

Norman Schofield
Gonzalo Caballero
Daniel Kselman *Editors*

Advances in Political Economy

Institutions, Modelling and
Empirical Analysis

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Introduction

Political Economy is both a growing field and a moving target. The concept ‘political economy’ remains something of an open signifier, alternatively used to describe a methodological approach in political analysis, grounded in the application of formal and quantitative methods to the study of politics; or one of any number substantive areas in the contemporary social sciences. In economics, new institutional economics (Williamson 1985, North 1990) has established the fundamental importance of history- and polity-specific governance structures in sustaining economic markets. Comparative research has investigated the effect of democratic institutions and processes on economic policy and outcomes, research given perhaps its most comprehensive statement in Persson and Tabellini (2000) and Drazen (2001), which have constituted the so-called “macroeconomics side” of political economy (Merlo 2006). Development economists increasingly recognize that, absent sound governance institutions, standard macroeconomic prescriptions for economic growth and stability often fail to bear fruit (Rodrik 2007). Economists have also recently joined political scientists in examining the role of economic factors in explaining democratic transitions and the evolution of political regimes (Acemoglu and Robinson 2000, 2006). Dewan and Shepsle (2008) have emphasized that in recent years some of the best theoretical work on the political economy of political institutions and processes has begun surfacing in the political science mainstream, and they consider that this is a result of economists coming more firmly to the conclusion that modeling governments and politicians is central to their own enterprise.

Moving to political science, work on the *modernization hypothesis*, motivated by the consistently high cross-national correlation between democratic consolidation and economic development, has also recognized the role of economic factors in determining the evolution of political regimes (Moore 1965; Przeworski et al. 2000). Furthermore, comparative political science in many ways beat economics to the punch in recognizing the role that political institutions play in determining the economic trajectories of developing and still industrializing economies (Haggard and Kaufmann 1990). Economic class structures, and their embodiment in labor unions and professional organizations, have occupied an important place in comparative politics research on the economic institutions of advanced industrial societies

(Hall and Soskice 2001). Studies of voter behavior have identified both the role that conjunctural economic factors play in informing voter choice and the relationship between voters' professional context and their preferences for redistribution. As already mentioned, the label political-economy also refers more loosely to the application of formal and game theoretic methods first developed by economists to the study of political phenomena, including legislative bargaining (Shepsle 1979; Krehbiel 1998), government coalition formation (Laver and Schofield 1990; Laver and Shepsle 1996), and campaign position-taking (Cox 1987, 1990; Schofield 2006). In this sense, the effect of economics has been felt more strongly in contemporary political science than any other social science (Miller 1997).

As evidenced by this brief, and necessarily incomplete, literature review, political economy is a concept with fairly flexible boundaries, encompassing research from a wide variety of fields and approaches. For example, Weingast and Wittman (2008) viewed political economy as the methodology of economics applied to the analysis of political behavior and institutions, but they assumed that it is not a single approach because it consists of a family of approaches. Previously, two views had been distinguished in the new political economy, and both have contributed to the advance of the understanding of modern political economy: on the one hand, Hamiltonian political economy has been interested in economic patterns and performance, but it considers that political institutions and political choices are relevant explaining factors; on the other hand, Madisonian political economy has assumed that the economic approach is central in political analysis, quite apart from economic content (Shepsle 1999). Rather than an explicit "field" or "discipline" in and of itself, the notion of political economy represents rather a growing awareness in both political science and economics that their respective contributions to our understanding of society are intelligible only in mutual conversation. It is one thing for scholars in both disciplines to recognize the interdependence of their subject matters; it is another to create professional fora in which practitioners of these two disciplines come together. The current volume results from the latest in a series of conferences designed to engender a closer collaboration between economists and political scientists. Its contributions represent a broad spectrum of research, and its contributors a diverse group of scholars from diverse academic traditions in political economy. Nonetheless, as a group we share a commitment to mutually beneficial interdisciplinary collaboration, such it has been shown in previous efforts (Schofield and Caballero 2011).

These conferences took place in April and May of 2012. The first was held at the Juan March Institute in Madrid, Spain, and was entitled *Contemporary Applications of the Spatial Model*. Ever since Downs' seminal work (1957), the spatial model has been a workhorse in formal political theory. While its core content addresses how parties choose the relative extremism or moderation of campaign positions, its results have also been used in studies of economic policy and redistribution (Meltzer and Richard 1978; Persson and Tabellini 2000). The Madrid conference brought together a group of leading scholars working on contemporary applications of the spatial paradigm, including theoretical contributions on spatial consequences of primary elections and the spatial consequences of vote buying; and empirical contributions on the measurement of parties actual policy positions, the extent to which

voters accurately perceive such positions, and how these perceptions are moulded by voters' ideological predispositions.

The second conference was held in Baiona, Spain, and supported by the Erenea Research Group at the University of Vigo, and the Center in Political Economy at Washington University in Saint Louis. This conference was in fact the second installment of the *International Conference on Political Economy and Institutions* (ICOPEAI); and like the first, which was held in June 2010, it brought together political scientists and economists from many countries. The spatial model featured prominently in Baiona as well; but to this agenda was added a variety of papers on political transitions, democratic performance and human capital formation, social networks, and new institutional economics, and voting.

