"The Political Economy of State Reform -- Political to the Core"

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Only a professor of political science, indeed a specialist in *theories* of politics, would have the audacity to address a subject -- state reform -- on which he has intelligent opinions at most, and apply his views to state reform in a political system -- Colombia -- about which he appreciates only its broadest contours at best. Yet this is the task your National Planning Department has set for me, and this is what I have agreed to do. To no one's surprise I will proceed as a professor might, first laying out some of my general views about the subject of political economy and only then turning my spotlight to illuminate issues of state reform.

As a political scientist working in a field that historically has been dominated by economists, I will be especially attentive to the political aspects of political economy. Too often, I am afraid, economists treat topics in political economy as applied economics, reducing politics to a black box conceptually, and regarding it as a genuine nuisance substantively. This is no more evident than in the *World Development Report 1997* produced by the World Bank. Subtitled "The State in a Changing World," this elegant report is the product of highly intelligent Bank economists and technocrats who have a considerable disdain for politics. Their advice is to create state institutions that are, as much as possible, *purged* of politics. Politics in this view is something that distorts, even perverts, noble objectives. Politics interferes with mechanisms designed to foster economic investment, growth, and fair distribution. If only politics did not rear its ugly head, all would be, if not sweetness and light, then at least a marked improvement over a world in which politics is pervasive. Politics, in short, is a large part of the problem, and certainly not part of the solution.

I am not entirely naive, but my own opinion differs from those of the *World Development Report* authors by a matter of degree -- 180 of them! Politics is part of the problem, for sure. But it *must* be part of the solution as well. State institutions are inherently political, from their initial charters, to their authority and annual operating budgets, to the manner in which they go about the business of regulating, taxing and spending, redistributing, and producing public and private goods. Those engaged in state reform must take politicians and political motivations as a fixture and try to design institutional arrangements in light of these, not despite them.

I will arrive at this conclusion shortly and suggest ways in which problematical political motivations can potentially be harnessed and constrained. But first I need to describe how to put the "political" back into political economy. I will do this by portraying two political economy approaches and four social science revolutions. This is mood music sung in decidedly academic octaves -- what else could you expect from a professor? -- but it will give you some sense of how I arrive at my conclusions about state reform.[1]

1. Two Views of the New Political Economy

When the United States was becoming a new nation in the late eighteenth century, the founding elites were very practical men. These men, after all, had led a revolution against a colonizing power -- probably the most powerful nation in the world at the time. In a very unsettled period following their victory, they sought to craft political arrangements that would preserve the liberties of the people while simultaneously allowing the citizenry to prosper. In retrospect what is truly remarkable to us today is not their practical wisdom, though that was surely impressive. Rather it was their deep and subtle intellectual appreciation -- almost a philosophical sensibility -- of alternative institutions for and strategies of governing.[2]

Two of these leaders, Alexander Hamilton and James Madison, participated in drafting the Constitution and then led the campaign for its ratification in the states.[3] Each was interested in governance and in the role of political and economic institutions in doing this. In effect, each believed that the equilibria of unregulated, uncoordinated, political and economic life could be improved upon by *institutional design* -- precisely the same belief shared by the economists and technocrats who drafted the World Bank's *World Development Report* and, presumably, also shared by those of you attending this Seminar for State Reform here in Bogota. By this they meant that through institutional design property rights could be made secure; that transaction costs, in both private markets and public life, could be reduced; that externalities could be better internalized and public goods production incentives made more attractive; in effect, that the

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[1] If time and space had permitted, I would have included three different views of institutions as further background. As interesting as I find these kinds of discussions, I expect I will already have tried my audience's patience with the abbreviated version found here.

[2] This combination of wisdom and practicality is not so surprising, since it was born of experience. This "new" nation of the late eighteenth century had had more than a century of limited self-governance as part of a highly decentralized and far-flung empire.

[3] Except for very practical campaign activities in their home states, the largest role played by Hamilton and Madison was as authors of pamphlets and editorials explaining the various features of the proposed constitution. These were distributed across the land over the pseudonym Publius, and subsequently gathered together into the now-famous volume, *The Federalist Papers*.

dividends of cooperation could be better secured and captured. Of course, Hamilton and Madison did not think in precisely these terms, though both were products of the Scottish Enlightenment and the intellectual ferment then taking place on the European continent, and thus were familiar with the writings of Adam Smith and David Hume as well as those of Condorcet and Montesquieu. In short, each brought a prudent cynicism to considerations of human nature, but nevertheless were optimistic that "political science" -- a term coined by Alexander Hamilton -- could be utilized to design institutions to harness human nature for productive purposes. To us Hamilton and Madison would be recognized as political economists. But there was a difference between them reflected today in two different types of political economy.[4]

Hamiltonian political economy. Many of you in this room, and many who join me here as lecturers, are Hamiltonian political economists. At the end of the day you *are* economists. As Hamiltonians, you are interested in economic patterns and in providing explanations for them. But unlike your neoclassical brothers and sisters, you believe that political choices and political institutions are a significant part of the story. Explorations in Hamiltonian political economy, for which there are large and impressive theoretical and empirical literatures, include the analysis of:

- patterns of covariation in inflation and unemployment influenced by the electoral calendar in democratic societies -- the so-called political business cycle;
- interest-rate and money-supply patterns affected by the degree of independence of the central bank;
- public expenditures financed by a mix of debt and taxes in proportions dependent upon political reputation mechanisms; and
- economic growth as an endogenous result of political arrangements.

