to deal with the question of *common knowledge* – the foundation of our beliefs about the beliefs of others.

Duncan Black (1958) reintroduced Condorcet's work to a modern audience and thus contributed to the extension of preference-based theory to include the analysis of beliefs. Almost all the elements of what has come to be known

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as spatial voting theory are present in Black's *The Theory of Committees and Elections*. Just as Arrow had investigated whether individual preferences could be aggregated into a social utility function, Black investigated the possibility of equilibrium in voting systems. In this context an equilibrium is a point or outcome that is unbeaten (although it need not beat every other conceivable point). Suppose that three voters have distinct preferred points on a left–right political continuum, and that each voter has single-peaked preferences (preferences that are maximized at a single point). Then the middle (or median) voter's preferred point cannot be beaten under majority rule, where a majority requires two out of three. Black called this equilibrium a 'majority motion' in his book. In more recent work, the voting equilibrium is known as the *core*.

Part 2 Equilibrium and cycles

Suppose now that the decision problem involves more than a single continuum. For example, preferences for social liberalism or conservatism might be independent from preferences for economic liberalism or conservatism. Under such conditions, even with single-peaked individual preferences, the likelihood of the existence of an equilibrium is negligible. As Black writes, 'the conditions that must be satisfied before there can be any majority motion are highly restrictive. The frequency of occurrence as a fraction of the total number of cases possible . . . is infinitesimally small or "practically zero"' (1958: 139).

Indeed, Black seemed to equate cases without an equilibrium with the occurrence of cycles, so he apparently took it for granted that when there is more than one dimension to voters' preferences, voting cycles will occur. Economics postulates that any observed behaviour must express an actor's preference. A voting equilibrium, therefore, would be expected to manifest collective preferences. If there is no equilibrium, however, the theorist can make no behavioural predictions. Chapter 6 by Charles Plott gives an analysis of the necessary conditions under which a majority rule voting equilibrium would occur, suggesting that indeed, the possibility would be practically zero. Later papers by Richard McKelvey (Chapter 8) and Norman Schofield (Chapters 9 and 10) explored the conditions under which the core would be typically empty and cycles could wander *chaotically* through the policy space. Two other papers by Gerald Kramer (Chapter 7) and Schofield (Chapter 11) looked for conditions under which there would be a supermajoritarian equilibrium, requiring more than a simple majority. Schofield and Craig Tovey (Chapter 12) and Tovey (Chapter 13) considered the probability of core existence when the electorate is sampled from a population distribution that is centred on the origin. Chapter 14, the final paper in this section, is based on the lecture on social choice that Amartya Sen gave in Stockholm in December 1998, when he received the Alfred Nobel Memorial Prize in Economics.

In the absence of a behavioural prediction based on preference theory, the natural step was to account for observed outcomes by modelling the way beliefs influenced behaviour. To be more specific, it appeared plausible that the outcome would depend on the expectations of agents, their ability to bargain by making guesses about other agents' behaviour and so on. One of the important results in the purely preference-based theory of voting was that voting cycles could, in principle, go everywhere in the policy space. Yet this occurrence of theoretical indeterminacy or chaos did not necessarily imply behavioural chaos, since there existed no belief-based model about what voters would actually do in the context of theoretical chaos. Indeed, experimental work by Fiorina and Plott (1978) seemed to demonstrate that coreless games do not produce markedly more unstable outcomes than do games with cores. The empirical work did suggest that a rational choice theory that incorporates beliefs should smooth out the difference between games with and without a core.

The work on theoretical voting chaos represented in this section induced a period of intense debate within rational choice political theory (see also Rubinstein 1979 and Cox 1984). Two of the protagonists in this debate, Riker (1980, 1982, 1986) and Tullock (1981), drew quite different conclusions concerning the significance of chaos results for the study of legislatures.