There was substantial overlap in the participants at both conferences, allowing for a fruitful extended dialogue that, along with an internal peer-review process, has improved the content of the volume's contributions.

The editors thank the University of Vigo, the Juan March Institute, and the Center in Political Economy, Washington University in Saint Louis for the support they provided. In addition, an earlier version of Chap. 4 was presented at the conference on the Political Economy of Democratic Institutions, organised by Laretta Frederking at the University of Portland, June 2009. We thank Laretta and the University of Portland for organising this earlier conference.

We have decided to structure the volume in three sections, each dealing with a particular emphasis in political economic research: Institutions, Modelling, and Empirical Analysis.

Each chapter in this book went through a review process before publication. These chapters deal with theoretical and empirical issues over the behavior of institutions and the operation of democratic elections.

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Contents

Part I Institutions

Transaction Cost Politics in the Map of the New Institutionalism 3
Gonzalo Caballero and Xosé Carlos Arias

**Political Transitions in Ancient Greece and Medieval Italy: An Analytic
Narrative 31**
Leandro De Magalhães

A Collective-Action Theory of Fiscal-Military State Building 47
Luz Marina Arias

Stable Constitutions in Political Transition 67
Katja Michalak and Gerald Pech

Quandaries of Gridlock and Leadership in US Electoral Politics 91
Evan Schnidman and Norman Schofield

**Sub-central Governments and Debt Crisis in Spain over the Period
2000–2011 129**
Fernando Toboso

Deciding How to Choose the Healthcare System 145
Olga Shvetsova and Katri K. Sieberg

Part II Modelling

Challenges to the Standard Euclidean Spatial Model 169
Jon X. Eguia

A Non-existence Theorem for Clientelism in Spatial Models 181
Daniel Kselman

Nonseparable Preferences and Issue Packaging in Elections 203
Dean Lacy and Emerson M.S. Niou

When Will Incumbents Avoid a Primary Challenge? Aggregation of Partial Information About Candidates’ Valence 217
 Gilles Serra

Measuring the Latent Quality of Precedent: Scoring Vertices in a Network 249
 John W. Patty, Elizabeth Maggie Penn, and Keith E. Schnakenberg

Part III Empirical Analysis

The Politics of Austerity: Modeling British Attitudes Towards Public Spending Cuts 265
 Harold D. Clarke, Walter Borges, Marianne C. Stewart, David Sanders, and Paul Whiteley

Modeling Elections with Varying Party Bundles: Applications to the 2004 Canadian Election 289
 Kevin McAlister, Jee Seon Jeon, and Norman Schofield

Spatial Model of Elections in Turkey: Tracing Changes in the Party System in the 2000s 317
 Norman Schofield and Betul Demirkaya

Do Competitive Districts Necessarily Produce Centrist Politicians? 331
 James Adams, Thomas L. Brunell, Bernard Grofman, and Samuel Merrill III

A Heteroscedastic Spatial Model of the Vote: A Model with Application to the United States 351
 Ernesto Calvo, Timothy Hellwig, and Kiyoung Chang

Inferring Ideological Ambiguity from Survey Data 369
 Arturas Rozenas

Biographies 383

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Part I

Institutions

Transaction Cost Politics in the Map of the New Institutionalism

Gonzalo Caballero and Xosé Carlos Arias

1 Introduction

During the mid-eighties, Matthews (1986) affirmed in his presidential address to the Royal Economic Society that the economics of institutions had become one of the liveliest areas in economics. Two years prior to that, March and Olsen (1984) stated “a new institutionalism has appeared in political science” and that “it is far from coherent or consistent; it is not completely legitimate; but neither can it be entirely ignored”. Although sociology had been less responsive than political science, this was quickly changing, and the new institutionalism also became incorporated into sociology (Brinton and Nee 1998).

There has been a considerable and notable increase in research on institutions since then. The different social sciences have begun to assume that “institutions matter” and that they can be analyzed and therefore there has been an ongoing research effort both at the theoretical and applied levels on the subject of notion, role and change of institutions. The New Institutional Economics (NIE) has been developed in economics, based on the contributions of authors such as Ronald Coase, Douglass North, Oliver Williamson and Elinor Ostrom. In as far as political science is concerned, the literature of the new institutionalism includes political scientists such as Guy Peters, Johan Olsen, Peter Hall, Kenneth Shepsle and Barry Weingast. The new institutionalism in sociology is part of this emerging paradigm in the social

An initial version of this paper was presented at the Annual Meeting of the Public Choice Society (USA, 2009). This renewed version was presented in a specialized workshop at the European School for New Institutional Economics (Cargese, France, 2011) and the Second International Conference on Political Economy and Institutions, ICOPEAI (Baiona, Spain, 2012).

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sciences, and it includes the contributions of authors such as Paul Dimaggio, Walter Powell and Victor Nee, among others.