A Hamiltonian political economist, as these examples make evident, takes economic patterns and regularities as things to explain or forecast, but believes they are at least partially the product of political incentives and structural arrangements. Economic outcomes, that is, are the equilibrium patterns driven by both economic incentives *and* public policy. Public policy, in turn, is the endogenous product of interactions inside political institutions among politicians and bureaucrats; it is neither some exogenously stipulated condition nor the choice of a mythical social planner. Contemporary Hamiltonians would include my Harvard colleagues, Alberto Alesina, Robert Barro, and Andrei Schleifer, as well as luminaries such as Nobel laureates Douglass North, James Buchanan, and George Stigler.

[4] This distinction between Hamiltonian and Madisonian political economy was first made by Robert Bates, "Institutions as Investments," Development Discussion Paper No. 527, Harvard Institute for International

Madisonian political economy. Alexander Hamilton was preoccupied primarily with jump-starting the economy of a new nation. A political constitution that encouraged investment and development through secure property rights and prudent fiscal, monetary, and trade policy was seen by him as means to those ends. His famous *Report on Manufactures*, as well as a number of the essays authored by him earlier in *The Federalist Papers*, emphasized a sound currency, the federal assumption of state revolutionary war debts, a balanced budget, and a tariff and subsidy regime that would allow "infant industries" to prosper. He was an economist who believed in the role of state performance and the necessity of state intervention for a prospering economy and economic growth. His schemes were early incarnations of what we have come to call "industrial policies." His interest in political institutions -- bicameralism, separation of the legislature from the executive, electoral arrangements, an independent judiciary and central bank -- was driven by instrumental and pragmatic concerns. He wanted to check and reduce the damage he felt had been perpetrated by the inefficient institutional arrangements of the earlier regime under the Articles of Confederation (1776-1789).

James Madison, on the other hand, was a political economist of a different stripe. He was *not* so preoccupied as Hamilton with economic performance. He shared with Hamilton, however, a view of human nature that some of his contemporaries (and some of ours!) characterized as cynical, but that modern social scientists now would describe as rationality-based. For a Madisonian political economist, it is the economic *approach* that is central, quite apart from economic content. Processes of preference formation, revelation, and aggregation follow a rationality-based economic logic, though they need not be described in terms of economic substance. Madison, something of a political philosopher and student of the ancients, sought to understand the working properties of political institutions for their own sake. The Madisonian political economist, then, uses the apparatus of individualism, self-interest, and rationality that forms the foundation of modern economics, but adapts it to conduct *political* analysis. Explorations in Madisonian political economy, for which there are also large and impressive research literatures, include the analysis of:

- the operating characteristics of majority rule and other voting mechanisms -- of which Arrow's famous Impossibility Theorem is the exemplar;

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- the spatial formulation of political competition popularized by Anthony Downs and Duncan Black, displaying the centripetal tendencies of majority-rule decision making in legislatures and elections;
- the advantages that accrue to agenda-setters in committee deliberations;
- the significance of rules of procedure and the division and specialization of labor, especially those governing the power to propose and amend, in committees and legislatures; and
- the influence of bureaucracies, both as repositories of expertise and as possessors of a "last move" advantage, in the implementation of public policies.

Contemporary Madisonians, among whom I number myself, include Kenneth Arrow, Duncan Black, Anthony Downs, Morris Fiorina, Mancur Olson, William Riker, and Barry Weingast. Their major interests, as the examples above illustrate, are in the operating characteristics of institutions of governance.

Modern political economy consists of Hamiltonians and Madisonians, but in my view it is not a horse race or a beauty contest between these two types. They should be thought of as complements, not substitutes. If I were to provide a summary distinction, it is that Hamiltonians have little use for politics per se, except that they wisely realize it cannot be ignored, whereas Madisonians take little intrinsic interest or pleasure in exploring the trucking and bartering of the marketplace, except that they wisely concede the central significance of economics in defining the individual preferences that stimulate political action. Each needs the other and, in the closing decades of the twentieth century, each has contributed to what we now recognize as the *new political economy*.

2. Political Economy and Institutions: A History Lesson about Four Revolutions

Having described two kinds of political economy, I now turn ever so briefly to four revolutions that brought political economy to its present preeminence in political analysis. As I am a political economist of the Madisonian type, this brief bit of intellectual history will describe the evolution and present condition of more formal and even mathematical approaches to the study of political institutions.

Before the second world war, political science consisted of two major enterprises:

- *political theory* -- by which was meant the history of political thought and other forms of ancestor worship; and
- *institutions* -- principally thickly descriptive and heavily historical discussions of political organizations and practices, e.g., legislatures, bureaucracies, courts, law, diplomatic arrangements, etc.

