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CHOICE OF CONSTITUTIONS AND ELECTORAL SYSTEMS

THE CHOICE OF INSTITUTIONS*

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Economics and political institutions

The “classical” economists, Adam Smith, David Ricardo and Karl Marx clearly thought that socio-political forces were important determinants of economic development and change. In contrast, the “neoclassical”, school starting with Jevons and Walras, developed their economic theories in an institution-free environment. Institution-free economic theory has been the dominant school of thought at least until the 1990s. There were, however, a few exceptions.

While the Anglo-Saxon School developed optimal taxation theory in an institution free world, the *Italian Public Finance School* of the late nineteenth century embedded fiscal policy discussion and fiscal theories into political considerations.

The *classical constitutional theory* of Hayek, set out in his 1960 *Constitution of Liberty* and by Buchanan and Tullock (*The Calculus of Consent*, 1960), provide a major normative pillar which greatly helps our thinking today about the choice of institutions and constitutions. The emphasis on the risks associated with the tyranny of the majority remains one of their major contributions.

The *Public Choice School* developed around the work of Buchanan and associates. The key idea of this school of thought is that politicians maximize self interest fairly narrowly defined. The government is viewed as a Leviathan to be restrained because its goal is to “steal” from the private sector extracting taxes, rents and bribes.

Unfortunately, the Public Choice School remained largely outside the mainstream of post-war economic theory. Both sides are responsible for lack of communication. Mainstream economists had a tendency to underestimate the importance of institutions, and they were quite narrow-minded in their approach to modelling policy making, refusing to understand the importance of politicians’ motivations and constraints in choosing policy. Or if they did, they felt that it was not the economist’s role to incorporate them in models of policymaking. Public Choice theorists refused to embrace the methodological innovations in economic theory, such as a new way of thinking about expectations, new developments in game theory and more generally the mathematical and statistical rigor that was becoming the norm in the field.

In the meantime the field of political science developed an area that was later known as the *Rational Choice approach*, in which researchers applied mathematical tools borrowed from economics to analyze voting behaviour and various issues of political institutions. This field owes a lot to Arrow’s paper of 1951 on the impossibility theorem (in *Social Choice and Individual Values*). In fact the initial impetus from the field was to overcome the “negative” result by Arrow. Thus, models have been developed in which voting could be understood in a predictive manner.

William Nordhaus formalized the idea of an electoral business cycle in a traditional Phillips curve model with a stable trade-off between inflation and unemployment (*The Political Business Cycle*, 1975). Immediately after this contribution macroeconomic theory moved to rational expectations, and his contribution remained a bit on the sidelines of the field.

Gary Becker offered, in his path-breaking paper in 1983 (*A Theory of Competition Among Pressure Groups for Political Influence*), an approach to modelling lobbying pressure to buy policy from policymakers. This approach was widely applied to international trade and protectionist policies.



* This is a revised version of the CESifo Munich Lecture, held by the author at 14 November 2006 in Munich.

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The New Political Economics

In the late 1980s a new line of research emerged, sometimes referred to as “New Political Economics”. Contrary to the previous experience of the Public Choice School, this area of research became immediately fully integrated within the field of economics and adopted the same methodological tools of the latter. This approach quickly developed applications in virtually every field in economics: macroeconomics, development, international trade and finance, economic growth, public finance, etc.

Perhaps the timing is not surprising. The 1980s were a decade of great turmoil and transformation in the American economy. President Reagan was at the centre of this “revolution”. There were large budget deficits, taxes were being cut and the economy deregulated. In contrast continental Europe was entering a long period of sclerosis, some countries in Europe (but not all) were accumulating debts that were rising to almost war time levels. The need for structural reforms and liberalization in Europe was evident, but they were delayed. A dozen European countries were moving towards uncharted territories of monetary and some sort of political union. Latin America was in the middle of a huge debt crisis and of a “lost decade” with very high or even hyperinflations, foreign debt defaults and large budget deficits. Unavoidable policy reforms were delayed increasing the economic costs and leading to crisis. The Soviet Bloc was about to collapse and when it did, it opened a Pandora’s box of politico-economic questions.

It was increasingly difficult to fit all of the above complexities and varieties of experience into traditional models of economic policy in which benevolent social planners maximize the utility of a representative individual. Therefore the New Political Economics acknowledged as a starting point that economic policy should not be modelled as if it were chosen by institutional-free social planners. If one wants to understand how policymaking actually occurs and how to move towards optimality, one needs to acknowledge that, instead, economic policies are chosen by politicians, facing elections in democracies or with other political constraints in non-democracies. More specifically, and this brings us closer to my specific topic: different electoral systems may lead to different strategic interactions

amongst political agents, such as elected representatives, the voters, or party organizations.