Thus, the “return of institutions” has become unquestionable in social sciences, and the focus on institutions as a key concept in social sciences has given rise to a variety of new institutionalist approaches (Nee 2005). This has provided a strong impetus to political economy based on new theoretical foundations thereby boosting interdisciplinary relations among the social sciences (Schofield and Caballero 2011). This modern political economy of institutions has included relevant advances in issues such as the effect of extractive political and economic institutions (Acemoglu and Robinson 2011), the modeling of the authoritarian regimes (Schofield and Levinson 2008), the study of social order (Schofield 2010) and the utilization of a higher dimensional policy space in the analysis of different political situations (Schofield et al. 2011), among others.

The different institutional arrangements have systematic effects on policy-making (North and Weingast 1989; Haggard and McCubbins 2001). But if we want to have a deeper understanding of the relationships between institutions and policy, we should view public policies as the outcome of political transactions made over time (Spiller and Tommasi 2007). Political life is characterized by exchanges, agreements and transactions, which frequently are only an attempt, therefore transaction analysis is a fundamental step for studying political interaction and institutions of governance.

The notion of transaction costs was the key concept that the NIE used to understand how institutions affected efficiency in economy. Coase (1937, 1960) and North (1990a) enabled the justification of the importance of institutions and organizations for the economic mainstream and furthermore, the notion of transaction costs surpassed the limits of economic relationships (Caballero 2001). “Modifying the standard rational choice model by incorporating transaction cost theory into it can substantially increase the explanatory power of the model” of political markets (North 1990b, p. 355). In this manner, the new transactional institutionalism has dealt with the study of political institutions and processes through the Transaction Cost Politics research program (TCP) carried out over the past twenty years (Weingast and Marshall 1988; North 1990b; Dixit 1996, 2003; Epstein and O’Halloran 1999; Williamson 1999; Spiller and Tommasi 2003, 2007).

TCP uses political transaction as the unit of analysis, and explains the evolution of political relationships in their condition as transactions and contracts, thereby highlighting the relevance of institutions in political markets, which are characterized by incomplete political rights, imperfect enforcement of agreements, bounded rationality, imperfect information, subjective mental models on the part of the actors and high transaction costs. If the presence of transaction costs decisively affects economic exchange then their relevance is even greater for the functioning of political markets. This is so not only for political transactions carried out between citizens and politicians, which both North (1990b) and Dixit (1996, 1998) emphasized, but also for those in which all participants are politicians, as dealt with by Weingast and Marshall (1988), Epstein and O’Halloran (1999) and Spiller and Tommasi (2007). In this sense, TCP allow us to make more sense out of the political markets we observe.

Transaction Cost Politics (TCP), besides considering the contract as an analysis unit, also studies the enforcement mechanism of contracts, compares the different *governance* structures and adopts the bounded rationality supposition (Epstein and O'Halloran 1999). A first approach to the theoretical bases of TCP is characterized by the following proposals: (1) The application of the transactional approach to the political field leads us to consider political interaction as a set of (implicit or explicit) contractual relations. In this sense, public policies are the outcome of transactions among policy-makers. (2) Institutions are the rules of the political game, and they determine the incentive structure of the agents, and therefore institutions affect public policy *outputs*. (3) Organizational structures of governance are quite relevant when explaining the relations between institutions and outcomes. (4) Transaction costs tend to be higher in the political field than in the economic one and therefore the design of an efficient institutional structure becomes more complex in the political world. (5) In recent times, we are witnessing the progressive vision of public policies as a result of a series of inter-temporal political transactions. (6) TCP provides a central role to the notion of credible commitment, which justifies the importance of *reputational capital* and the organizational formulae of the State.

This chapter reviews and analyzes the approach of Transaction Cost Politics as a new transactional institutionalism in political economy. Moreover, the paper places TCP within the current panorama of new institutionalism and studies the theoretical foundations and the main contributions of TCP up to the present day. When reviewing the literature, we specify the most relevant contents of the main contributions, and for the rest of references, we only mention its arguments. The main goal of the paper is searching the theoretical sources of TCP, and relates it with other approaches, both close and rivals. TCP is a positive approach of political analysis, and this paper shows the analytical characteristics of TCP in a comparative way.

Section 2 presents several approaches of new institutionalism within the social sciences. Section 3 presents the two approaches of new institutionalism that formed the fundamental basis on which Transaction Cost Politics (TCP) was constructed: Rational-Choice Institutionalism (RCI) and the New Institutional Economics (NIE). Section 4 studies the fundamental arguments and contributions of Transaction Cost Politics. Section 5 shows why transaction costs are so high in political markets. Section 6 analyzes the governance of political transactions in Congress as a case-study from TCP. Section 7 compares the TCP approach with that of Constitutional Political Economy. The conclusions are outlined at the end of the chapter.

