WHY DO GOVERNMENTS LACK POLITICAL WILL? AN EXPLANATION FROM THE TRANSACTION-COSTS PERSPECTIVE

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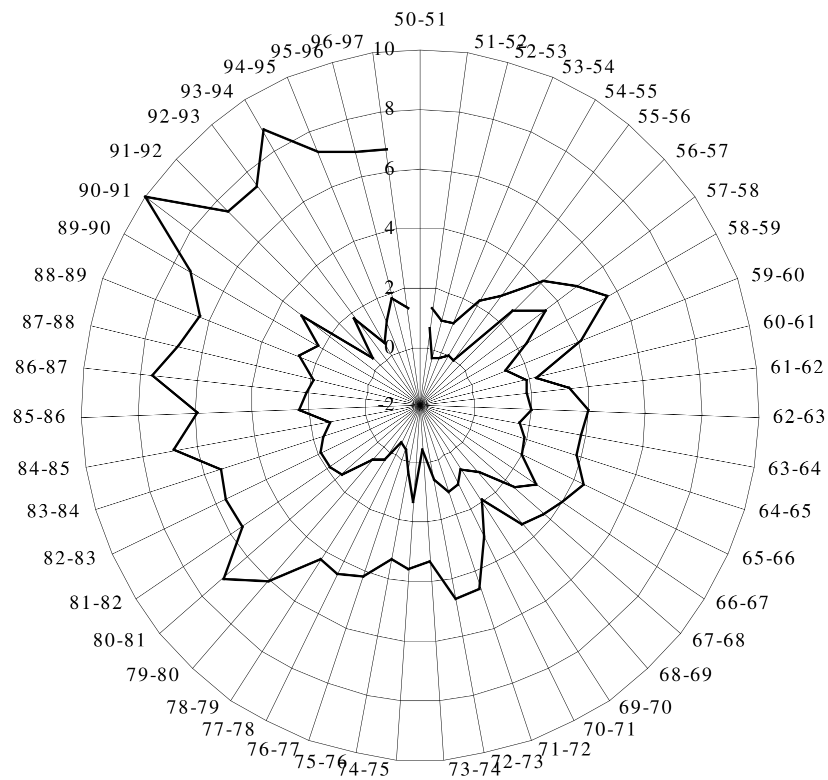

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Abstract

A substantial body of literature is now available which points to extensive and inappropriate state intervention as the primary cause of macroeconomics problems that beset many economies. Even when it is apparent that a more efficient, alternative form of government intervention is available, this intervention does not get implemented. Numerous explanations have been proposed to understand the inertia that impedes the move from inefficient to efficient policies. Of these explanations, the reliance doctrine, path dependence and corruption are important.

This paper proposes "lack of political will" as the most important reason why a ruling political party is unable to commit itself to economically efficient choices or policies. The notion of political will is explicated using concepts from the transaction-costs perspective. The paper models the interactions between an interest group and the ruling party on the one hand and between general electorate and the ruling party on the other as quid pro quo relationships or transactions. In the first type of transaction, the ruling party offers the interest group of favourable policy (say, subsidised public sector output) in exchange for political support. In the second transaction, the ruling party offers the general electorate subsidised welfare amenities (say, basic health care) in exchange for political support. The analysis in the paper shows that the transaction-costs associated with the interest group-ruling party exchange will be lower than the transaction-costs in the case of the general electorate-ruling party exchange. Consequently, the ruling party will implement policies which are inefficient for the point of view of the economy but which work to the benefit of the interest group.

Key Words: Transaction-costs, Interest groups, Political will
JEL Code(s): D23, D72, H23, L14

WHY DO GOVERNMENTS LACK "POLITICAL WILL"? AN EXPLANATION FROM THE TRANSACTION-COSTS PERSPECTIVE*

1. INTRODUCTION

A substantial body of literature is now available which points to extensive and inappropriate state intervention as the primary cause of macroeconomic problems that beset many economies. Even when it is apparent that a more efficient, alternative form of state intervention is available, this intervention does not get implemented. For instance, consider the following:

1. Dixit and Londregan (1995) point out that subsidies and protection have kept declining industries going even when it was apparent that the more efficient solution would have been to permit labour and capital to migrate to more productive alternative uses. It has been estimated (Hufbauer and Elliott 1994) that, for the 21 industries in the US that are the most heavily protected, tariffs and quotas cost the consumer $32.3 billion in higher prices.
2. Governments spend on goods and services, which ostensibly have public goods characteristics, but benefit only a subset of (powerful) voters (Tullock 1959).
3. On the other hand, goods, which genuinely involve positive externalities (e.g. basic education and health) and are, arguably, deserving of subsidies, tend to get short shrift (Dreze and Sen 1996; Karnik 1999; Government of India 1997).