Electoral rules and economic policy

One of the topics that has received much interest – including in a previous CESifo Munich Lecture by Guido Tabellini and in the book that followed by Torsten Persson and Guido Tabellini (2003) – is the effect of electoral institutions on economics outcomes.

Electoral systems vary a great deal across countries, from a first-past-the-post majoritarian systems of Britain to an almost fully proportional system in Sweden and to proportionality with thresholds like Germany. In a proportional system the fraction of votes cast by the citizens for a party translates more or less exactly to the same fraction of seats in the legislation. In majoritarian systems this is not generally the case, and there is a prize for winning the majority in a district or plurality, depending on the system. Some of the implications of these differences are clear: in a proportional system without thresholds even very small parties can gain representation,¹ while with thresholds very small parties are not viable but it is still possible to have a multitude of parties if they overcome the threshold. In general, in majoritarian systems (and there are various types), parties have an incentive to form blocs. Thus, majoritarian systems tend to produce blocs of two parties or at least of two coalitions, the so-called Duverger’s law. Whether or not such coalitions or blocs remain stable or squabble after the election varies across countries. We also have presidential systems in which presidents are elected by the people, as in the US and France, and hold substantial executive power, while in other countries the president is elected by parliament and holds either a purely ceremonial role or some executive and procedural power.

The key question is: Do different electoral systems and various voting rules have different effects on economic policy in general and fiscal policy in particular?

In the literature we can find a few answers, not all in agreement with each other. According to the *Chicago School*, electoral laws really do not matter that much. Lobbying pressure will determine policies regardless of the details of electoral laws. What

¹ How small depends on details of the system such as the size of districts, etc.

matters is lobbies' abilities to gain voice in the political arena and this has very little to do with the details of the electoral law.²

According to the line of thought of the *Cultural-Social Capital School*, what really matters is not the institutions of the polity per se but deeper variables like different cultures, various anthropological variables, measures of social capital and trust. Economists are (re)discovering the importance of culture in explaining attitudes towards the economy and economic policy. While I am not aware of a paper that directly tests the superiority of "culture" versus "electoral institutions", the argument is "in the air" so to speak.³

For the *Institutionalist School*, electoral laws matter because they affect the political equilibrium, the nature and structure of party systems and therefore it has profound effects on policies. A vast literature in political science – the extensive work by Persson and Tabellini (e.g. 2003), the work by Milesi-Ferretti, Perotti and Rostagno (2001) and many others in economics – holds this view.

My view is somewhere in between. It is true that lobbies can manoeuvre around the intricacies of electoral laws to buy favours. It is also true that deeper cultural and social variables are critical. However, electoral rules are relevant. But the question is how to disentangle their specific effect.

How can electoral rules matter?

Electoral rules affect the nature of party systems, the composition of legislature and the relationship between the executive and the legislature. Thus rules can have an impact on economic policy through their effect on the structure of parties. Here are a few examples discussed in the literature:

- i) Proportional electoral systems with large coalition governments produce larger budget deficits and have difficulties in promoting fiscal stabilization.
- ii) In proportional electoral systems social spending is higher and the welfare systems more generous because of more diffuse representation of various groups.

- iii) Presidential systems are more pro-active; they stabilize sooner and spend less in social expenditures.
- iv) In US cities different voting rules for electing representatives affect racial minority representation and policies in that respect.

These are only a few examples of the effects of electoral rules on policy outcomes, but there are many others. The critical question, however, is the following: how can electoral institutions be considered explanatory variables, i.e. "exogenous" variables in economic jargon? After all they are chosen by individuals in different societies, they are not randomly assigned. So why do different societies choose different rules?

Let me begin by reviewing the arguments in favour of treating electoral rules as "primitive", exogenous courses of economic polities.

Electoral laws are costly and complicated to change

This is correct, and this consideration would make it reasonable to use electoral rules as explanatory variables (predetermined or exogenous) as an explanation for economic policies and outcomes. However, the original introduction of the electoral law may reflect stable historical characteristics of a society that may be correlated with what one wants to explain with the electoral law. For example, we will discuss below how differences in social policies in the US and continental Europe stem from deeper variables ingrained in history than from different electoral rules, or to put it differently: the choice of electoral rules depends on those variables.

In other words, even though electoral rules may be relatively stable over time, they may still be correlated with other stable characteristics of a society, and the latter may be the true explanatory variable. Stability of electoral rules is not a completely valid explanation for regarding them as exogenous.