2 New Institutionalism: An Overview into the Social Sciences

2.1 Definitions of Institutions

During the last two decades of the 20th century, institutions have reopened an agenda for research into the social sciences based on renewed theories. The new institutionalism has emerged in economics, sociology and political science, and has led to sizeable progress on how institutions are understood. Nevertheless, there is

no unique definition of institutions, and several different views of institutions can be presented. For example, Acemoglu and Robinson (2007) distinguish the efficient institutions view, the social conflict view, the ideology view and the incidental institutions view. According to Kingston and Caballero (2009), we should introduce at least the “institutions-as-rules” approach and the “institutions-as-equilibria” approach. Greif and Kingston (2011) extended that perspective: the institutions-as-rules approach focuses on a theory of how the “rules of the game” in a society are selected, while the “institutions-as-equilibria” approach emphasizes the importance of a theory of motivation and thereby endogenizes the “enforcement of the rules”.

According to the Northian approach, institutions are the rules of the game, that is to say, the humanly devised constraints that structure political, economic and social interaction. Institutions consist of formal rules, informal rules and enforcement mechanisms, and they provide the incentive structure of an economy. This approach assumes a specific reference to transaction cost theory. “In order to lower the costs of exchange, it was necessary to devise a set of institutional arrangements that would allow for exchange over space and time”, and institutions “reduce uncertainty by creating a stable structure of exchange” (North 1990b, p. 359). Institutions determine the level of efficiency of political markets and the level of efficiency “is measured by how well the market approximates a zero transaction cost results” (North 1990b, p. 360).

Following the institutions-as-rules approach, March and Olsen (1989) state that institutions are “collections of interrelated rules and routines that define appropriate actions in terms of relations between roles and situations”. Peters (1999, p. 18) further adds four key characteristics to the concept of political institution: (A) An institution constitutes a structural feature of the society and/or polity. (B) An institution shows some stability over time. (C) An institution must affect individual behavior. (D) There should be some sense of shared values and meaning among members of the institution.

The institutions-as-equilibrium approach defines institutions as equilibrium solutions of a game. Historical and Comparative Institutional Analysis (Greif 1998; Aoki et al. 2001) assumed this view of institutions, although recent theoretical developments in institutional analysis by Avner Greif (2006, p. 39) consider “institutions as systems of interrelated rules, beliefs, norms, and organizations, each of which is a man-made, nonphysical social factor”, and this definition “encompasses many of the multiple definitions of the terms institutions used in economics, political science and sociology”.

2.2 Institutional Approaches

The study of institutions can be carried out using several approaches. The new institutionalism—that has been developed on new theoretical bases during the last two decades of the 20th century—can be distinguished from the old institutional traditions in economics, political science and sociology, although there are several connection points.

- (a) The original institutionalism in economics (Thorstein Veblen, John Commons, Clarence Ayres) rejected the foundations of neoclassical analysis and adopted the methods of holism analysis. The contributions of such old institutionalists was marked by an anti-formalist nature, a tendency to argue in holistic terms and a “collectivist and behavioristic framework”, as well as their rejection to the individualist welfare criterion and their tendency towards a certain economic interventionism (Rutherford 1994). It was centered on distributive consequences of the many institutional structures and devised its theories and analysis based on the conceptualization of power.
- (b) The old institutionalism tradition in political science was made up of a set of multi-approach heterogeneous contributions and assumed certain general characteristics such as legalism, structuralism, holism, historicism and normative analysis (Peters 1999).
- (c) The earlier sociological institutionalism pioneered by Talcott Parsons (1937) assumed the existence of institutions, but it did not emphasize institutional analysis. Just as Nee (1998, p. 5) points out the tradition of comparative institutional analysis established in the classical and modern periods of sociology, provides an appropriate foundation for the new institutional approach in sociology, where Weber (1922—*Economy and Society*) is probably the best example of the traditional sociological approach to comparative institutional analysis.

On the other hand, New Institutionalism in the social sciences assumes the choice-theoretic tradition and generally presumes purposive action on the part of individuals, who act with incomplete information, inaccurate mental models and costly transactions (Nee 1998). It tends to move towards methodological individualism, the conceptualization of voluntary exchange and the study of the effects of alternative institutional frameworks on efficiency. In this manner, “new institutionalism” appears to be more formalistic, individualistic and reductionist, it is orientated to rational choice and “economizing models”, and it shows a less-interventionist character (Rutherford 1994).

In economics, Coase (1984) sustained that “if modern institutionalists had any antecedent, then we should not be looking for these in their immediate predecessors”. NIE therefore did not arise from the old institutionalism but was created thanks to a set of contributions that highlighted the relevance of institutional and organizational aspects, and these contributions arose from different scientific areas such as Property Rights Analysis, the New Economic History, the New Industrial Organization, Transaction Cost Economics, Comparative Economic Systems, and Law and Economics (Eggertsson 1990). The analytical framework of the NIE is a modification of neoclassical theory, and it preserves the basic assumptions of scarcity and competence, as well as the analytical tools of microeconomic theory, however, it modifies the assumption of rationality and further adds a time dimension (North 1994).

Nevertheless, the idea of a serious rift between the old and new institutionalist economists has been modified in recent times. For example, North (1994, 2005), Greif (2006) and Ostrom (2007) surpassed the limits of the methodological individualism and the hypothesis of rationality, going beyond the bounded rationality.