It is important to realise that all such government interventions involve, at least, some redistribution. In the example of Hufbauer and Elliott (1994), the redistribution is from consumers to labour and capital of the protected industry. Where powerful interest groups are able to capture the benefits of publicly provided goods the redistribution is from all taxpayers to such groups. It is apparent, however, that such redistribution often involves inefficiency. An efficient solution in many instances would be the termination of inappropriate state intervention possibly with lump-sum compensation being paid to the losers of such a change. The gains from implementing such solutions would come from increased productivity of labour and capital in alternate uses. Alternatively, where the government spends on basic health and education, substantial external economies would be available to the society as a whole.

It is clear that changes such as those listed above would bestow benefits not on specific interest groups but on society at large. If the government or the ruling party were to enforce such efficient solutions, one could say that it has acted in the public interest. Conversely, if it continues to protect labour and capital in declining industries or continues to provide benefits of public expenditures to powerful groups in society, one could say that it has acted in favour of vested interests.

Politicians, in general, and ruling political parties, in particular, have often been accused of ignoring the “public interest” and promoting “vested interests”. The term public interest is generally used to connote the genuine welfare needs of the diffused mass of voters. This mass of voters does not constitute a well-defined interest group and, in a democracy with regular elections, generally lacks the political power to dislodge the government. Vested interests are generally assumed to include interest groups or lobbies, which can play a critical role in the making or breaking of a government at elections time. The inability of the government or the ruling party to distance itself from interest groups or to promote the welfare of the masses is seen as a lack of “political will”.

Streeten (1995) appears to strongly disapprove the use of the phrase “lack of political will”. In fact, he suggests that the “expression should be banned from political discourse” (1995, p. 228). However, he relents on this rigid stand and states that “Political will should be subjected to analysis, and, for purposes of action, to pressures and mobilsation” (1995, p.

228). My use of the expression "lack of political will" will probably invite Streeten's ire though I hope my attempt at analysis of political will meet with his approval.

The term "lack of political will" appears to lack a precise definition[1]. Even though it is used frequently in common parlance, a definition from an economic and a political perspective is hard to come by. The following quote from Dixit and Londregan (1995, p.856) appears to capture the essence of it: Political will is seen to be lacking when "politicians are unable to commit themselves to ignoring political characteristics and making long-term promises to reward economically efficient choices".

In this paper I seek to offer an explanation for lack of "political will" or the inability of the ruling party to commit to economically efficient choices in a specific situation. The specific situation selected for analysis in this paper is the preferential treatment given to interest groups in the form of discretionary favours by the ruling party. Simultaneously, I try to understand why the ruling party is reluctant to introduce policies that benefit the diffused mass of voters. Many such policies have public goods characteristics and it is not possible to target their benefits to specific groups or individuals. To put the research question being posed here in a nutshell, I ask: why does the ruling party favour interest groups over the diffused mass of voters?

I propose an explanation from the perspective of Transactions-cost Politics (TCP) (Dixit 1998), an approach that extends the ideas of Transaction-Cost Economics (TCE) (Williamson 1985). Section 2 relates the ideas developed in this paper to the existing literature pertaining to the problem of persistence of inefficient economic policies. Section 3 proposes an alternative explanation for the persistence of inefficient policies. In Section 4, I discuss various aspects of Transaction-Cost Politics, the underlying basis of the alternative approach developed in this paper. Section 5 describes the political setting against which the inter-relationships between the ruling party, interest groups and voters are played out. In

Section 6, the relationships between the ruling party and interest groups, and between the ruling party and other voters are modelled as political contracts, each with its own transaction costs. Section 7 compares the two political contracts from the point of view of magnitude and distribution of transaction costs. Concluding remarks are set out in Section 8.

2. RELATION TO THE LITERATURE

The inertia that impedes changes in economic policy is open to alternative explanations. Past policy actions often create constituencies that gain from the policy, who then resist any changes to take away these gains. The farmer's lobby in India, for example, resists reduction in subsidies on fertilizers, credit or electricity (Pursell and Gulati, 1993). Such a policy may persist for a long time despite the costs that it inflicts on the economy. Persistence of such policies has been explained in terms of the 'reliance doctrine' (Dixit, 1996), path dependence or economics of QWERTY (David, 1985), obstacles erected by interest groups who lose out in the reforms process (Fernandez and Rodrik, 1991) and corruption, by means of which interest groups are able to induce the government to continue with the existing inefficient policies (Bardhan, 1997, Tanzi, 1998).