Formally, the chaos theorems on which they drew apply only to committees, where there is some foundation for supposing the voters have well-specified preferences. It is not at all clear that representatives in a legislature can be assumed to have preferences that are similar in kind to the members of a committee. It may be intuitively plausible that each legislator seeks to provide certain kinds of 'goods' to constituency members. But until the voter–legislator connection is modelled in detail, there is no formal rational choice basis for the study of a US-style legislature.

Part 3 Bargaining and electoral competition

Michael Laver and Norman Schofield (1990) argue, however, that it is plausible that the models of committee voting are applicable to European-style legislatures involving well-disciplined parties. In particular, it appears reasonable to assume that party leaders in such legislatures do have preferred policy outcomes, and that they attempt to construct legislative majorities to implement these policies. In Chapter 15 Schofield and Laver produce empirical predictions on payoffs in the form of cabinet portfolios in European cabinets. One insight that comes out of this work concerns the possibility that a large non-majority party may form a minority government when its preferred point is at the core or equilibrium position in the policy space. In general legislative political games, however, there will be no core. Chapter 16 by David Baron and John Ferejohn, and Chapter 17 by James Snyder, Michael Ting and Stephen Ansolabehere provide bargaining

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models that are applicable to the examination of legislatures, with or without a core.

Rational choice theory also provides a logical framework within which to make some sense out of some well-established empirical relationships that have been noted in multiparty political systems. For example, the fragmentation of parliamentary systems into many small parties is highly correlated with government brevity in the European systems. It should be obvious that in the absence of a core or policy equilibrium, any government that does form may be defeated by another majority coalition with a counter-policy proposal. Thus a connection between political fragmentation and the remote probability of a core would give insight into macropolitical relationships.

There is a venerable tradition on the connection between proportional representation and political fragmentation (Duverger 1954). The empirical work by Taagepera and Schugart (1989), for example, provides a detailed examination of this connection. European polities in general use proportional representation and typically have more than two parties. Duverger (1954) argued that this tends to result in weak government. By the same token, there is some evidence that plurality systems based on single-member constituencies tend to produce two parties and thus a clearer electoral choice. The British electoral system, for example, which clearly is a plurality, or first-past-the-post arrangement, has always tended towards two dominant parties. While this is consistent with some rational choice models of elections, Duverger's argument that small parties will wither away under plurality is confounded by the continued presence of small British parties such as the centrist Liberal Democrat party in the United Kingdom. Indeed, this party became a member of the coalition government, with the Conservative Party, after the 2010 election.

On the other hand, although the United States is usually regarded as having a two-party system, its parties appear less disciplined, in general, than European-style parties. In particular, members of Congress are generally more heterogeneous in their voting behaviour than one would expect within a European-style party system. The political science literature, from Duverger onwards, is even more inadequate in terms of the theoretical (rather than empirical) analysis of these relationships. Our own view is that the formal analysis of elections should start with a general conception of electoral laws and deduce facts about the number and nature of political parties.

There are two distinct classes of models of electoral competition. The first class assumes that voting is *deterministic*. That is, the candidates make promises and each voter picks a candidate depending on which promise the voter prefers. Within this class of models, policy blind models assume that the candidates gain no utility except from winning, and that they attempt, therefore, to gain the maximum number of votes. Just as in the committee model examined by Black, if the space of possible outcomes is one-dimensional,

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then two rational candidates will make the same promise, attempting to occupy the point at the median voter position.

As an economist, Downs (1957) could be justified in viewing this as a solution to the equilibrium problem in political economy. From the perspective of public finance, two-party competition could be assumed to provide a median tax schedule which could then be used to cover the provision of the public good in question. Obviously, however, government provides more than one public good, so individual voter preferences must be described in more than one dimension. The results from the committee voting model imply that, in such cases, there will be no core. In other words, no matter what one candidate promises, an opponent can promise something else that will obtain a majority. From the perspective of non-cooperative game theory, the non-existence of a core means there is no pure strategy Nash equilibrium (PSNE) in the two-candidate game.