In this sense, Groenewegen et al. (1995) found some bridges between new and old institutionalism via the North's contributions, and Hodgson (1998) pointed out the evolution of the new institutionalist project towards a possible convergence with the thinking of the old economic institutionalism. In spite of the considerable concern among new economic institutionalists to differentiate themselves sharply from the old American institutionalism, some aspects of the new institutionalism are connecting back to the old institutionalism in recent years (Rutherford 2001).

Simultaneously with the consolidation of the New Institutional Economics, Hall and Taylor (1996) stated that during the eighties and nineties of the 20th century, there existed three approaches in political science and sociology, each of which called itself a "new institutionalism" as a reaction to the behavioral perspectives, these being:

- (1) Historical Institutionalism developed in response to the group theories of politics and structural functionalism, and it defines institutions as formal and informal procedures, routines, norms and conventions embedded in the organizational structure of the polity. This approach emphasizes the relevance of early decisions throughout political history: the initial political decisions determine the course of politics and consequently of any posterior political decision (Thelen and Steinmo 1992; Thelen 1999; Pierson 2000; Pierson and Skocpol 2002). This implies that there exists a "path dependence" which generates an institutional inertia, which results in the persistence of initial decisions made by government. Historical institutionalism, whose term was coined by Theda Skocpol, has Peter Hall (1986) as one of its principal precursors, however it was Steinmo, Thelen and Pierson who provided some of the main contributions to this approach.
- (2) Rational choice institutionalism (RCI) arose from the study of the American congressional behavior and it received some inputs from the "new economics of organization". This approach perceives institutions as a system of rules and incentives for behavior within which individuals try to maximize their benefit and therefore RCI sustains that behavior is a function of rules and incentives. Four of its features are as follows: (A) It employs a model of rationality when it tries to explain human behavior. (B) It tends to see politics as a series of collective action dilemmas. (C) It emphasizes the role of strategic interaction in the determination of political outcomes. (D) With respect to the origin of institutions, RCI explains the existence of the institution by reference to the value provided by those functions to the actors affected by the institutions.
- (3) Sociological institutionalism has been developed in sociology, especially in organization theory. It considered that many of the institutional forms and procedures were not adopted to gain efficiency, but instead should be considered as culturally-specific-practices. This type of institutionalism, to which Hall and Taylor (1996) incorporate the contribution of March and Olsen (1984), can be characterized in the following manner: (A) Sociological institutionalists define institutions much more broadly than political scientists do, and their definition includes a set of elements such as symbol systems, cognitive scripts and moral templates. (B) It emphasizes the highly-interactive and mutually-constitutive

nature of the relationship between institutions and individual actions. (C) In as far as the origin and change of institutions is concerned, institutions can adopt a new institutionalist practice because it enhances the social legitimacy of the organization and its participants.

A more complete map of new institutionalism in social sciences has been presented using eight approaches (Peters 1999): Normative Institutionalism, Rational Choice Institutionalism, Historical Institutionalism, Empirical Institutionalism, New Institutional Economics, Sociological Institutionalism, Interest Representation Institutionalism and International Institutionalism. Although some of the classification criteria are not clear and could be discussed or adapted, this extended map is quite useful for understanding the diversity, pluralism and complexity of the new institutionalism in social sciences.

In that map, the sociological institutionalism indicated by Hall and Taylor (1996) is divided into two approaches namely, a normative institutionalism and a truly sociological institutionalism. (A) Normative institutionalism highlights the central role assigned to norms and values within organizations for understanding how institutions function and their influence on the behavior of individuals (March and Olsen 1984, 1989). Institutions mold their own participants and supply meaning systems for those participating in politics, and therefore this approach renounces the exogeneity of preferences. (B) There has been a strong institutional analysis tradition in sociological research right from the time of classical authors such as Weber or Durkheim. Such tradition has been maintained in areas like historical sociology and organizational sociology and we can distinguish between an old and a new institutional school of thought in sociology, based on the irrational sources of institutions, the conception of relations between the institution and its environment and the molding role of politics. The new approach in sociology should be construed as an individualization process of societies.

Moreover, another approach, empirical institutionalism in politics, has been added in the map due to its lack of theoretical approach and because it emphasizes a set of traditional empirical institutional issues. This approach empirically studies certain institutional differences and their effects, and furthermore indicates that government structure conditions the politics and decisions of governments. Empirical institutionalism has been centered on the study of a group of applied issues, such as the differences between presidential and parliamentary government, the case of the “divided government”, the legislative institutionalization or the independence of central banks. Some of these contributions are descriptive and nearer to the old traditionalist approach (for examples, the contributions of Woodrow Wilson), but others imply a more advanced empirical analysis (Peters 1999).