In addition, electoral laws are not always so stable. In the first half of the nineteenth century and with the extension of the franchise, they changed frequently. But even after this turbulent period, electoral rules were not cast in stone. In fact, in some cases electoral laws changed frequently. France after World War I, Italy after 1990, and Eastern Europe after democratization are some examples. Many former communist countries started with very proportional systems and then adjusted them in a more majoritarian direction. Countries where

² For a recent example of this argument, see C. Mulligan and X. Sole I Martin (2004).

³ See however G. Tabellini (2005).

Communist parties were still dominant stayed with majoritarian systems and then slowly moved towards proportionality. In Latin America there were several movements back and forth from dictatorships to democracies. Often the electoral laws that are chosen depend upon the nature of the previous dictatorship. For instance, stringent term limits in that region stem from the fear of a return of a one-person dictatorial rule common in Latin America in the fairly recent past.

France underwent 12 reforms of electoral laws from 1870 to 1988. Virtually all of the reforms can be tied to the desire of whoever was holding power to increase its expected electoral benefits – at least the perceived benefits. Here are a few examples. In 1945 a proportional system was adopted for fear of too much concentration of power. Christian Democrats and Conservatives were afraid of a Communist victory. In 1951 there were some modifications introduced to favour the parties then in office. In 1958 a constitutional reform towards presidentialism instigated by de Gaulle tried to avoid the problems of political deadlock caused by proportional representation and too many parties. In 1985 the Socialists realized that the chances of maintaining power in the National Assembly were low so they returned to presidential rule to limit the size of the defeat.

In fact, electoral laws do not change that often, but a higher frequency of changes increases future frequency of changes. Why? There are two reasons. One is that if a constitution makes it too easy to change electoral laws then it is relatively easy for a government to change the rules in its favour. The second reason is that the longer rules remain unchanged, the more they acquire a status of “focal point” and of “tradition” so that the reputational costs of a government trying to strategically manipulate them may become quite high.

Risk aversion and unpredictability of results of changes

For a ruling group to change laws one has to be sure about the outcome. A high degree of uncertainty about the effect of a rule change might lead to a status quo bias and low frequency of change. Even when the institutional costs of changing the laws are relatively low, risk aversion about not knowing what the result would be may lead parties to keep the law unchanged. An example is Germany in 1947. After

the war and after the Nazi period there was much uncertainty about the distribution of preferences across the population, with considerable uncertainty about which party would have benefited from alternative rules. The result of this uncertainty was proportionality, corrected with a relatively high threshold to avoid the Weimar problems of excess fragmentation. A majoritarian system would have produced a clear winner and a clear loser; risk aversion coupled with a large uncertainty made this prospect too risky for everyone.

Thus risk aversion may increase the stability of rules, but as we discussed above stability is not a synonym for being exogenous.

Role of former colonizers

Former colonies often adopted the electoral rules of former colonizers. For example, India adopted a majoritarian system and never moved to full proportionality despite the fact that a religiously fractionalized society may be prone to adopt more proportionality. In this case then to some extent electoral rules are exogenous to the country in question because they are imposed from above.

Obviously however, not all countries were colonies, and in fact much of the work on the effect of electoral rules on economic outcomes is on OECD countries that have never been colonies.

Who chooses electoral laws?

Let us assume that electoral laws matter in the sense that they seem to be correlated with different political equilibria and party structure. The next is the chicken or the egg question: what causes what? Let me explain with an example. Duverger’s law suggests that in a first-past-the-post system only two parties emerge in equilibrium. But perhaps in systems where we only have two dominant parties they choose a first-past-the-post system because such choice is in their interest to reduce the competition of smaller parties. Conversely, proportionality of electoral rules creates many parties and a system that is sometimes accused of not being capable of delivering fast and pro-active legislation because of the veto power of even small parties in ruling coalitions. But perhaps multiparty fragmented systems reflect fragmentation of society, and proportional systems are chosen precisely because it is the only

way to grant representation to all groups and avoid social conflict.

In a narrow sense one may argue that electoral systems derive from the desire of ruling elites and ruling parties to maintain their power. So electoral rules change if the ruling elites are threatened by changes of conditions that require a change in electoral rules to maintain power. An obvious example of changes in conditions is the introduction of universal suffrage. As we discuss below the introduction of universal suffrage often leads to a move towards proportionality if the ruling elites feel that they cannot control growing socialist parties and believe that maintaining a majoritarian system might lead to a socialist victory. On the other hand sometimes proportional electoral systems are in the interests of the socialists and they obtain them as a result of strikes and street revolts despite the opposition of ruling elites.