The obvious theoretical response is to develop a more general notion than the core. The nice feature of the so-called *uncovered set* (McKelvey 1986) is that the support of mixed strategy Nash equilibria (MSNE) of the voting game will belong to this set. Thus, the political economist can assert that actual political outcomes will lie in the uncovered set. To some extent, at least, the theoretical problem of equilibrium is thus solved.

However, the motivation for this modelling strategy comes from economics, not political science. Its sole purpose is to solve the formal requirements of public economics, not to describe actual politics. Indeed, any model that predicts that candidates will make identical promises cannot be considered to have made any effort to characterize real politics.

Wittman (1977), and others, have attempted to inject some political reality into the model by assuming the candidates are policy motivated, in the sense that the candidates' own policy preferences are reflected in the promises they make. A candidate may, for example, contract with a group of supporters to constrain his or her personal policy objectives in a certain way in return for campaign contributions. A policy-motivated candidate may find a way to be more credibly committed to supporters' objectives, and thus raise much greater campaign contributions, than a pure election-seeking candidate. In any case, the possibility of a trade-off between contributions and voting suggests that a PSNE can exist where the candidates make quite different promises.

The second class of electoral models assumes that voters are *probabilistic* rather than deterministic. Once the candidate promises are made, a voter in the deterministic model chooses one of the candidates with certainty (except when the two candidates are identical in all respects). In the probabilistic model, on the other hand, the voter's behaviour, after the candidate promises are known, is a random variable which is based on the voter's beliefs about the likely consequences of the choice. In particular, such beliefs should deal with the estimates each voter makes concerning the likelihood that the candidates will deliver on their promises.

The advantages of the probabilistic model are twofold. First, if voter preferences and candidate promises (or positions) are known, then it is possible to model the voter response econometrically. The early empirical work concentrated on two-candidate models (Enelow and Hinich 1984), but recent research has modelled multicandidate and multiparty competition.

It is important to note that the probabilistic model is continuous in voter and candidate positions, and the chaos theorems (mentioned above) do not apply. Because the total vote for each candidate is a random variable, it can be characterized by its expectation and variance. Probabilistic models typically assume 'pure-election seeking' candidates who make promises to maximize their expected vote. The usual result in models of two-candidate competition is that there exists a PSNE where both candidates propose the mean rather than the median position (Coughlin 1992; Lin, Enelow and Dorussen 1999). This result solves the equilibrium problem of public economics very neatly.

Chapter 18 by Richard McKelvey and John Patty, and Chapter 19 by Norman Schofield present extensions of the probabilistic model of voting. McKelvey and Patty consider what happens in the case of a large electorate, while Schofield obtains the necessary and sufficient conditions for convergence of parties to the electoral mean. Schofield assumes that party leaders are viewed in different ways by the electorate, some have high valence (or quality) and some low. If the valence differences are low enough, and the electoral variation is also low then the parties will converge. On the other hand, if the valence differences are high, and the electorate is polarized, in the sense that the electoral variation is high, then parties will diverge. Recent extensions of this model have been applied to Israel and Turkey (Schofield and Sened 2006; Schofield *et al.* 2011).

The last paper in Volume I, Chapter 20 by Timothy Feddersen and Alvaro Sandroni, deals with a perennial problem in voting theory: why do citizens vote when it is costly to do so, and it is unlikely that any voter can change the outcome. Their paper refers back to the work of Condorcet and Madison, in the sense that they model a situation where some voters have a sense of civic duty in that they wish to choose a candidate who they feel is better for the country, rather than voting in terms of their own selfish interests.

Our observations about these models are intended to highlight the differences in the requirements of public finance and formal political theory. For public finance, the motivation is to extract predictions about political choice that can be used to evaluate the optimality of public decisions concerning taxation and public goods provision. The need to add greater political verisimilitude has obliged political theorists to address questions of belief formation (particularly regarding what voters believe the winning candidate will do after the election) and candidate commitment. From the perspective of public finance, the more refined model appears untidy and less parsimonious. The political theorist, however, faces the quite difficult task not just

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of comparing predictions with reality, but of evaluating how reasonable the assumptions about belief formation are. It is only recently that these belief-based models have been developed to a degree sufficient to offer plausible predictions.