3. AN ALTERNATIVE EXPLANATION

Grossman and Helpman (1994) begin their article with the following: "When asked why free trade is often preached but so rarely practised, most international economists blame 'politics'" (p.833). This quote may be paraphrased to suit the context of this paper as follows: The reason for the persistence of economically inefficient policies is "politics" or "lack of political will". In what follows, I explicate the notion of "lack of political will" in a transaction-cost framework.

The analysis of political will, or rather the lack of it, in this paper, places the ruling political party and its desire to hold on to power at the centre stage. A ruling party in a democracy has to validate its mandate to govern the society at elections held at regular intervals. It is the urge to be re-elected that forces the ruling party to promote vested interests rather than the public interest. Promoting vested interests earns for the ruling party sufficient political support to win a re-election, while, it is feared that, promoting public interest may not offer the ruling party sufficient political support to ensure its re-election. Such an approach to explaining the lack of political will has strong connection to the works of Grossman and Helpman (1994) and Stigler (1971) wherein economic policies are set by an incumbent government – ruling party in the terminology of this paper - seeking to maximise its political support.

The predilection of the ruling party to favour interest groups was linked to the urge of the party to be re-elected. However, this explanation of ruling party behaviour raises one further question: If the main objective of the ruling party is to win re-election, why does it not try to capture the votes of the general electorate (i.e. the diffused mass of voters) instead of depending on interest groups to provide it the required political support. Numerically the mass of the general electorate can bring sufficient votes to the ruling party to enable it to win a majority and yet the ruling party considers it more desirable to secure the support of interest groups. Assuming that obtaining political support from interest groups involves a quid pro quo, why does the ruling party adopt a strategy that keeps it beholden/hostage to the interest group throughout its tenure? What prevents the ruling party from seeking the support of the mass of voters, which will reduce its dependence on interest groups? These are the questions that this paper seeks to answer.

4. TRANSACTION-COST POLITICS

Dixit (1996) has pioneered the extension of the notion of Transaction Costs (TC) to politics. The problems of moral hazard, opportunism and asset specificity as well as those of commitment, which have been developed and tested in industrial economics (Williamson

1985, 1989), have strong parallels in political economy. These parallels, detailed in Dixit (1996), are discussed below:

4.1 Notion of a Contract

One of the central problems of organisation is motivation. The question of motivation arises because individuals have private interests, which are only imperfectly aligned with the interests of other individuals or even, with the interests of society at large. In an idealised setting, a *complete contract* could solve all problems related to motivation. In reality, however, limited foresight, imprecise language, costs of calculating solutions and the costs of writing down a plan (Milgrom and Roberts 1992) mean that all contingencies cannot be accounted for. All contracts, inevitably, tend to be incomplete.

In TCE, a contract is a basic unit of analysis and has the same connotation stated above. It is accepted that there are costs to writing a contract. Where it is costless to identify, plan for and agree to provisions of future events, parties engaged in trade would be able to write complete or comprehensive contracts (Hart 1991). This is, however, unrealistic since transaction costs are pervasive and large, and contracts will be incomplete in the sense that they will contain gaps. The inability to write complete contracts is known as bounded rationality. Further, the economic agent involved in contracting in the TCE framework is given to self-interest seeking of deeper and more troublesome kind than is an agent in neo-classical economics (Williamson 1989). This has significant implications when the actions of parties to a contract are characterised by varying degrees of observability, reversibility and may be taken at different points of time.

In Transaction-Cost Politics (TCP), the parties to the contract are citizens (individuals or groups) on the one hand and politicians (individuals or parties) on the other. The contract, as in TCE, consists of an exchange: the promise of a policy in return for votes. In spite of this similarity between TCE and TCP, the notion of a contract in the two areas may be very different: a political contract may be far more complex and may be much harder to enforce. Political outcomes are susceptible to as much or much greater degree of uncertainty than are economic outcomes. Consequently, it would be virtually impossible to write down a complete contract, factoring in all possible contingencies. Further, even in the case where contingencies may be identified, the actions to be taken by the parties to the contract may not be well specified. The difficulty involved here is compounded by the fact that political contracts will rarely be well articulated or written down. If the transactions between the political party and voters contravene some law, then, necessarily, the contract will have to be implicit. In the light of these difficulties associated with a political contract, it is apparent that such a contract will be difficult to enforce.