During and after the war, the advent of survey research methodology, descriptive statistical methods, other enhancements in measurement and data collection, and the growing dominance of social-psychological approaches produced a virtual sea-change in political studies known as the *behavioral revolution*. This first scientific revolution was a salutary one in the sense that it pushed political science away from a more essayistic, interpretivist enterprise and toward empirically based social science, away from history-writing and toward systematic description and "middle-range" theorizing. In its eagerness to reject the past, however, the behavioral revolution pitched overboard the treatment of institutions. Indeed, "individualism" took hold so firmly that even when it was necessary to make reference to an institution or an organization -- family, political party, firm, bureau -- these were treated as *unitary actors*, falsely personified as having beliefs and preferences like indviduals. The behavioral revolution, in sum, conceived of society as consisting of atomistic individuals without the social glue that we associate with institutions, norms, and other social practices.

The behavioral revolution in political science was a triumph of empirical and theoretical sociology and psychology over a kinder, gentler, historical and philosophical scholarship. During this same postwar period another revolution was occurring in economics -- actually two revolutions, one associated with game theory and the other with social choice theory. The *social choice revolution* and its exemplars -- Kenneth Arrow, Amartya Sen, Herbert Simon, and others -- provided a methodology with which to study groups from a decidedly non-sociological, non-psychological perspective. In effect, it imported variants of the rational-actor approach from economics to the study of group decision-making in non-market settings. The nature of the group was left unspecified so that it was entirely possible to remain within the province of economics by employing it, for example, to enrich the theory of the firm. On the other hand, it was a flexible methodology that could reach out into non-economic realms, enriching the study of bureaucracies, political parties, legislatures, clubs, and other non-market institutions. It provided a major impetus for a general theory of organizations that has reached fruition in what is today referred to as the *new institutional economics*, associated with Coase, North, and Williamson, among others.

The social choice revolution provided a method for explaining collective decisions on the basis of the individual preferences of participants and the mechanism by which those preferences were revealed and aggregated into a social choice. Although there were numerous normative debates informed by this approach, the significant positive contribution for political analysis concerned the operating characteristics of majority rule and other methods of non-market group choice. The social choice revolution raised the consciousness of political scientists about the possibility of a deductive approach through which to develop insights about the practices of real institutions.

In the context of group choice by methods that essentially involve voting, the most profound result, the Arrow Impossibility Theorem, established that it is not possible to assure that otherwise well-behaved individual preferences will add up to a well-behaved group preference. To the political scientist of the 1960s (and perhaps still true today), it was genuine news that you could have "rational man and irrational society," that coherent individual preferences need not aggregate into coherent group or collective preferences. From this it became apparent that badly behaved group preferences meant that group choices need not be stable. Having just taken a choice, a group might well be disposed to revisit the issue because some decisive coalition of actors preferred a different choice. This latter choice, in turn, was similarly afflicted, so that whatever the group decided was unstable and thus constantly vulnerable to revision. The theoretical results that are now impolitely referred to as "chaos theorems" strongly implied that social choices, unlike individual choices, were not decisive and, because of this, were always open to cabal and intrigue. As my mentor, the late William Riker, used to enjoy asserting, "Politics, not economics, is the truly dismal science."

The chaos and indecisiveness of the *theory* of social choice, however, resided uncomfortably with the stylized fact that groups often *do* come to decision, and that they do so decisively in the sense that they feel no strong need to revisit and reconsider issues already decided. If, as Arrow says, social choices are chaotic, then why so much stability? This was the question that engaged the curiosity of the next generation of social choice theorists, yielding two answers, and thus two lines of theoretical research. The first answer was *transaction costs* -- Coase was just coming into fashion at the time -- by which was meant that even if group "preferences" exhibit incoherence, its choices may nevertheless exhibit equilibrium-like stability once one takes the costs of reconsideration into account. The second answer to the "why so much stability?" question was *institutions*. According to this view, institutions provide structural and procedural devices, empowering agenda setters and veto players, on the one hand (for example, committee chairs, party leaders, executives), and restricting the alternatives available for choice, on the other (for example, rules governing amendments in a committee or legislature), and from these devices chaotic instability is suppressed. Each of these lines of inquiry has provided several decades worth of Madisonian-style insights.

A third revolution, one that is still on-going, is the *game theory revolution*. Politics is not just about structure and preference, it is about strategy as well. Arrow's early papers on social choice were produced at a time when a warm glow still surrounded von Neumann and Morgenstern's *Theory of Games and Economic Behavior*, a book that dominated economic theory just after the second world war. After a brief postwar enthusiasm, game theory went into intellectual hibernation for several decades during which time the social choice revolution gained steam. A few "true believers" kept it alive during this period, but a particular feature of the approach was ill-suited to political analysis thus limiting its applicability to this subject.

The game theory of von Neumann and Morgenstern assumed that strategic actors had the capacity to make *binding commitments*. Once a deal was struck, it stayed stuck! In effect, this required that there was some exogenous enforcement institution that guaranteed all promises. This stipulation might be regarded as reasonable in an environment in which the rule of law existed and legal institutions smoothly conducted their business. Indeed, perhaps it did make sense as a stylized characterization of the environment in which buyers and sellers interacted. If the nature of exchange were simple, if contracts were unambiguous and inexpensive to implement, and if legal institutions swiftly and cheaply punished those in breach of such contracts, then this stylization might well lead to interesting insights.