In general, history, distribution of power within society of various ethnic and religious groups, distribution of income and culture are determinants of electoral rules. All of these variables also determine policy preferences. Therefore the correlation between electoral rules and policy outcome may be overstated or simply be the result of third factors. Also the initial level of income inequality may affect the choice of electoral systems. Even culture may matter. Certain cultures may have a preference for broad participation rather than delegation, proportionality versus majoritarianism.

Normative versus positive models

Extensive work on normative models of constitutions considers the question of how constitutions should be written behind a Rawlsian veil of ignorance. But in reality constitutions and electoral reforms are not chosen behind a veil of ignorance. Those who change the rules generally know who will benefit or at least they can form expectations. In this case electoral rules are chosen strategically to benefit (or at least attempt to benefit) the ruling coalition. There are of course some more or less egregious examples. In Italy in 2005, a reform of the electoral law was introduced immediately before the election, allegedly to make the system more proportional and, by doing so, minimizing the expected loss of the ruling majority. The ruling coalition did indeed lose, by a handful of votes, and because of some tech-

nicalities, even though they were well behind in the polls. A case in the opposite direction was New Zealand in 1997, which witnessed a move toward proportionality (a German type model) as a result of the recommendation of a technical, non-partisan commission that ruled against the stated interests of the two major parties.

These two examples suggest that one can certainly not assume that changes in the electoral rule are dictated by a welfare-maximizing social planner, nor can they be thought of as being chosen behind a veil of ignorance. But often ruling majorities do not have a completely free hand in choosing the rules that maximize their narrow interests. In fact in some countries electoral rule can be changed only with qualified majorities, which is a good check against excessive manipulation by narrow-minded ruling majorities.

Summing up and two examples

Electoral laws are not irrelevant as determinants of political equilibria and economic policy, but treating them simply as given, not changeable and exogenous, can lead to seriously misleading results. Especially if one is interested in long-run phenomena like the size of the welfare state, the evolution of minority protection in voting rights and the structure of groups of society's representation in the polity, one has to keep the endogeneity of electoral laws in mind.

So what is left for the student of electoral laws and economic policy? Unfortunately what is left is a difficult task that cannot simply be to look at electoral rules as exogenous and look at the correlation between such rules and economic policy. One has to go deeper. Here are two examples.

Example 1: The choice of proportionality and the effects of proportionality on welfare spending

Solid empirical evidence suggests a strong correlation between proportionality of electoral systems and the level of social spending. This is one of the major themes of the book by Persson and Tabellini (2003).

There is indeed a strong correlation between the generosity of welfare systems and the level of social spending as a fraction of GDP. However, in many countries the introduction of proportionality has a

lot to do with the strength of Socialists and Communist parties, which, of course, were also in favour of generous welfare states. So proportionality of the electoral system may be only an intermediate variable, not the original cause

A prime example of this relationship is a comparison between the United States and Western continental Europe, an issue addressed in a book by Ed Glaeser and myself (2004). In Europe proportionality was introduced as a result of the increase in the power of Marxist parties after World War I and II. Two forces were at play. First growing socialist and communist parties demanded representation in post-World War I. Before the war only Belgium, Finland, Portugal and Sweden had some form of proportional representation. Between 1917 and 1920 Austria, Denmark, France, Germany, Italy and the Netherlands adopted various forms of proportional representation, often in the aftermath of leftist insurgencies. In some cases the leftist movements were peaceful (Switzerland, Netherlands, Sweden in 1907), in others violent (Belgium, Italy, Germany). In the latter case conservative forces had to acquiesce to the demands of the leftists who dominated the streets. That is, from the point of view of maximization of electoral advantages, ruling elites would have preferred a majoritarian system but the pressure from the protesters and the weakened armies after World War I made it impossible for the ruling elites not to concede proportionality to semi-insurgent movements. Second, when Marxist parties were very strong it was even in the interest of ruling parties to introduce proportionality to avoid defeat. This was the case, for example, in Italy and France in the aftermath of World War II. In Sweden in 1909 at the time of the extension of the franchise, the conservative party, being afraid of losing against radical and socialist parties, changed the laws to create a proportional system.

Thus, the reason why the US did not adopt a proportional representation system is because of the lack of pressure from a socialist movement in this country, contrary to most countries in continental Western Europe. In the US, communist parties were weak and could not impose on ruling elites the choice of proportional representation. It was indeed debated, and in some cases adopted. The state of Illinois adopted proportional representation in 1860. In the first thirty years of the twentieth century several cities, especially in Ohio, did the same. But it did not catch on because with the extension of the fran-

chise it became clear that proportional representation would have allowed the election of blacks and representatives of the small Socialist or even Communist parties. In the south not only proportional representation was not adopted after the abolition of slavery but a variety of measures were introduced to disenfranchise blacks.