4.2 Contract Enforcement

It is often supposed that in the event of a breach of contract, a third party intervention would be able to resolve the dispute. This supposition makes a few assumptions: that property rights are well-defined, that courts are *not* boundedly rational and that they are able to acquire all the relevant information costlessly. The justice dispensed by such an ordering will be costless. However, bearing in mind the costs that may attend such a legal ordering, it is very likely that "in many instances the participants can devise more satisfactory solutions to their difficulties than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute" (Gallanter 1981 quoted in Williamson 1996, p. 10). Such problems with legal ordering prompts what Williamson (1996) calls "private ordering": parties have an incentive to devise contractual safeguards and self-enforcing agreements.

Contract enforcement in politics is far more complex. If the government makes a promise, there is no higher authority to compel it to keep its promise. Moreover, by the very nature of the electoral process, political property rights are insecure: a ruling party cannot credibly commit to a policy for a duration longer than the electoral period. There is no external enforcement mechanism to police agreements once struck; majorities at time t cannot bind majorities and government at time t+1 (Moe 1990). The only recourse that voters may have is to vote out a government that reneges on its promise.

The impossibility of a court ordering in the enforcement of a political contract makes it even more likely that parties to such a contract will prefer to devise a private ordering. Contracts that are self-enforcing are more likely to be struck than those that offer scope for reneging. Just as this situation leads to the emergence of non-standard forms of organisation in TCE, in TCP it would lead to non-standard forms of institutions such as nexuses/contracts between interest groups and the government.

4.3 Bounded Rationality

All complex contracts are unavoidably incomplete on account of bounded rationality (Williamson 1996, p. 6). Bounded rationality is defined by Simon (1961) as behaviour that is "intendedly rational but only limitedly so". TCE acknowledges that rationality is bounded and emphasises both parts of the definition. An economising orientation is elicited by the intended rationality part of the definition, while the study of institutions is encouraged by accepting that there are boundaries on rationality. With rationality being bounded, the costs of planning, adapting and monitoring transactions need to be expressly considered. The question that TCE tackles in this context is: which governance structures are more efficacious for which types of transactions?

If the world of TCE is, indeed, complex, and places severe limits on the cognitive competence of agents, the world of TCP is as, or, even more, complex. Therefore, political agents will also be bounded in their rationality, implying thereby that political contracts will, necessarily, be incomplete. Explicit contracts that make political promises contingent on various international developments, domestic shifts of opinion, etc. would be extremely complex; in such a situation bounded rationality has more serious bite than in TCE (Dixit

1996). As in TCE, so in TCP, governance structures, such as political institutions or organisations, will emerge that economise on transaction costs. A particular governance structure that might emerge is a nexus between interest groups and the government and even though it may face some of the costs of a principal-agent relationship, these costs tend to be more manageable as compared to other governance structures.

4.4 Opportunism

Bounded rationality was one of the characteristics of human nature that TCE accepts; the other is opportunism. Opportunism is understood as self-interest seeking with guile and includes, among others, lying, cheating and stealing. It refers to incomplete or distorted disclosure of information with a view to obtaining unfair advantage over the other party to the transaction. Were it not for opportunism of this kind, all behaviour would be governed by rules. Self-interest seeking that is described by TCE is also referred to moral hazard or agency (Williamson 1989).

The presence of opportunism has important implications for organisation of economic activities. Transactions that are subject to *ex post* opportunism will benefit by devising *ex ante* safeguards. Thus an agent who might be in a position to behave opportunistically, *ex post*, might have to offer credible commitments *ex ante* to signal his bona fides. In any case institutions/governance structures will have to be devised to reduce the transaction costs of opportunism.

Political transactions are equally likely to be afflicted by opportunism, as are economic transactions. Lying, reneging on promises and other forms of opportunism seem natural in a political setting given the record of politicians in most democracies. Agency relationships[2] that are endemic in TCE are likely to be even more prevalent in TCP; further they are likely to be far more complicated and more susceptible to moral hazard.

4.5 Asset Specificity

Asset specificity refers to durable investments that have to be undertaken to support particular transactions. These durable investments may be in physical or human assets, but they have the common property that their opportunity cost is much lower in alternative uses should the original transaction be pre-maturely terminated (Williamson 1985). Asset specificity combined with opportunism makes the party making the irreversible investment vulnerable to demands by the other party to re-negotiate the contract and get for itself a greater share of the returns (Dixit 1996).

The problem of asset specificity in TCP can be related to the time inconsistency problem wherein a policy is reversed/modified after investments are locked in. Such time inconsistency problem combined with moral hazard (Dixit 1996) can lead to the exploitation of one party to the contract by the other. The problem of political contracting in the presence of bounded rationality, opportunism and asset specificity will lead to the development of institutional forms that protect the interests of the parties to the contract. For example, the reliance doctrine, mentioned earlier, would be able to reduce some of the hazards of the time inconsistency problem and enable durable and non-reversible investments to be made. It will be proposed later in this paper that the establishment of a nexus between interest groups and the ruling party is born out of a need to minimise the costs of transacting arising out of asset specificity.