There were, however, two serious objections to this formulation as it applied to political analysis. First, legal enforcement is an inherently *political* function, and yet the game-theoretic approach just described treated it as exogenous and entirely unproblematical. As the *World Development Report 1997* makes amply clear, however, issues of lawlessness and highly imperfectly functioning legal systems must be regarded as an essential *endogenous* feature of a political economy. Moreover, given the essential role played by enforcement, it is necessary to analyze the incentives facing the enforcer. Whether as a judge, a prosecutor, a sheriff, or a godfather, this enforcement agent does not work for free; and, unless one repairs to an assumption of benevolence (of the sort implausibly describing the social planner of welfare economics), one must assume that even the enforcer has personal ambitions and objectives. Second, so much of political life is conducted outside of the shadow of the law. Promises and commitments made between politicians, for example, are not legally binding, and therefore cannot rely upon official forms of exogenous enforcement, even if the latter were unproblematical. Even contracts among economic agents nominally covered by legal conditions are so incomplete and ambiguous as to handicap exogenous enforcement severely. So much of politics, it seems to me, and by extension so much of political economy, depends upon elements of *self-enforcement* -- trust, reputation, commitment, the prospect of continuous dealings, etc. And in these respects the game theory of von Neumann and Morgenstern was inadequate.

An alternative variant of game theory emerged in the 1970s, however, in a form that allowed it easily to be incorporated into political analysis. Known as noncooperative game theory, its early structure anticipated by Thomas Schelling, it has in two decades captured the imagination of many economic theorists. In this variant it is *not* assumed, by fiat, that deals, promises, and threats will necessarily be implemented. Indeed, only those that the agent making them finds it in his or her interest to follow through on will be taken seriously. If an agent is anticipated to find it attractive to renege, then, because he or she has the actual discretion to do so, the agent's initial commitment will not be regarded as credible at the time it is made.

This game theory revolution has allowed strategic behavior to be accommodated in a natural way by making *credibility* its centerpiece. Because agents in the political economy often find themselves blessed with discretion and unconstrained by the prospect of subsequent enforcement, they also find themselves *cursed* by this very same discretion. Discretion is not all it is cracked up to be, for it prevents deals that may be mutually beneficial from ever occurring. What noncooperative game theory highlights is the necessity, absent exogenous enforcement, for political and economic agents to find devices through which to bind themselves, much as Ulysses did in committing not to be seduced by the Sirens' song. Some of these devices are individual, as in the economic agent's concern for reputational integrity to enable future dealings. Others are social and institutional in nature and have the effect of disabling discretion. A majority coalition's offer to a legislative committee of a *closed rule*[5] to protect its legislative recommendation, for example, serves as a credible commitment by the legislature not to amend the committee's product. It therefore also serves as an inducement for the committee actually to report a piece of legislation of mutual benefit to committee members as well as those of the majority coalition in the legislature, rather than to exercise its authority to "keep the gates

[5] A closed rule in a legislative proceeding protects a bill against amendments from the floor. Accordingly, the bill drafter is effectively empowered to make a "take-it-or-leave-it" proposal to the legislature.

closed." Tying its hands, as the majority does when it grants a closed rule, means that it will get some improvement over the status quo rather than nothing at all.

To sum up this tour of revolutions, the behavioral revolution put a premium on science and a focus on the individual. The social choice revolution maintained the commitment to science and the behavioral focus on the individual, but imported rational-actor methods from economics, on the one hand, and traced their implications for non-market collective decision processes, on the other. The game theory revolution allowed strategic behavior to be accommodated, emphasized the importance of discretion and credibility, and provided a framework in which to embed phenomena that play out over time. I have promised you a fourth revolution, to which I now turn, but need to emphasize here that while all of the revolutions just described provide powerful tools and fundamental building blocks, they fail to allow for a full elaboration of the analytical feature in which students and practitioners of reform are most interested -- namely, institutions. The next revolution I describe takes this as its focal point.

The *neoinstitutional revolution* is of recent vintage. An older institutional tradition in economics and political science, more historical and descriptive than analytical, had been rejected fifty years ago. Behaviorists in political science and sociology focused almost entirely on individuals, treating them as disembodied roles or statuses or attitudes. Economists, whether social choice theorists, game theorists, or plain vanilla neoclassicists, treated individuals as disembodied preference orderings or utility functions. Nearly all of social science had chucked overboard any role for institutions. Neither proactive, maximizing, rational man nor reactive, pre-programmed, sociological man is any more than a free-floating atom in these theories, unconnected to others not to speak of any broader social or institutional structure. The economist James Duesenberry got it about right when he quipped that "economics is all about how people make choices; sociology is all about how they don't have any choices to make." Neither approach models the structure of a broader society. I call this broader structure *institutions*.