Finally, pointing out the aim of the study, two other institutionalist approaches have been incorporated in the map. On the one hand, Interest Representation Institutionalism analyzes the structure of such “institutionalized relationships” between State and society, assuming that there are many relations in politics that are conceptualized as being less formal and highly institutionalized, such as Kickert et al. (1997) show. The interest representation institutionalism is especially centered on the analysis of the actions of political parties and interest groups. On the other hand,

the approach of International Institutionalism conceives international politics along institutional lines and highlights the role of structure when explaining the behavior of States. International institutionalism perceives regimes as international level institutions, since they generate stability and predictability, shape the behavior of States and promote a set of values. One of the relevant research lines in international institutionalism has been led by Keohane and Nye (1977).

In this sense, the views of Hall and Taylor (1996) and Peters (1999) on institutionalism are different but compatible, and we should complete the overview with the incorporation of the NIE. In order to integrate TCP within the new institutionalism, we need to first perform a detailed analysis of RCI and the NIE.

3 Rational Choice-Institutionalism and New Institutional Economics

3.1 Rational Choice Institutionalism

The program of Public Choice was the principal development of rational choice for studying politics after the Second World War. Sometime later, academic tradition of rational choice gave rise to a set of tasks that assumed the importance of institutions in political life and included political institutions into the research agenda of rational choice theory. We can therefore use the concept of RCI (Shepsle 1986, 2006; Hall and Taylor 1996; Weingast 1996, 2002; Peters 1999).

RCI emerged from the rational choice approaches that assumed methodological individualism, and it inherits the importance of basing political activity on human behavior theories that explain the nature of individuals. As against other approaches, such as normative institutionalism, which do not provide a specific theory for human behavior, rational-choice is characterized for presenting a clear and explicit model of individual behavior. However, even though Rational Choice did not attend to institutions in a relevant manner during its early stages, it did end up generating theoretical developments which incorporated the role of political institutions. In this sense, some authors have used the expression “actor-centered institutionalism” to indicate the important role bestowed to individuals by the RCI (Peters 1999).

Rational choice theory has provided a distinctive set of approaches to the study of institutions, institutional choice and long-term durability of institutions (Weingast 1996, p. 167). This approach provides a systematic treatment of institutions through the importation of the micro-foundations of institutional analysis from rational choice theory. Institutions are conceived as a set of rules and incentives that restrict the choice possibilities of political agents, who seek to maximize their preferences within such an institutional framework. According to Kiser and Ostrom (1982), institutions are rules that individuals use to determine what and who is included in decision-making situations, how the information is structured, what measures can be taken and in what sequence, and how individual actions are integrated into collective decisions. In this manner, RCI sets out the role of institutions in political activity as a means of containing the uncertainty of action and political results.

RCI considers political institutions as structures of voluntary cooperation that resolve collective action problems and benefit all concerned. Therefore, the way to resolve collective action problems through cooperation can be found in formal or informal institutions, and this permits opportunistic individuals looking for personal gains to obtain mutual benefits.

Individuals observe that institutional rules also limit the choice possibilities of competitors, and realize that rules benefit the entire group of individuals. Shepsle (1986) states that any cooperation that is too costly at the individual agent level is facilitated at the institutional level. In this manner, institutions appear as ex-ante agreements to facilitate cooperation structures, as claimed by Weingast (2002), when he affirms that we need institutions to obtain gains from cooperation.

RCI assumes the following three features: (1) Rational individuals that maximize personal utility are the central actors in the political process. (2) RCI has been concerned with the problem of stability of results and the problem of control of public bureaucracy. (3) Institutions are formed on a tabula rasa (Peters 1999).

Weingast (1996) points out four characteristic features of RCI: (A) This approach provides an explicit and systematic methodology for studying the effects of institutions, which are modeled as constraints on action. (B) The methodology is explicitly comparative, through models that compare distinct institutional constraints with their corresponding implications in behavior and outcomes and through the analysis of how behavior and outcomes change as the underlying conditions change. Moreover, this approach affords comparisons of the behavior and outcomes under related institutions within a given country and of the effects of similar institutions across countries. (C) The study of endogenous institutions yields a distinctive theory about their stability, form and survival. (D) The approach provides the micro-foundations for macro-political phenomena such as revolutions and critical election.

Two separate levels of analysis can be distinguished in the RCI (Shepsle 1986, 2006; Weingast 1996), namely; (a) A level considers institutions as fixed and exogenous, i.e., analyzes that study the effects of institutions; (b) the other level studies institutions as endogenous variables, that is to say, why institutions take particular forms (Weingast 1996).

In as far as Weingast's (1996) first level of analysis is concerned, we have to point out that work has been done on almost all democratic institutions such as constitutions, the legislative body, the executive body, bureaucracy, the courts of justice and the elections. The analysis is centered on how institutions influence results and we can verify that micro level details have a great influence on results.

With respect to Weingast's (1996) second level of analysis, it covers questions such as why institutions take one form instead of another, and why institutions are altered in some circumstances but not others. The rules of the game are provided by the players themselves; and these tend to be simple rules. Institutional arrangements are focal and may induce coordination around them (Shepsle 2006). A model of institutional stability must allow institutions to be altered by specific actors and it must show why these actors have no incentives to do so (self-enforcing institutions) (Weingast 1996).