5. THE POLITICAL SETTING

The setting for political contracts envisaged in this paper is a democratic society[3] with periodic elections. The ruling party (RP), at the end of its electoral term, has to seek a fresh mandate of the electorate. Its main objective is to ensure that it is re-elected to govern the country. It is assumed that there is one opposition party (OP) that seeks to dislodge the RP from power. The electorate is divided into two non-overlapping sets, IG and V: $IG \cap V = \phi$.

IG stands for interest groups and V stands for all those voters outside IG, the so-called diffused mass of voters.

Interest groups are defined as groups of individuals with identical tastes and incomes. If U^{i}_{IG} and U^{j}_{IG} are the utility functions of individual i and j, who are members of the IG, then (Mueller 1989, p. 203),

$$U^{i}_{IG} = U^{j}_{IG} \text{ for all } i, j = 1\ldots g, i \neq j \qquad (5.1)$$

where g is the size of the ith IG.

Individuals are assumed to be identical in order to ensure that they are affected identically, either beneficially or adversely, by changes in economic policy. However, this requirement of identical effect of economic policy on all members of the IG does not need identity of the utility function. The following condition would achieve that objective: A change in economic policy S, will affect all members of IG identically if

$$\delta U^{i}_{IG}/\delta S = \delta U^{j}_{IG}/\delta S, \text{ for all } i, j = 1\ldots g, i\neq j \qquad (5.2)$$

where i, j $\in$ IG and g is the size of IG.

The commonality of goals of an IG makes the achievement of these goals a public good *within* the group. This naturally creates incentives for free-riding within the group, as in the case of all public goods. However, the smaller and more tightly knit the group is, the greater is the possibility of monitoring the actions of group members and thereby reducing free-riding. Collective and concerted action is distinctly possible by members of the IG.

The importance and power of an IG is not related to its size but to the influence it has on the RP and this is contextual. There can be no *a priori* guideposts/ parameters, which can help determine the point at which a group becomes influential. If in the perception of the RP, the IG can bring or take away votes during elections, then the group would be accorded favourable treatment. Political support from an IG includes commandeering of votes[4] for the RP and providing funds to the RP which translate into votes via vote-buying, better publicity, etc. Buying or commandeering of votes occurs when members of V are induced or coerced into voting for the RP even though the policy being implemented does not benefit them, either individually or as a group.

To keep the description of V similar to that of IG it may be assumed that members of V have identical tastes and incomes. Their incomes would, generally, be much lower than those of members of IG. Thus,

$$U^m_V = U^n_V \text{ for all } m, n = 1\ldots\ldots v,\ m \neq n \quad (5.3)$$

where m, n ∈ V and v is the size of V.

However, as in the case of IG, it is not necessary to assume that all members of V have identical utility functions. It is only necessary to assume that all members of V are equally affected by changes in a specific economic policy. Note that the economic policy of interest in the case of V is different from the one in case of IG. For some economic policy H, all members of V will be affected equally if:

$$\delta U^m_V/\delta H = \delta U^n_V/\delta H,\ m, n = 1\ldots\ldots v,\ m \neq n \quad (5.4)$$

where, m,n ∈ V and v is the size of V.

Even though V may be large in size, its influence on the RP is minimal. This harks back to the point made above: there need not be a positive correlation between size and the influence wielded by a group. While IG is able to bring to bear a substantial amount of influence on RP, V is not. Some of the differences between IG and V may be noted:

1. The number of members of V being substantially greater than in IG, there will be substantial incentives for free-riding within V. Since monitoring the actions of members of V is likely to be very difficult, if not impossible, V will not be able to take collective and concerted action. Impossibility of monitoring makes it possible for some members of V to be bribed/coerced into voting with IG.

2. Political support from V can only come in the form of votes cast by its members.

It has already been stated that V and IG constitute two non-overlapping sets. I shall also assume that V do not derive any benefit from S, the policy targeted towards IG and vice versa. Symbolically,

$$\delta U^{i}_{IG}/\delta H = 0 \qquad i = 1\ldots..g,\ i \in IG \tag{5.5}$$

$$\delta U^{m}_{V}/\delta S = 0 \qquad m = 1\ldots..v,\ m \in V \tag{5.6}$$

6. POLITICAL CONTRACTS

The *quid pro quo* that is envisaged in this paper consists of a promise of favourable policy by the RP in exchange for political support from IG or V. The preferred policy of the IG (labelled S in the previous section) is availability of subsidised public sector output to itself. For V, the preferred policy (labelled policy H in the previous section) is availability of subsidised welfare amenities (basic education and primary health care) to its members. Availability of subsidised public sector output to IG and availability of welfare amenities to V, both, involve government expenditure. In order to make the problem being studied here non-trivial, I assume that either the RP may provide subsidised public sector output to IG or provide welfare amenities to V, but not both. In the absence of this constraint the RP will be able to favour IG and V[5], and secure the support of both groups.