Note

1 We distinguish here between empirical research and positive research. While the latter is based on theoretical arguments, it also attempts to make assertions about the empirical world.

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INTRODUCTION

Part 4 Legislatures and voting

The first section of Volume II focuses on applying versions of the formal model of voting to political institutions such as the US Congress and President. Chapter 21, by Nolan McCarty, Keith Poole and Howard Rosenthal examines whether it is party discipline that forces apart the members of the parties. It has become a common theme in recent years that politics in the US is highly polarized, even though the general electorate, while heterogeneous, appears to be much less polarized (Fiorina *et al*. 2005, Fiorina and Abrams 2009). In Chapter 22 Gary Miller and Norman Schofield use a formal model to provide an explanation of this paradox. They argue that neither the equilibrium theory of Downs nor Riker's arguments about chaos are valid; instead they suggest that activists pull the parties apart. But the activists themselves must form coalitions to be effective, and these coalitions slowly shift with time, inducing a slow rotation of party positions over time. The authors note, for example, that the north-east states tended to vote Republican in the elections around 1896, but now form the heartland of the Democrat party. Chapter 23, by Geoffrey Layman, Thomas Carsey and Juliana Horowitz, reviews the empirical and theoretical literature on polarization in US politics. In Chapter 24 Samuel Merrill, Bernard Grofman and Thomas Brunell build on earlier work by Alesina and Rosenthal (1989) and Alesina *et al*. (1993) and present empirical evidence that these cycles do occur.

In Chapter 25 Elizabeth Penn considers a very general equilibrium model where voters look into the future and guess what will happen. An equilibrium in this model is one where votors' current actions are compatible with their beliefs about the future. Penn uses a clever fixed point argument to show that such an equilibrium will exist under reasonable conditions. In the last article in this section, Chapter 26, James Adams *et al*. examine the difference between mainstream and niche parties.

Part 5 Historical accounts

We may assert that the political economic equilibrium in a society is the result of a bargain between the elite holders of factors of production and those who govern the institutions. A political leader, whether democratically elected or holding onto power by force, must have enough support from the elite or the people, or both, to stay in power. In Chapter 27 Douglass North and Barry Weingast use this argument to address the quandary facing the British Parliament after the glorious revolution of 1688. James II had been forced to leave the country by what was in effect an invasion by William III, who was married to Mary, James's daughter. William had fought the French for many years, and obviously wished to continue the conflict. The fear was that the war would become extremely expensive. War would require a standing army. If William controlled the army then this could give too much power to the monarch, endangering liberty. The solution was to divide control of the standing army between Parliament and the monarch. Although William had the potential to be an autocrat, this Parliamentary strategy restrained his power.

The creation of the Bank of England in 1693 provided a method of imposing credible commitment on Parliament. The dilemma facing any government of that time was that war had become more expensive than government revenue could cover. Consequently, governments, or monarchs, became increasingly indebted. Risk-preferring, or war-loving, monarchs, such as Philip II of Spain or Louis XIV of France, were obliged to borrow. As their debt increased, they were forced into repudiation, thus making it more difficult in the future to borrow. Since the Bank of England 'managed' the debt in Britain after 1693, there was an incentive for Parliament to accept the necessary taxation, thus avoiding the temptation of repudiation. This had the effect of reducing the cost of public debt.

However, the cost of war kept increasing. The War of Spanish Succession (1701–14) brought war weariness, and the governing party, the Tories, sought to avoid the costs (and taxes) induced by war. The fundamental problem was that the majority of members of both the Commons and the Lords were of landed interest. The obvious method of funding government debt (which had risen to £36 million pounds by 1710) was by a land tax. Indeed the land tax raised approximately 50 per cent of revenue. In Chapter 28 David Stasavage addresses this question of credible commitment and argues, contrary to the argument of North and Weingast, that the escalating war debt had made repudiation an increasingly attractive option by 1710. It was not obvious therefore why Parliament would choose to commit to fiscal responsibility. Stasavage goes on to build a conceptual framework that combines partisan politics, institutions and credibility, and applies the framework to compare the situation in Great Britain from 1688 to 1720 with that of France from 1715 to 1789.

