

Too Many Cooks but How is the Broth?

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The Political Economy of Fragmentation Effects
on Compensation Payments

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By

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Chapter I: Introduction

1 Research question

Decision-making is at the core of politics and thus, the framework in which decisions are taken must be well chosen so to ensure a fluent and welfare enhancing policy. If this process is constructed poorly or hindered by any external factor reform blockades and delays will emerge and may entail negative aftermaths, so preventing a country from reacting flexibly to changing economic conditions.

The political process of decision-making is fundamentally shaped by the constitutional setting. It will be affected by the form of government as well as by the voting system and inherent to that by the number of veto-players, the number of agents having the opportunity to stop the decision-making process (Tsebelis, 2000). Furthermore, the political process is influenced by the voters' choices and the judicial review by constitutional courts.

The thesis at hand contributes to the discussion on decision-making by focussing on the effects of fragmentation among the political sphere. A large branch of theoretical and also empirical studies is devoted to the problems that cause reform delays and inter alia the effects of political fragmentation.¹ Most of them predict that a higher number of players or generally a higher degree of fragmentation is more likely to generate conflicts, thus causing adverse effects to a country's reform activity. They find support in historical experiences. Concentrating on the high budget deficits in South America especially in Argentina (Lora, 1997) and among the OECD countries in the 80s they detect a close connection to political fragmentation (see Perotti/Kontopoulos, 2002 for an example).

¹ See Drazen for a survey (2000, pp. 403).

Surely, the idea is intuitive. A higher number of players will increase the conflict potential resulting in higher chances of stalemates in decision-making. In this view, the focus of many studies lies on the effects of political fragmentation while more or less ignoring that conflicts can only arise if there are differences in preferences between decisive agents. Most research on reform delays is concentrated on the problem of high budget deficits and hence, it is doubtful if those results can be expanded to other areas of decision-making. Furthermore, taking other practical examples into account, which rather contradict the prediction, the hypothesis can be scrutinized. For instance, in the European Union, with many clashing preferences and a high number of veto players especially in decisions that require unanimity, blockades must be prevalent. Yet, there seems to be nearly no inertia (Heisenberg, 2005). Even after the first eastern enlargement of the Union in 2004, a sclerosis did not arise, although it was feared that the increasing heterogeneity in income per capita, standards of living, history, traditions or simply preferences could make it impossible to make any progress in integration (Hagemann/DeClerk-Sachsse, 2007). This example cannot be explained by the hypothesis mentioned above.

Thus, a general verdict on the effects of fragmentation cannot be pronounced. Hence, there must be more to the story apart from simple fragmentation. There are at least some issues worth thinking about in this context. The first is related to the previous results, which can be discussed on a technical level. Most of these studies focus on one special politics area and are limited to a certain country sample. Furthermore, the indicators applied to fragmentation and also to the indication of reforms may not perfectly measure the impacts of both items and their interrelation. Thus, it is necessary to analyze the impact of various methods in the empirical research and which indicators best resemble the connection.

The second argument relates to the limitation of these studies. The hypothesis that fragmentation leads to more blockades is based on the assumption that every conflict results in a stalemate. This prediction is unrealistic. Differences in preferences can perfectly be balanced by negotiations and compensation payments. This possibility is already mentioned by earlier work. Coase (1960), although addressing differences in private interests, demonstrates that externalities can be internalized without a welfare loss. This idea can be easily transferred to the political sphere suggesting giving compensation payments to those who are disadvantaged by a proposed reform (Acemoglu, 2003). This may help to overcome blockades and also shows another aspect of fragmentation. In contrast to previous findings, the consideration of transfers enables fragmentation to reduce reform costs.

The method of giving compensation payments indicates the disregard of some agents' preferences and it does not necessarily enhance overall welfare. This is only possible if negotiations between the agents are allowed (Asheim et al., 2006). However, this is not a particular characteristic of compensation payments but rather a characteristic of the majority rule, which is prevalent in the political sphere (Tullock, 1959). Although a majority rule as well as a decision brought about by side payments may lead to inefficient outcomes, compensation payments are regarded as unfair, while a majority rule is not. The difference here is that whereas a majority rule explicitly allows every agent to express his opinion by his vote, compensation payments may not. Usually they are not negotiated publicly, so that not every reluctant group has the same chance of being compensated. This clearly contradicts democratic ideas.

Following this, the question arises in what way agents react to compensation payments or fragmentation and its characteristic to decrease compensation costs. This can be tested in an economic experiment, in which students simulate the situation.

However, the topic addressed is clearly a political one and hence might be problematic to compare students' behaviour in a laboratory to the behaviour of politicians, as the decision-making process might be driven by political motives. First of all, politicians normally do not bargain over their own budget but over the budget of their jurisdiction. Therefore they will be more willing to pay transfers as it does not directly decrease their pay-off. Secondly, the political sphere is marked by constitutional restrictions that may keep politicians from paying transfers or at least determine in which way transfers can be given. Thirdly, the time horizon is much longer for politicians than for individuals in an experiment and thus building reputation and acting strategically makes sense in this framework. But especially, the last point underlines the importance of Behavioural Economics in politicians' action. In the Political Economy and Public Choice the objective of a politician is his private income, which strongly depends on his time in office. If politicians aim to be re-elected it is imperative for them to gain the voters' goodwill. Hence, they can be expected to pay attention to social norms prevalent among the population. Therefore, the reaction of individuals in a laboratory may reflect politicians' behaviour, which makes an experimental test of these reactions opportune. The results of the experiment at least emphasize the rules and social norms politicians have to maintain to gain a good reputation in the public.

As a last step, the thesis compares the results found in the experiment to observations made in the real world to find out if and how compensation payments are given in practice. In addition, the analysis will reveal whether the characteristic of fragmentation concerning the reform costs is taken as an advantage. Moreover, it will help to identify whether politicians are guided by their reputation and pay attention to social norms and thus whether their behaviour resembles the participants' behaviour in the experiment. Hence, there are many aspects that might influence

the connection of fragmentation and reform costs. This thesis sheds some light on this connection.

2 Methodology

The effects of fragmentation on the decision-making process strongly depend on the assumptions made and the viewpoint chosen. For a sensible answer to the question whether fragmentation and compensation payments are efficient, it is most important to consider objectives of the government. These motives at least differ among the different branches of economic thinking. Neoclassical models assume the authority to be a benevolent dictator or at least a social planner who seeks to maximize social welfare not his own (Windisch, 1998). A project meeting the Kaldor-Hicks criterion ensures efficiency and therefore the distribution of gains and losses within agents and between agents and the authority should be of no relevance. Following this, fragmentation and their characteristics should have the maximal effect on reducing reform costs.

In contrast, Public Choice emphasises that the assumption of a social planner is unrealistic and that politicians are rather guided by selfish motives. They claim methodological individualism for the political sphere as well, while the neoclassical world only considers the population but not the authority to be individualistic. Moreover, it criticises the neoclassical ideas for neglecting to carefully consider the decision-making process (Windisch, 1998). The New Political Economy points in the same direction. It also models politicians as selfish individuals being led by own interests, which may differ from the public's interests. Normally, their motivation is characterized by focussing on their chances of being re-elected. Yet, both directions of research are based on the assumption that agents strive to maximize their profit and thus rely on traditional thinking but address different questions. While Public Choice