In the late 1970s a number of rational choice oriented political scientists, myself included, grew frustrated with these overly atomized conceptions of political and social life. Politics takes place in context, often formal and official (as in a legislative, bureaucratic, or judicial proceeding), but often informal as well (as in a club or faculty meeting). Though committed to the rational-actor methodology, we felt that explanations and understandings based only on individual maximizing behavior were unnecessarily impoverished. In my own case this conviction came from studying *real* social choices -- namely those that took place in the legislative process of the United States Congress. There I was struck by the importance substantive scholars placed on *structural features* like the division- and specialization-of-labor committee system, leadership, staffing arrangements, and party groupings, and on *procedures* like rules regulating debate, amendment activity, and other features of daily institutional life. Game and social choice theorists had, for the most part, suppressed these kinds of details, feeling they were so specific -- so hopelessly place- and time-bound -- as to detract from otherwise general theories. But this was a mistake, a sort of intellectual hubris on the part of theorists in which the suppression of institutional details in the quest for generality actually robbed their theories of generality by limiting their coverage to rational behavior in the most spartan of all settings -- that of minimal institutional structure.

The complaints about minimal structure may well have gone unheeded were not the game-theoretic developments I described earlier in full throttle. Noncooperative game theory, in requiring a detailed specification of the rules of strategic interaction, the strategic options available to each player, the sequence in which each player made his or her moves, and the information available to the player at the time of choice, had provided an analytical way to represent institutional processes. It was less thickly descriptive than the older institutional tradition, but clearly more fine-grained in its requirements than the more abstract and parsimonious theoretical approaches that preceded it. The neoinstitutional revolution exploited this structure while, at the same time, redressing the diminished attention to historical and descriptive detail of institutional processes that had been the result of prior scientific neglect.

I conclude the story here not because I have done justice to the neoinstitutional revolution that is upon us, but rather because this revolution is still working itself out and further assessment will require some distance from these ongoing events. From the flurry of research activity currently under way, I believe it is increasingly evident that this approach, essentially the working out of the Madisonian program in political economy, will provide us with insights and direction for tackling questions of institutional design that are uppermost in the minds of those concerned with state reform.

3. A Parable

Permit me one last bit of throat clearing before turning to the main topic of this seminar. Consider the following parable. There once was a farmer who owned a goose that laid golden eggs. The farmer and his family lived well off the goose's issue. The farmer, moreover, enjoyed special privileges as head of household. There came a time in this story, however, when the farmer, now quite old, was tempted to kill the goose that laid golden eggs in order to enjoy a delicious meal it would provide him. The farmer, after all, had little time left so all those golden eggs that might have been brought forth in the future were of little value to him. The prospect of indulging in a feast of glorious proportions, on the other hand, was a matter of immediate and immense gratification. Would the farmer kill the goose that laid golden eggs? Should the farmer kill the goose that laid golden eggs?

Since I've said this was a parable, it must stand for something more profound than a mere farmer and his goose. Before turning to that, let's develop the parable a bit more by examining exactly who has what at stake. We have already noted that the farmer, with only the faintest shadow of the future to influence his thinking, is disposed to consume now at the cost of a stream of future golden eggs, a cost that the farmer heavily discounts. And we need not dwell much on the obvious fact that the goose, herself, has an interest in all this. A life of continued service to the family is not heaven on earth, but it is considerably better than consuming now, since the goose would be the "consumee." The farmer's children and heirs clearly have a stake as well. They are denied their birthright and the eldest son, in particular, will eventually be elevated to the head of a considerably poorer household. Others, too, would likely take an interest. Animal rights activists, for example, would hardly approve of having the goose's neck wrung.

Nevertheless, as head of household, it is the farmer's choice to make. As a rational man he would weigh the utility of a sumptuous feast of roast duck against the present value of the stream of benefits derived from the flow of golden eggs on into the future. Being broad of mind -- he is an enlightened leader -- he might well give weight to matters in addition to his own narrowly defined welfare. The present value of the not-consuming alternative thus will impound such things as dowry, bridewealth, and inheritance for his children; the political and ideological nuisance of alienating activists; and his own future welfare, even if it does not stretch very far in time. The question is: how much weight will he give these other factors? He could live, at least for a brief moment, like a king. Will he forego that pleasure to insure the future welfare of his people? More generally, must families depend upon enlightened heads of household for their welfare, and failing that, will theirs be a life of perpetual misery?

The point of the parable should be clear, but just in case it isn't, let me illustrate with a real case from a distant land. On July 1, 1997, the relationship between the crown colony of Hong Kong and Great Britain came to an end, and authority over the island was transferred to the People's Republic of China (PRC). Speculation was rampant during the several years of run-up to the transfer, and remains so to this day, about the intentions of the PRC leadership. Would the Chinese leaders, it was asked, "kill the goose that lays golden eggs"? They are old men, it was observed, and there is no telling whether they are disposed to behave in an enlightened manner, preserving the vibrancy of the Hong Kong economy into the distant future, or turning it to present needs of which there were many. As in the parable above, assuming rationality on the part of the PRC leadership, and even allowing for (limited) enlightenment, the magnitude of pressing current needs, on the one hand, and the age and hence foreshortened time horizons of the leadership, on the other hand, are not a promising basis for the goose to get its hopes up.[6]