In Chapter 29 Douglass North *et al.* briefly sketch the argument about the creation of open access societies discussed in their recent book (North *et al.* 2009). Norman Schofield, in Chapter 30, builds on the comments by Stasavage and develops the notion of a social compact, instituted by Walpole, Chancellor of the Exchequer and First Lord of the Treasury, to stabilize confidence in 1721, after the collapse of the 'South Sea Bubble'. Walpole instituted a complex system of customs and excise, which essentially protected land. This compact between land and capital provided the engine for economic development in Britain, until the repeal of the Corn Laws in 1846. Such a system of protection was against the interests of the poor, and to be maintained required a restriction of the franchise. It was only in 1867 that Disraeli was able to change the nature of this compact, against the interests of his own party, by the electoral reform bill of 1867. Schofield goes on to develop this notion of social compact to elaborate on US history and the political economic synergy between Britain and the US until the dawn of the twentieth century.

In Chapter 31 Kenneth Sokoloff and Stanley Engerman turn to the question of why the US and Canada, which in 1790 were relatively poor in comparison to the Caribbean islands, became incomparably richer two hundred years later. For example, 'Haiti was likely the richest society in the world on a per capita basis.' Sokoloff and Engerman suggest the reason was the difference in factor endowments between North America and the Caribbean. Later work by Acemoglu *et al*. (Chapter 44 in Volume III), argues that the settlers in North America brought with them institutions that had been devised in Great Britain, and had been shown to be conducive to economic development.

In Chapter 32 Philip Keefer presents a review of the literature, extending the institutional arguments of North as presented in his article on 'Economic performance through time' (Chapter 42 in Volume III), and suggests that the existence of political checks and balances provides the best model of why some political economies flourish and others do poorly.

Part 6 Autocracy and new or partial democracies

While many polities have become democratic in recent years, particularly since 1990, Levitsky and Way have commented that

> the post-Cold War world has been marked by the proliferation of hybrid political regimes. In different ways, and to varying degrees, polities across much of Africa (Ghana, Kenya, Mozambique, Zambia, Zimbabwe), postcommunist Eurasia (Albania, Croatia, Russia, Serbia, Ukraine), Asia (Malaysia, Taiwan) and Latin America (Haiti, Mexico, Paraguay, Peru) combined democratic rules with authoritarian governance during the 1990s. Scholars often treated these regimes as incomplete or transitional forms of democracy. Yet in many cases these expectations (or hopes) proved overly optimistic.
>
> (2002: 51)

In Chapter 33 Jennifer Gandhi and Adam Przeworski attempt to understand these hybrid political institutions, where autocrats use the institutions that

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are available to neutralize threats from larger groups. In other words, 'legislatures incorporate potential opposition forces, investing them with a stake in the ruler's survival'.

Przeworski *et al*. (2000) have also argued that modernization (or increase in per capita GDP) is not, by itself, a causal factor in the process of democratization. It is true, however, that rich democratic societies are very unlikely to become autocratic, and it is this fact that generates the relationship between modernization and democracy. If true, this argument is relevant for understanding the likely future of China, for example. 'Partial democracy' is the term used by David Epstein *et al*. in Chapter 35 for polities where democratic institutions are less developed or lack some key components, such as a free press. They note that while the number of pure autocracies may have fallen in recent years, the number of partial democracies has risen. Though these partial democracies may be fairly stable, the institutional theory that we have available suggests that they will lack a system of checks and balances. Theory suggests that their economic development at some point will be stymied. (Of course, the example of China is an obvious counter example.)