Why didn't the US have a strong communist party as in European countries? This is a question that already received attention by Engels, and later by Sombart in the early twentieth century. In my book with Ed Glaeser, mentioned above, we discuss in detail several reasons. First is the role of racial fragmentation of the American working class. As already recognized by Engels and Sombart, ethnic diversity made it more difficult to develop a unified and cohesive, working class sentiment in the US, more so than in continental Europe and this made it more difficult for communist organizers in the US. The open frontier to the west allowed some respite from the social tension in eastern US cities and the countryside. The low density and high distances between cities made it more difficult for communist movements to organize. Finally, much of the communist uprising in Europe came after the devastation of World Wars I and II. The US did not suffer such devastation.

The bottom line is that the effect of proportional representation on welfare policies needs to be understood in the context of the deeper historical and sociological variables that led at the same time to the choice of proportional representation and, amongst others, the preferences of society for welfare policies achieved by the strength of socialist movements.

Example 2: Fragmentation of society and fragmentation of party systems

Multiparty systems (the result of proportional electoral rules) may make policymaking more difficult because of veto power, weak and unstable coalition governments, etc. In particular, a large amount of evidence shows that coalition governments have more trouble reacting quickly to budget deficits and often allow them to grow too much. A good example stems from a comparison of the United Kingdom and Italy in the 1970s and 1980s. Both countries went through difficulties. But in the UK, despite the period of decline until the early 1980s, there were never budget deficits of great significance. In Italy, with its

at the time strict proportional system and multiparty coalition governments, deficits accumulated such that in the early 1990s the public debt to GDP ratio was more than 120 percent.

Are multiparty systems thus responsible for budget deficits? Perhaps, but multiparty systems may be the results of fragmented societies, so it is really social fragmentation that causes difficulties in policy making not the fragmentation of party systems per se.

Should we expect more diverse societies (ethnically, linguistically, religiously) to have more parties? This is the message of work carried out on OECD countries by political scientists like Lijphart (1977). In fact, if we imagine a constitutional assembly whose goal is to have representation of all societal groups, more fragmentation of the population will lead to a choice of party structures that enables many groups to feel represented and to the choice of an electoral rule that allows many parties to be represented, i.e. proportional rule. Therefore, multiparty systems and electoral rules that allow the existence of many parties are not the cause of policy inefficiencies; they merely reflect the cleavages of society. In fragmented societies it is difficult to make policies, regardless of the nature of party systems.

Therefore it would be incorrect to conclude that proportional representation and multiparty systems are responsible for the breakdown of policy making, delays in reforms, etc. Multiparty systems may be the product of fragmented societies. This fragmentation is what ultimately determines the policy failures discussed above. In fact, one may make an even stronger argument: proportional representation and a multiparty system may be the only feasible plan for a fragmented and diverse society. Alternative rules that do not allow broad representation in these types of societies may be even worse, leading to social conflict, tension, even violence.

Whether or not multiethnic societies generate more parties and more participation of various groups depends on the nature of who writes the constitution and determines the distribution of power. If a group (be it religious, ethnic or linguistic) is dominant at the constitutional table, it may choose rules that allow it to rule the country without opposition, in the extreme eliminating democracy, in less extreme cases choosing systems that do not allow the non-ruling opposition to interfere. Aghion,

Alesina and Trebbi (2004) show that in a vast sample including all countries in the world, less protection of minority rights can be observed in societies with greater ethnic fragmentation, another indication that constitutions are not chosen behind a veil of ignorance. There is then a difference between advanced democracies and autocracies. In the former more diversity in society leads to more proportionality, in the latter more diversity may lead to one group seeking power at the expense of the others.

Conclusions

The study of the effect of electoral law on party formation and policy outcomes is complicated because electoral laws are endogenous, i.e. they respond to socio-political economic forces. Especially in a long-run perspective and for cross-country comparisons, seeing electoral laws as predetermined or exogenous may lead to misleading results, and it is essential that the evolution of laws is carefully considered. The same applies to institutions more generally, not only electoral laws.

Do institutions in general and electoral institutions in particular evolve towards optimality? Douglass North (1990) argues that they do, since an evolutionary principle, namely only wealth or utility-maximizing institutions, survives. However, he then argued that transaction costs (which are often not well-specified) may interfere with the move towards optimality of institutional design. The arguments developed here serve as a clarification of what these transaction costs are. They are due to the fact that institutions are chosen endogenously by groups of society that have power and intend to keep it. These groups are not maximizing optimality for society as a whole but operate in their own self-interest.

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