The parable has several messages. The politics in the parable is minimal, but issues of leadership and of succession nevertheless play a role. (In a moment I will elaborate this point.) Second, the politics unfolds over time. The time horizons and valuations of the future may not be well synchronized among the actors in a political situation. The presently powerful, for example, may discount the future more heavily than younger followers, moving benefits up to the present and pushing off costs to the future, because they do not expect to bear the consequences of these otherwise ill-advised choices. The PRC leadership, as we just saw, may be too consumed by present requirements, including their own well-being, to give much weight to the longer term in their actions toward Hong Kong. The same may be said for the farmer, in which case his family's goose is cooked! Third, enlightened leadership is *one* mechanism for synchronizing the present with the future, but it is a weak reed. Here "synchronizing the present with the future" should be taken as an inelegant way of describing a path of economic and social development that, if not optimal in some sense, is at least respectable. In sum, the implication from this parable having significance for the issue of state reform, one that I will emphasize in

[6] This same question was reportedly asked by Shanghai businessmen of the intentions of newly victorious Mao Tse-Tung and the communists in 1949. It was mainly asked rhetorically, however, for the businessmen were certain that the communists would not kill the goose that laid golden eggs -- in this case the thriving international business community in Shanghai. It is wildly inaccurate forecasts like this one that give force to the aphorism that hindsight is better than foresight by a damn sight! This story is developed in

the remainder of this paper, is the necessity of arranging institutional features to accomplish appropriate intertemporal synchronization. This is an institutional design question that is pure Madisonian political economy. But first, let me add one complication to the parable.

4. The Parable Revisited

Let us revisit the parable of the farmer and the goose that lays golden eggs. As before we have a farmer with the authority to decide whether to eat the goose or let it remain a family asset. I now introduce a second political actor, the eldest son. According to tradition and practice in the village in which the farmer's household resides, the eldest son succeeds to the head of household upon the death of his father and, while the father lives, the son is his deputy. As deputy, the son does more than just pass time. In any "executive decision" by the head of household to depart from customary practice, the head requires the acquiescence and assistance of his deputy. Thus, if the head allows the goose to live and, like any piece of productive capital, continue producing for the family's welfare, then this policy is automatically implemented. Everyone, in effect, keeps doing what they have been doing. If, on the other hand, the head determines to depart from the status quo, he requires the assistance of his deputy to consume the capital. The deputy enjoys none of the consumption (not even a drumstick!), but his collaboration is required to kill the goose that lays golden eggs.

Although this revised parable depends upon custom and tradition in the village, we could imagine a slightly more general story in which the household had a constitution which specifies the institutional arrangements I just described.[7] Uber-officials determine policy changes, but they require the assistance of unter-officials for their implementation. If, for example, the PRC leadership determined to spend down the capital windfall represented by the transfer of Hong Kong to their authority, and if such a policy departure required the implementation services of lower-level officials, officials who aspired to become leaders at some point in the future, then the discretion of the leaders, like the discretion of the farmer, is qualified. The outcome will depend upon the willingness of ambitious deputies, like the eldest son in the household, to serve the wishes of their leaders but then risk a depleted cupboard when it is their time to lead.

Bueno de Mesquita, Bruce, David Newman, and Alvin Rabushka, *Red Flag over Hong Kong* (Chatham House, 1996).

[7] The issue of crafting a constitution capable of coping with intertemporal issues like economic development is analyzed in Soskice, David, Robert Bates, and David Epstein, "Ambition and Constraint: The Stabilizing Role of Institutions." *Journal of Law, Economics & Organizations* 8 (1992): 547-561. I have borrowed heavily from this fine article.

5. The Political Economy of State Reform, I: Politicians

Early in this paper I alluded to the antipathy planners often have toward politics and politicians. I briefly mentioned indications of this found sprinkled throughout the *World Development Report 1997* (WDR) of the World Bank. In that report its authors seek to isolate politics and insulate the reform process from it, unless a political leader is enlightened as was a possibility in the parable above. They reserve their praise for "reform-oriented political leaders and elites," describing them as "farsighted political leaders" who "gave greater voice to often-silent beneficiaries" and "spelled out a longer-term vision for their society, allowing people to see beyond the immediate pain of adjustment" (*WDR*, p. 14).

In effect, planners appreciate that the temporal path for successful economic development requires short-term pain for long-term gain. Investment -- whether in infrastructure, currency reform, budgetary balancing, trade liberalization, or human capital -- requires a political fortitude that is typically in short supply among political leaders. With this view I have little disagreement. Politicians *may* be intrinsically committed to development, prosperity, and a fairer distribution of income and wealth. Most politicians, however, are professionals and, like those in other professions, are mainly concerned with their personal survival and advancement. In democracies the electoral connection is never very far from their minds, those that are uber-officials wish to remain so, and those that are unter-officials are eager to advance and become uber-officials. The press of attention to short-term requirements, surely an important feature of political systems that rely upon regular and frequent popular elections, means that most politicians are only incidentally "enlightened." The World Bank planners are absolutely correct to applaud enlightenment when they find it, but not to bet on it.