Institutionalists of rational choice highlight the role of institutions in strategic interaction between actors and in determination of political results (Hall and Taylor

1996). However, this institutionalism does not explain the details of how institutions are created, although it recognizes the possibility that the creation of institutions is a rational action of actors who are interested in the creation of those institutions. This approach, in any case, has a functionalist content (Peters 1999) and concludes a sense of “goodness” of institutions (Moe 2005).

3.2 *New Institutional Economics*

Price theory enables us to respond to some economic matters but not to others that require a richer theoretical body. NIE does not try to replace price theory but tries to “put it in a setting that will make it vastly more fruitful” (Coase 1999b), which implies the incorporation of institutional issues. As indicated by Arrow (1987), the NIE movement consists of answering new questions that traditionally were not framed in economic mainstream.

NIE accepts orthodox neoclassical assumptions of scarcity and competition, but it rejects the neoclassical assumption of perfect information and instrumental rationality, and it considers a theoretical framework with incomplete property rights, positive transaction costs and institutions, and assumes a world where the passage of time matters (North 1994).

The theoretical framework of the New Institutional Economics combines the *coasean* notion of transaction costs with the *northian* notion of institutions, such that institutions are a medium for reducing transaction costs and obtaining a greater efficiency in economic performance. On the one hand, Coase (1937) generated a microanalytical approach of organizations which gave rise to “transaction cost economics” (Williamson 1975, 1985, 1996); while on the other hand, Coase (1960) generated a macroanalytical approach that studied the relations between institutions and economic performance, as well as institutional change processes (North 1990a). NIE incorporates both approaches, which are mutually inter-related, that is to say, NIE studies institutions and how institutions interact with organizational arrangements within economy (Menard and Shirley 2005; Ostrom 1990, 2007).

Property rights are one’s ability to exercise choices over a good. Individuals will carry out transactions, i.e., they will carry out property rights transfers, which will produce transaction costs. We can define transactions costs as the resources used to maintain and transfer property rights (Allen 1991), that is to say, “transaction costs arise when individuals try to acquire new ownership rights, defend their assets against transgressions and theft, and project their resources against opportunistic behavior in exchange relationships” (Eggertsson 2005, p. 27). Transaction costs are the sum of costs required to perform the “transaction function”. The carrying out of transactions can be understood as a contracting problem, such that transaction costs are those which are derived from the signing *ex-ante* of a contract and of its *ex-post* control and compliance (Eggertsson 1990).

In a world with zero transaction costs, the parties concerned would carry out all the transactions that would result in social efficiency gains. However, as against this

hypothetical world where negotiation does not cost anything, economic markets are characterized by the presence of positive transaction costs, and therefore no transaction is carried out whenever such costs surpass the expected gains from such transaction. The readjustment of rights will only go ahead whenever the value of production from such transactions is greater than the costs implied in producing the same (Coase 1960).

The level of transaction costs will depend on the characteristic traits of each specific transaction as well as on the nature of the institutional environment in which the transaction is being carried out. In this sense, every society will have its own “rules of the game”, which will determine the cost of carrying out transactions (North 1990a).

Understanding the relationship between institutions and economic performance requires the study of human decision-making. NIE considers that the orthodox rationality approach of human behavior is defective because: (a) individual motivations are not limited to maximizing wealth or utility: altruism and individual’s self limitations also influence behavior; (b) individuals subjectively process incomplete information of the world around them: there is need to distinguish between reality and perception (North 1990a). NIE defends that individuals act with incomplete information and models that have been subjectively deduced, and assume the model of bounded rationality, by conceiving the individual as intentionally rational but only in a limited way (Williamson 2000).

Along these lines, North (1994, p. 362) states that “history demonstrates that ideas, ideologies, myths, dogmas, and prejudices matter, and an understanding of the way they evolve is necessary”. In order to understand the behavior of individuals in decision-making within an uncertainty context, NIE considers the subjective mental models of individuals as key factors. Such mental models will be closely linked with institutions. “Mental models are the internal representations that individual cognitive systems create to interpret the environment; institutions are the external (to the mind) mechanisms individuals create to structure and order the environment” (Denzau and North 1994, p. 4).

Together with the study of mental models and human behavior, NIE assumes the importance of the passage of time to create institutions. Institutional change is characterized by increasing returns and imperfect markets with high transaction costs. In this theoretical framework, path dependence is reinforced by the externalities of the institutional matrix, by the processes of social learning and by the creation of the *shared mental models* on which individuals make decisions. Path dependence is one way of bridging the choice gap and binding the evolution of a society over time (North 1990a).

In this manner, the institutional framework not only determines the current economic results but also delimits the set of opportunities that affect our future situation. We can adopt an efficiency view when analyzing evolution of institutions, according to which relative prices are the source of institutional change, however, NIE sustains that the existence of transaction costs provokes the agents to not always coincide towards the search for a greater efficiency.