6.1 Interest Group-Ruling Party Contract

The contract between IG and RP states the following: *The RP will make available subsidised public sector output to IG in exchange for political support which enables re-election of the RP*. The order of play that is envisaged here is that IG first provides political support and on re-election the RP supplies the favourable economic policy. This is very similar to the situation described by Grossman and Helpman (1994, p. 833): "Organised lobby groups evaluate members' prospects under alternative policy proposals and contribute resources to that party that promises them the highest level of welfare…..Clearly, the motivation for political contributions in this setting is to influence the election outcome".

This contract will be incomplete for the following reasons:

Bounded Rationality:

The IG offers political support *in anticipation* of the RP's re-election. It is not at all certain that the RP will be re-elected and the political support extended by the IG may well come to naught. Further, in the event of the Opposition Party's (OP) victory, the IG may be "punished" for supporting the RP[6].

The TCs arising out of bounded rationality are generally non-reducible in a democratic set-up. In any democracy, the outcome of elections belongs to the realm of systemic uncertainty and any effort to reduce this uncertainty, in order to ensure victory for the RP, would infringe on the notion of democracy that is being assumed. In reality, commandeering of votes by IG may abridge democratic rights of the under-privileged who may be coerced into voting for the RP (Vilas 1997). Where democratic traditions are not strong, such measures may indeed be employed by IG and RP to reduce the TCs of the exchange between them.

Opportunism:

The second reason for the incompleteness of contracts is ex-post opportunism that may be employed by the RP. It is quite likely that after being re-elected the RP may renege on its contract with the IG and not provide the policy that was promised before the elections. This is a moral hazard problem, which must be faced by the IG. In terms of agency theory, IG is the principal and the RP is its agent, which is supposed to further the interests of the IG by implementing policies favourable to it. As is usual in the case of agency problems, the IG is unable observe the actions of the RP, but it can observe the outcomes of its actions. Should the IG find that the desired policy has not been implemented, it would be able to detect reneging on the terms of the contract by the RP.

Reducing the TCs arising out of ex-post opportunism by the RP can be achieved by better monitoring the actions of the RP coupled with a rewards/punishment strategy (Milgrom and Roberts 1992). Rewards may be made available to legislators belonging to the RP, who push through policies favourable to IGs. On the other hand, a RP that reneges on its part of the bargain may not be able to secure the support of the IG at the time of the next elections. Such a punishment strategy will ensure that co-operation evolves between the IG and RP. Punishing the RP for violating the terms of the contract will require co-ordinated and collective action by the members of the IG, which may be plagued by problems of free-riding (Olson 1965). However, the small number of members in the IG and the coincidence of their economic interests will alleviate free riding problems and make possible measures to reduce the TCs of the exchange between the IG and the RP.

Asset Specificity:

The problem of asset-specificity is related to two aspects of the IG-RP contract: one, where the RP does not win re-election and two, where the RP, after re-election, reneges on its commitment.

Should the RP be defeated in the elections, the political investment – political contributions to the RP, commandeering of votes – of the IG comes to naught. The investment is specifically oriented towards the RP and cannot be costlessly redeployed towards the OP. This non-reversibility of the political investment arises from a combination of bounded rationality and asset specificity. In a democratic set up, the transaction costs arising out of this situation cannot be legally mitigated. As stated above, where democratic traditions are weak, the political investments made by the IG may be protected by coercing the under-privileged, usually members of V, to vote for the RP.

The second situation arises out of a combination of opportunism and asset specificity. If, after re-election, the RP refuses to fulfil its terms of the contract or seeks opportunistically to change the terms of the contract in its favour, the IG cannot costlessly re-deploy its investment in favour of the OP. This is the situation referred to as “hold-up” in Milgrom and Roberts (1992).