Chapter 34, by Norman Schofield and Micah Levinson, attempts to provide an answer to the question: Why would a dominant elite give up oligarchic power and allow a transition to democracy? The authors consider three historical regimes: the Argentine junta of 1976–83, Francoist Spain, 1938–75 and the Soviet system, 1924–91. On the basis of the case studies, it is argued that party dictatorships are more institutionally durable than military or fascist ones.

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INTRODUCTION

In Volumes III and IV, we attempt to organize research that applies models of voting and political institutions to the motivating question of this 'Major Works': why have individuals throughout history, and even today, found it so difficult to organize for economic performance (as opposed to inefficient distribution)? Volume III starts this application by reviewing what we know about the mechanics of economic performance (growth and business cycles). It then investigates political-legal forces that regularly turn the apparently simple engineering problem that emerges from this mechanical understanding into a complex system, the emergent properties of which depart with remarkable consistency from those that generate high levels of wealth and widely distribute economic opportunity.

Part 7 Economic growth and business cycles

Modern macroeconomics arguably starts with Robert Solow's considerable 'contribution' in 1956 to our understanding of how economies grow (Chapter 36). Made famous here is the notion of the Solow-residual – variation in rates of growth that cannot be rationalized by differences in the levels of capital and labour that an economy employs, and must thus be due to differences in rates of technological change. Understanding why such rates differ, both mechanically and from a policy perspective, subsequently motivated scholars in politics, law and economics, and serves as the deep objective that we see unifying the other articles in Volumes III and IV.

Following Solow's article we present, as Chapter 37, Robert Lucas's interpretation of the logic of business cycles.

Chapter 38, Paul Romer's article on 'Increasing returns and long-run growth' formally models the role of geographic concentration and knowledge spillovers in economic growth.

The 'economic growth' part of this section includes perhaps the most ambitious effort of which we are aware to explain the mechanics of economic growth: Chapter 39, Oded Galor and Omer Moav's model of how evolutionary forces could have selected for human traits that ultimately produce the pattern of growth we have observed over the centuries. This work appears remarkable on a number of dimensions, and is especially interesting for our purposes because it formally addresses the transition of economies from

Malthusian stagnation to sustained growth, the type of dynamic whose understanding would appear necessary for successful development policy.

While we know a lot about the mechanics of economic growth, unfortunately, the same cannot be said about economic fluctuations. This gap should be concerning. Importantly, despite our relatively good understanding of growth mechanics, political forces for inefficient distribution appear to regularly stand in the way of realizing high levels and wide distributions of wealth. And if politics can trump good economics, we may be even more concerned about its ability productively to address problems that are less well understood.

Chapter 40, by Olivier Blanchard, is an authoritative review of the literature on economic fluctuations with the simple goal of better appreciating the serious obstacles that stand in the way of our understanding of business cycle mechanics. In Chapter 41 Robert Hall and Paul Milgrom model the wage-setting process through a non-cooperative alternating offer model.

Part 8 The political economy of growth

Volume III concludes with a set of articles that place the mechanics of economic performance in a political environment. Chapter 42 is a transcript of Douglass North's speech on the occasion of his being co-recipient of the 1993 Nobel Memorial Prize in Economic Sciences.

In Chapter 43 Robert Hall and Charles Jones address the question of why some countries produce so much more output per worker than others. Daron Acemoglu *et al*. follow, in Chapter 44, with an innovative research design identifying 'institutions for private property' as playing a fundamental and important role in a society's economic performance. In Chapter 45 Peter Blair Henry and Conrad Miller offer an interesting case study of how policy differences can rationalize residual differences in this performance (i.e. differences that remain after controlling for a society's institutional endowment).

These contributions are interesting in themselves and also because they set the table for our next political economy question: Why, if institutions and policy can indeed put the principled mechanics of economic performance into practice, don't more societies simply copy successful institutions and policies? In Chapter 46 Daron Acemolu offers a clever theoretical model for why commitment problems in political markets can preclude individuals from realizing such mutual benefits (i.e. why the Coase theorem might offer a better positive theory of strongly performing economic markets than the political markets on which that performance ultimately depends). Robert Fleck, in Chapter 47, offers a firmly grounded empirical illustration of how related frictions can interact with economic performance in a manner that causes democratic policy to settle for inefficient distributions.