The NIE argues that the processes of institutional change are normally incremental due to the increasing returns of institutional change: (A) Institutional change is

an incremental process that is heavily weighted in favor of policies that are broadly consistent with the basic institutional framework. (B) Institutional change is characterized by a slow evolution of formal and informal limitations. (C) Individual and specific changes in formal and informal institutions can change history but will find it difficult to reverse the course of history (North 1990a, 1990b).

Positive economic analysis conclusions cannot be exported from one economy to another in the case of economies with positive transaction costs, mental models and institutional changes: “you get a different answer for every country and every historical situation. . . there is no one way better economic system because everything depends on the society you are in” (Coase 1999a, p. 5).

The NIE is a research program that continually evolves, and recent new institutional contributions incorporate relevant advances and interesting questions on institutions. Eggertsson (2005) presents a general framework to reflect on institutional failure, social technology and institutional policy. North (2005) explores the relationships among cognitive science, institutions and economic change. Acemoglu and Johnson (2005) conclude that property rights institutions have a first-order effect on long-run economic growth and investment, while contracting institutions appear to matter for financial intermediation. Acemoglu and Robinson (2008) construct a model of simultaneous change and persistence in institutions where the main idea is that equilibrium economic institutions are a result of the exercise of *de jure* and *de facto* political power. Recently, North et al. (2009) propose the theoretical foundations for understanding violence and social order in human history.

4 Transaction Cost Politics

Transaction Cost Politics has emerged as an application of the theoretical approach of the New Institutional Economics to political analysis from a *madisonian* point of view in political economy (Shepsle 1999). Understanding the foundations of TCP implies a look to Rational-Choice Institutionalism and, especially, to the New Institutional Economics:

(A) Rational-Choice Institutionalism was interested in political markets and institutions, understood political institutions as a cooperation structure and assumed a model of rationality for political behavior. According to Rational-Choice Institutionalism, TCP focuses on political institutions, and indicates that “political institutions constitute *ex ante* co-operation agreements among politicians” (North 1990b, p. 359). Furthermore, TCP coincides with Rational-Choice Institutionalism when it defends the assumption of a rationality model for economic behavior, which implies a big difference from other institutionalists traditions such as normative institutionalism or the old approaches. However, the TCP rationality model is not found in Rational-Choice Institutionalism, and Rational-Choice Institutionalism forgot the main role of transaction costs and history, and therefore we should look to the NIE.

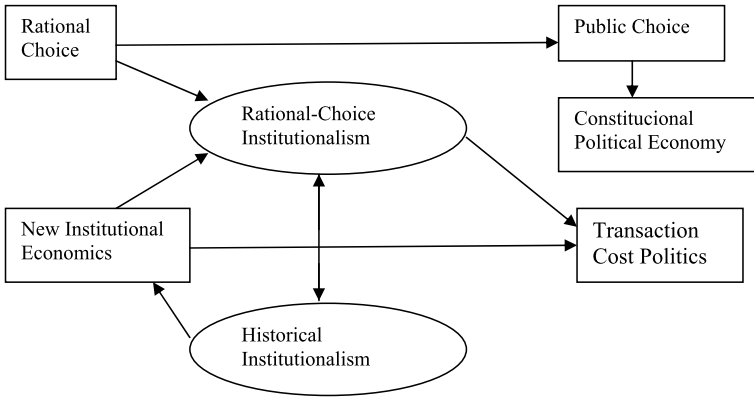


Fig. 1 Transaction Cost Politics

(B) NIE points out that the economic world is characterized by positive transaction costs and institutions. It rejects instrumental rationality by assuming the implications of bounded rationality and considers that the passage of time matters. TCP assumes these three NIE foundations when studying political transactions and institutions. “A transaction cost theory of politics is built on the assumptions of costly information, of subjective models on the part of the actors to explain their environment, and of imperfect enforcement of agreements” (North 1990b, p. 355). Moreover, TCP is interested in explaining the differential performance of polities over time, and therefore elaborates a theoretical framework where history matters.

TCP is different from RCI because TCP assumes three characteristic foundations of the NIE (bounded rationality, a transactional approach, passage of time matters). Figure 1 shows how the extension of Rational Choice theory towards political analysis allowed the emergence of Public Choice, with CPE as its main continuation, whereas the extension of the NIE towards political analysis allowed the appearance of TCP. In this sense, TCP—as an extension of the NIE—surpassed the theoretical framework of RCI in the same way that the NIE surpassed the (instrumental) rational choice approach. On the one hand, there is no direct relationship between CPE and TCP in Fig. 1 because their theoretical foundations have different origins, and on the other hand, historical institutionalism is shown as an antecedent of NIE and RCI but it has not a direct influence over TCP (the influence is indirect via NIE and RCI). Finally, we should point out that other institutionalisms, such as empirical, normative or sociological institutionalism, have not had influence on the emergence of TCP, and their references have not been incorporated in the background of TCP. Even these institutionalisms have not a fruitful dialogue with TCP nowadays.

While transactional analysis had been applied to economic and organizational interactions by a relevant tradition of literature, the approach of TCP focuses on political transactions and he considers that “public policy is a sometimes explicit, sometimes implicit agreement (or transaction) among policy makers” (Spiller and