The means of reducing the transaction costs associated with opportunism coupled with asset specificity are similar to those discussed above in the context opportunism: the IG has to monitor the activities of the RP and combine this with a rewards/punishment strategy. From the RP’s point of view, it may be beneficial to signal its commitment to fulfilling its terms of the contract. This may, of course, be difficult in the problem being studied here since the RP can implement the desired economic policy only after re-election. However, concern for its reputation may act as an effective check on the RP’s *ex post* opportunism. The value of a reputation depends on how often it will prove useful, which in turn depends on the frequency of similar transactions, the horizon over which the transactions are expected to occur and the transactions’ profitability (Milgrom and Roberts 1992). The interaction between the IG and the RP is likely to be an enduring one and likely to occur at regular intervals; further the transaction will likely prove profitable for the RP since it is helpful in its re-election bid. All these factors indicate that concern with its reputation will act as an effective check on the *ex post* opportunism of the RP.

6.2 Voters-Ruling Party Contract

It would seem that the contract between V and RP can be written in the same manner as the contract between IG and RP: *The RP will make available subsidised welfare amenities to V in exchange for political support which enables re-election of the RP.* However, deciding the order of play is important here. If there is no history (and hence no knowledge) of the relationship between V and RP, the exchange between them may well be modelled in the same manner as the exchange between IG and RP. The RP promises welfare improving measures in exchange for votes from members of V and, further, votes will be cast in anticipation of these amenities. However, in most developing societies there is a history of persistent neglect of the welfare of the diffused mass of voters (see Chalmers et al 1997) who are often deprived of the most basic amenities. Simultaneously, there is enough evidence and widespread knowledge of the nexus that exists between IG and RP (see Gibson (1997) for Argentina and Mexico, Moore (1997) for Sri Lanka, and Karnik and Lalvani (1996) for India). Given this background, it seems reasonable to conclude that V will not promise votes for RP in anticipation of welfare amenities: it would be suspected, and reasonably, that RP will renege on its promise after re-election. In order to make RP's commitment credible, the order of play will have to be reversed. The RP will have to provide welfare amenities in anticipation of votes from V[7].

The contract between V and RP, that takes into account credible commitments by the RP, may be stated as follows: *V promises political support to RP in exchange for prior provision of welfare amenities*. As in the case of the IG-RP contract, this contract too will be incomplete for reasons of bounded rationality, ex-post opportunism and asset specificity.

<u>Bounded Rationality</u>:

As stated above, the RP, in order to signal its credibility, will have to provide welfare amenities in anticipation of votes from V. Further, in view of the restriction mentioned in footnote 8 above, the provision of welfare amenities will have to take place substantially prior to the elections. The RP, at this point, cannot be certain of victory in the elections. This uncertainty that the RP has to face belongs to the class of systemic uncertainties which cannot be reduced in a democratic context.

The other problem arising out of bounded rationality is concerned with voter myopia. Since welfare amenities have to be provided substantially prior to elections, short voter memory[8] may mean that V does not reward the RP for the provision of welfare amenities.

The TCs arising out of bounded rationality have to borne by the RP and not by V. Should the RP lose the elections, its investment in welfare amenities will have come to naught. Further, voter myopia will mean that the RP may not be rewarded for providing V with welfare amenities. It may be remembered that in the IG-RP contract, the TCs of bounded rationality had to be borne mainly by the IG.

Opportunism:

The second reason for the incompleteness of the V-RP contract is ex-post opportunism on the part of members of V. Having received welfare amenities from RP, voters may renege on their commitment and vote for the OP. There are two reasons for this, the first of which was labelled "voter myopia" and discussed above. The more plausible reason could well be that voters might be bribed by the OP to vote against the RP. Voters, in this case, get the best of both worlds: they receive welfare amenities from RP and bribes from OP. The large number of voters makes the monitoring of voter actions virtually impossible for the RP; in any event, in all democracies, voting is by secret ballot and the RP cannot monitor voter action even if it were possible.

The TCs arising out of ex-post opportunism of V have to be borne by the RP. Neither monitoring of V's actions nor punishing V for reneging on the terms of the contract can reduce these TCs. As stated above monitoring of V's actions is virtually impossible and, in a democracy, legally not permissible. Even from the point of view of V, it is impossible to prevent free-riding, given the large number of members of V. As stated above the large number of members of V makes collective and concerted action by V extremely difficult. The threat of punishing V for reneging on its terms of the contract by the RP may not be very potent. Reneging by V will be discovered after elections, when the RP has already been unseated from power: in the absence of political power the RP cannot credibly threaten to inflict punishment on V. Thus, it appears that the RP has no means for reducing the TCs arising out of opportunism in the contract between it and V.

Asset Specificity:

The investment in welfare amenities made by the RP, in order to signal its credibility, is specific to the transaction. Once the asset has been created it is no longer fungible in the way government expenditure is. Should V renege on its commitment and not vote for the RP, the assets created for welfare amenities represent a sunk investment. These assets cannot be re-deployed to benefit IG: these assets have virtually no value in alternative uses.