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INTRODUCTION

Volume IV builds on what we know about how governance generically relates to economic performance (reviewed in Volume III) by assessing what we know about how democratic governance in particular influences economic performance. This form of governance is frequently applauded with an uncritical eye. But, as we will see, at the levels of both state and firm governance, considerable evidence exists that democracy need not lead to the types of institutions and policies that appear to support strong economic performance.

Part 9 Democracy and macroeconomics

The first set of articles in this volume looks at how democratic governance at the level of nation states might influence economic performance. In Chapter 48 Robert Barro offers an important and early contribution in this regard, finding that democracy exerts a weak (and perhaps negative) effect on economic performance, after holding constant variation in human capital and institutions like those reviewed in Volume III. Taking as given evidence like Barro's, however, in Chapter 49 Torsten Persson and Guido Tabellini report that interactions between economic and political liberalizations, expectations of such changes and differences in democratic form can each influence estimates of how democratic governance affects macroeconomic performance.

In Chapter 50 Robert Fleck explicitly models the types of changes that Persson and Tabellini must treat as exogenous in their research design. Importantly, this contribution from Fleck helps us to evaluate whether policy opportunities that might appear in research like that of Persson and Tabellini are truly available, or whether such opportunities are ephemeral as the Lucas critique might predict (i.e. whether actually pursuing policy opportunities would change the expectations that helped generate the very data in which the opportunity appeared in the first place). In Chapter 51 Alberto Alesina and Dani Rodrik similarly highlight obstacles to implementing any such reforms, modelling and evidencing how initial distributions of income relate to political support for policies that facilitate opportunistic redistribution rather than widely shared wealth.

Finally, Timothy Besley and Anne Case, in Chapter 52, and Dino Falaschetti, in Chapter 53, develop evidence that democratic governance can go too far when evaluated against the standard of long-run economic performance measures, while Allan Drazen, in Chapter 54, reviews the associated literature where short-term fluctuations constitute the normative metric.

Part 10 Democracy and corporate governance

The final set of articles for this volume, and for this Major Work more generally, looks at how democratic governance affects economic performance at the level of the firm. We think this application is interesting both because business performance is so important for economic performance more generally and because the organization of business frequently offers social scientists a natural lab in which to develop and evaluate the types of models that might interest readers of this collection. Indeed, Chapter 55, Bengt Holmstrom's lead article in this set, takes advantage of this design innovation, highlighting how a political economy's assignment of property rights can affect its contracting costs, a cost that Acemoglu highlights in Volume III (see Chapter 46) as being a fundamental obstacle to mutually beneficial exchange in political markets.

The remainder of this section of articles includes arguments for why democratic governance in corporations might be too weak or too strong, with each building from the types of models reviewed in the earlier volumes or adding empirical content therein. In Chapter 56 Yair Listokin offers striking evidence on the productivity with which voting and financial markets can govern large-scale organizations, evidence that is unavailable to political economy scholars who restrict investigations to a more narrow political domain. And in Chapter 57 Lucian Bebchuk looks at how rules that govern shareholder voting influence the magnitude of managerial agency problems. Here, again, we have an investigation that is interesting in itself, as well as for its potential to shed light on qualitatively similar problems in which political economists tend to be interested.

Finally, in Chapters 58, 59 and 60, respectively, Jeffrey Gordon, Dino Falaschetti and Lynn Stout build on the logic of formal social choice models to cast a sceptical eye on the efficiency of democratic governance in corporations – a scepticism that parallels that in the 'democracy and macroeconomics' literature reviewed in the first part of this volume. Indeed, just as we saw in earlier volumes how the ease of accessing political platforms affects the stability and efficiency of policy in politics writ large, we see it again in these investigations of the 'firm as a subeconomy' (to borrow Holmstrom's phrase).