I find fault, however, with the views of the World Bank planners in two respects. First, I believe it is essential to accord legitimacy to popularly elected politicians and leaders, and to respect their professional aspirations. Accountability requires a modicum of responsiveness, and properly arranged systems of representation provide this by rewarding officials that respond to the desires of their constituents. Because of this the time horizons of popularly elected officials are bound to be short; that is the way the responsiveness mechanism in most successful democracies is designed. As professionals, political officials are guided by this design feature, just as professional managers of firms are guided by design features that encourage responsiveness to the interests of employees, customers, and shareholders. Wringing one's hands about this aspect of political life, and seeking ways around it by trying to insulate policymaking from political influence, undermines the legitimacy required by representative systems.[8]

A second problem implicit in the *WDR*, and commonly articulated by social planners elsewhere, is to believe that "enlightenment" is the only asset available to mitigate the perverse incentives associated with the short time horizons of officials. Successful development, noncorrupt performance, and credible commitment, it is true, require (some) politicians to resist short-term temptations (at least some of the time). And it is also true that their own aspirations often dispose them in the opposite direction. The general solution, however, is *not* "enlightened leadership," for if this were generally available there would not be a problem in the first place. The solution is to channel private aspirations in more constructive ways. This is the classic Madisonian problem of institutional design. In crafting a constitution for a new nation, Madison took for granted that men were not angels, but rather were ambitious and self-interested. Through institutional design he sought to "pit ambition against ambition." He did not depend up "enlightenment," nor upon insulating policymaking from politics, as planners sometimes suggest. Successfully designed institutional arrangements, it appears to me as it did to Madison, may serve as a substitute for enlightenment, and is essential in a world in which the latter is in short supply.

6. The Political Economy of State Reform, II: Time Horizons and Discount Rates

I have made much in previous passages of the importance for policy of time horizons and attitudes toward the future of elected officials, conceding that most representative arrangements induce a short-term orientation inimical to the prospects for desirable public policies. Indeed, a short-term orientation is not unique to representative systems, for leaders of all complexions -- democratic or otherwise -- have a tendency to discount heavily events occurring beyond their service. I have also suggested that, even in the presence of this bias toward the short term and a concomitant absence of "enlightened" leadership, intertemporally balanced public policymaking might emerge from appropriately designed institutional arrangements. This may be called *Madison's hypothesis*.

I cannot claim to have the silver bullet that will set everything right. I will, however, nail my colors to the mast (and hope to obtain Madison's approval) by suggesting some potentially

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[8] This point is lucidly argued in Michael Laver, "Bringing the Politics Back In: The Public Accountability of Regulators." Ford Lecture in Political Economy, Harvard University, 1998.

fruitful ideas. By way of preview, there are two stylized features of political life that come into play in my formulation. First, politicians are not all of the same age or rank. This *distribution* means that not all politicians have coterminous careers and thus do not have precisely the same futures. Because their horizons differ, so too will the weight they accord the future. One politician's short-term perspective may differ from that of another's. Second, even though politicians may be regarded as short-lived players on the political scene, and may be assumed to focus disproportionately on their own personal (short) time horizons, they are not the *only* players on the scene. These other (mainly collective) players -- some from the political class and others from the broader civil society -- are longer-lived entities and this factor may temper the "short termitis" of politicians. In a nutshell, my claim is that the condition of most (all?) political orders is an officialdom that has powerful incentives to focus on the short term and to discount the future heavily, behaviors often at variance with more desirable public policies. This is the problem. The solution(s) reside(s) in designing institutional arrangements, in the spirit of Madison, that exploit the *different ages* and *different horizons* (and hence *different discounting practices*) of political actors. This is a big and provocative argument, only the broad outlines of which I can offer here.

Distribution of political ages and ranks. In the variation of the parable described earlier, there was a head of household and his eldest son serving as deputy. Changes in household policy required the implementation assistance of the deputy. Suppose the head were in his last period. During this period he enjoys the normal pleasures and prerogatives of the head of household. But his last period is the time of maximal temptation to kill the goose that lays golden eggs. The reason, of course, is that the head has no future after the present period, and therefore has no future to worry about. He might as well cook the goose and add a sumptuous feast to his last period's enjoyment. But this is precisely the time the eldest son is least disposed to assist. *His* future, as head of a household with a goose that lays golden eggs as a family asset, is rosy indeed; a future without the goose is too unpleasant to contemplate. The present head, despite the temptation but anticipating the resistance he would encounter from his eldest son, therefore will not propose to kill the goose that lays golden eggs. To the proverbial visitor from Mars, or more aptly to the itinerant anthropologist who appears in the village to conduct field research, the present head of household will appear "irrationally" to give weight to a future in which he will not participate. Indeed, the anthropologist's research paper will undoubtedly document the strange local custom of providing inheritance for one's progeny, or possibly offer the alternative hypothesis that humans are hardwired genetically to behave altruistically toward one's offsprings. In reality, however, it was the *institutional arrangement* of political rank within the family structure that did the trick.