The TCs associated with specificity of assets to be created for V have to be borne entirely by RP. The only way to reduce the TCs involved here would be to provide welfare amenities to V *after* elections. This, however, will dilute the credibility of RP's commitment to V. Consequently, it appears that the TCs of the contract between V and RP, arising out of asset specificity, cannot be reduced and have to be borne entirely by RP.

7. COMPARING THE TWO CONTRACTS

TCE focuses on the evolution of governance structures, whether institutions or contractual forms, to cope with transaction costs. Institutions and contractual forms will come into existence that seek to minimise a notion of cost that is more comprehensive than in neo-classical economics and includes, apart from production costs, transaction costs also. A similar idea runs through in TCP: "There is clear potential benefit from economising on transaction costs. Rules and institutions should, and do evolve to serve this purpose" (Dixit 1996, p.61). It is this perspective that guides the evaluation of the two contracts discussed in the previous section.

The RP needs the support of either the IG or V in order to win re-election. Getting the support of either of the two groups requires different types of contracts, each with its own magnitude and distribution of TCs. The TCs in the IG-RP contract are faced mainly by the IG, which can take measures to reduce these costs through monitoring and a rewards/punishment strategy. On the other hand, the TCs in the V-RP contract are faced mainly by the RP and it seems unlikely that any amount of monitoring and/or punishment strategy will enable reduction of these costs. From the point of view of minimising TCs, it is apparent, that the IG-RP contract works better and that is the contract that will be preferred by the RP, the common party in both the contracts. Further, in the IG-RP contract, the distribution if TCs is completely in favour of the RP, unlike in the case of the V-RP contract: in the former all TCs are borne by the IG and in the latter all TCs are borne by the RP.

In view of the above it appears that the RP will select the contract that imposes the lower cost on it. It is, therefore, not surprising to find the widespread prevalence of contracts/nexuses between interest groups and (ruling) political parties in democracies that require periodic elections.

8. CONCLUSIONS

The objective of this paper was to examine the close association between the ruling party and interest groups using the lens of transaction costs. Using the transaction costs perspective it was possible to show that, when being re-elected is the main objective of the ruling party, it would prefer to enter into a contract with interest groups rather than with the diffused mass of voters. This scenario would emerge even in the absence of corruption, that is, even when bribes and other illegal transactions between interest groups and the ruling party are assumed away. In the transactions between the ruling party and IG and between the ruling party and V, this paper has shown that the latter exchange involves much higher transaction costs. Consequently, the ruling party will prefer to deal with interest groups to attain its objective of getting re-elected.

END-NOTES

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[1] The following quote from Tendulkar (1983) is illuminating: " …the term 'political will' is not meant to imply 'political muscle' in the sense of going beyond the democratic process. The term is meant to capture the genuineness of commitment to the redistributive strategy at the operational level, the unequivocal political sanction and support behind the strategy as well as the political finesse in bringing about appropriate coalitions of interest groups to back the redistributive measure, the last two being conceived within the framework of established political process" (note 83, p. 126). This quote of Tendulkar exclusively refers to a redistributive process, while we are rather more interested in the pursuit of efficient economic policies by the government. (I would like to thank S. Mohan for bringing this contribution of Tendulkar to my notice.)

[2] It will be sometimes difficult to determine who is the agent and who the principal in the agency relationship. In the neo-classical framework, there is no divergence between the interests of the state and the citizens and, hence, the usual problems of a principal-agent

relationship do not arise. On the other hand in the public choice framework the state is itself the principal (Mueller 1989).

[3] Even though I do not distinguish between a developed and a developing society much of what follows seems more relevant in a developing society.

[4] Elites belonging to interest groups have been able to commandeer votes in Argentina and Mexico (Gibson 1997) and in India (Chicherov 1985).

[5] No doubt such a strategy will have consequences for government finances and the economy in general, but an analysis of these consequences is beyond the scope of this paper.

[6] Dixit (1996) notes that many IGs, that are pivotal in the political spectrum, are courted by both the RP and OP; consequently the danger of "punishment" may be remote.

[7] In India, a Model Code of Conduct enforced by the Election Commission prevents the government (RP) from taking decisions, that are likely to influence election results, after the dates/schedule of the elections are announced. Consequently, the provision of welfare amenities may have to take place substantially prior to the elections. This, as is obvious, will introduce grave imponderables in the exchange between V and RP.

[8] In Nordhaus (1975) voters are influenced by what has happened in the period immediately preceding the elections; events further in the past tend to be heavily discounted and may play no role in voting decisions. If voters in the V-RP contract are similarly myopic they may "forget" that the RP has provided welfare amenities to them.

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