It does not require a large leap to apply this logic to the explicitly political settings of the institutionalized state. Ambition to rise within hierarchical organizations, whether the military, a public bureaucracy, or a party organization, implies that the ambitious will want to preserve the privileges, authority, and capital assets associated with the higher offices to which they aspire. They would oppose actions by the current incumbents of those positions that would jeopardize these things. They would, in short, not be keen to participate in killing any goose that lays golden eggs. What is required as it applies to state reform, it seems to me, is an institutional structure in which seniors are dependent on juniors to implement policy, on the one hand, and in which there is sufficient assurance to juniors that adequate performance in their present capacity will auger well for advancement to the next rung on the career ladder. In these circumstances -- and there probably are other conditions that I have failed to identify -- incumbent officeholders, though temperamentally inclined to focus on the short term, will act as if they have a much longer time horizon. This, it seems to me, is an almost magical consequence of *institutionalizing ambition* and *embracing politics* rather than constraining or isolating them.

Short-lived politicians and long-lived organizations. The political world is filled with short-lived politicians with short time horizons. They are short-lived in the sense that their professional careers are brief relative to the duration of the ongoing political society in which they are embedded. (In fact, it is entirely possible that their political careers are but brief moments in their *own* full working lives.) Their short time horizon is driven partly by this fact, and partly by the mechanism by which their services are renewed. An especially short electoral leash, as is the case with the two-year term for members of the U.S. House of Representatives for example, will shorten the time horizon even further.

But short-lived politicians are not the only players on the scene. For one thing, the interests to whom they are beholden for their political survival -- labor unions, farm groups, corporations, religious organizations, etc. -- are long-lived, on-going entities. Even though a politician may not look past the next election, the interests whose support he requires do. Though not a perfect mechanism, it nevertheless has the affect of *lengthening* the time horizon of the otherwise short-term oriented politician, and *increasing* the weight he gives to the future -- even a future beyond his own political career. The important implication of this line of thought is that civil society, as characterized by long-lived voluntary associations, must be thoroughly integrated into political life.

The same may be claimed for the political parties to which politicians attach themselves. Individual politicians come and go, win elections and lose them, run or retire; but the political parties that sponsor them are long-lived, on-going operations. The next election certainly matters to them. But so does the one after that. The key here is that, while the individual politician may not give much weight to the future after his own defeat or retirement, the party to which he belongs does. And, in order for this to happen, the party whose candidates lose the next election *must* believe that they have either a genuine prospect of winning the election after that or some other satisfying role to play in the future.[9] The important implication of this line of thought is that political society, as characterized by long-lived and vibrant political organizations, must possess long-term viability, legal recognition and protection, and must be objects of respect not contempt.

7. Conclusion: Embracing the Political

This presentation has been a long-winded way of saying something that very possibly is trivial and obvious, but very frequently seems to have been overlooked in our general thinking about the structure of the state and reforms of it. Asserted boldly and easily fitted onto a campaign button or bumper sticker, it is EMBRACE THE POLITICAL. Professional politicians in a properly organized democracy will be ambitious for themselves and, given well-designed accountability mechanisms, they will be responsive to local and short-term matters. Democracies empower constituencies, and the aspirations of politicians are inextricably linked to constituent desires and pressures. This democratic impulse has the potential, as planners and technocrats often observe, to distort public policies, indeed distort them perversely by making those same constituencies *worse* off than need be. Too frequently it encourages eating the seed corn, killing the goose that lays golden eggs, and otherwise over-consuming and under-investing in long-lived capital assets that provide a foundation for prosperity and liberty. The blame is placed squarely at the feet of politics and politicians, and the proposed solution is typically some variation on the theme of suppressing politics and insulating policymaking from it, or relying on "enlightened leadership." This, I believe, is a doomed strategy.

[9] This point is made elegantly in Adam Przeworski, *Democracy and the Market* (New York: Cambridge University Press, 1991).

Madison's hypothesis, which I have taken to heart here, is equally cynical about human nature but provides a more constructive and promising approach. Rather than some form of democratic disconnect favored by planners and technocrats, Madison's approach takes political motivations as universal, pervasive, and highly resistant to quarantine. Making the best of an unpleasant reality, Madison puts ambition to work. In my rendering of it here, it takes the form of exploiting the fact that a snapshot of political life at any point in time reveals a hierarchy of political roles, overlapping generations of politicians, and both short-lived and long-lived political actors. These temporal properties, I believe, hold out some promise not for changing political ambition nor for lengthening individual time horizons, but rather the promise better to synchronize the temporal orientation of institutional performance. This will require institutional arrangements that offer political advancement, on the one hand, but always make the more senior officials with the shortest futures dependent upon those more junior officials with longer time horizons. It will also require institutional arrangements that attach short-horizon politicians to longer-horizon collective actors, many of which are found in the broader civil society.

Clearly this is no more than a general principle and a partial approach to issues of state reform. It certainly is not a well worked out or fully operational plan. But I believe that in his reluctant embrace of politics, Madison mostly got things right. The style of political economy that I have named after him represents the intellectual's efforts to grapple with issues of governance. It is my hope that there are lessons for practitioners of governance here as well.

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