

Modern Political Economics: An Overview

INTRODUCTION

In this paper it is argued that the disciplines of politics and economics have been linked in three main ways. First of all, the founders of political economy such as Smith, Mill, and Marx set economic prescriptions and descriptions within the context of a wider social vision, usually in a literary or polemical way. Secondly, the theoretical apparatus of welfare economics has been constructed to demarcate positive economics from normative questions. It is argued that "political economics" or "contemporary political economy" attempts to approach the comprehensive vision of the first school and to emulate the awareness of the positive/normative distinction of the second. Furthermore, there is a modern and pragmatic emphasis on estimated econometric models for policy analysis, advice and forecasting. It would of course be misleading to construe the interaction between these sets of ideas as being a seamless, almost programmed evolution. Nevertheless, the many levels on which complementary and conflicting issues and approaches arise within and between them may provide an adequate basis for judging the value of the main idea to be considered in this paper, i.e. political economics.[1]

This then may be considered the context of political economics - how it "fits in" - but how does it "jut out"? In other words, how is it distinct from other areas of social science, does it have a rationale of its own? This question is treated below in the terms of the growth in importance of government in modern economies and the consequent apparent need to model government as an endogenous entity when making forecasts.

These considerations have led to a number of different approaches from an essentially abstract theory of economic policy to simple and intuitively attractive empirical analyses to very complex politico-economic models which attempt to capture the interactions between many government institutions and classes of economic agents within a modern economy. Some of the major variants on these themes are sketched below.

POLITICAL ECONOMY AS A BROAD ENDEAVOUR

The notion of a comprehensive social vision is rooted in a time when intellectual leaders were expected to be generalists and because of the state of social inquiry, could justifiably claim to be just that. Ironically, it was Adam Smith, the man who impressed on economic thought the progressive nature of specialisation, who also exemplified this spirit of broad endeavour.

If Smith's reputation now rests with the "Wealth of Nations" (1776), it was first made with "The Theory of Moral Sentiments" (1759). Furthermore, he intended to complete his scheme with an ambitious review of forms of government throughout history. In this way he would have posited a closed theory of society, embracing a philosophical/ethical consideration of man in the social state, an account of the organisation of economic relations and a guide to the principles of good government. It is this huge synthetic exercise, rather than any one piece of economic analysis which some would see as guaranteeing Smith's place as a great, perhaps the first, social scientist.[2]

In much the same way the mind of John Stuart Mill could encompass philosophy (both moral and political) and economics and attempt to weld them into a coherent intellectual entity, which has a major influence on liberal democracies to this day. The relevant works in this case are "On Liberty" (1859), "Principles of Political Economy" (1848), and "Considerations on Representative Government" (1861).

These two thinkers are often pitted against Marx in terms of economic substance and political prescription. Certainly Marx used Smith to understand what Capitalism said about itself, in order to attack it. But in one

methodological principle there is a simple co-incidence between the positions of these three writers (and of others); the desire to construct comprehensive analytic systems, anchored in philosophical principles and relevant to contemporary political realities. Marx is renowned for such an inclusive vision - one that came to be seen by some adherents not as just "a good idea" but as "historically and scientifically true".[3] Schumpeter, in considering the case for a broad understanding of society, summed up admirably and wryly:

"In particular, an economics that includes an adequate analysis of government action and of the mechanisms and prevailing philosophies of political life is likely to be much more satisfactory to the beginner than an array of different sciences which he does not know how to co-ordinate - whereas to his delight, he finds precisely what he seeks ready-made in Karl Marx." [4]

The contributions of many individual economists of our own times owe a lot to the influences of the capitalist Smith, the liberal Mill and/or Marx. In the same way that a natural scientist hoping to advance a programme of research must start by accepting a set of fundamental principles already established, economists explicitly and implicitly build on the accumulated work of others. This may take the form of pragmatically accepting empirical results, analytic devices, or most importantly in this context value judgements.

Some however reject as sterile the resulting mass of specialised results and wish to start again with a social vision - or in Kuhn's terminology, shift the paradigm. Although in very recent times none has achieved the status of the three mentioned above, a few have been credited with (or accused of) making the attempt. One such is Galbraith.

In a typical passage, this maverick laments and ridicules specialisation; on expecting at the University of California to meet experts on agricultural economics or even fruit prices, he discovers economists whose domain is restricted to prune prices. He comments thus :

"They would have been less useful if exposed to more cosmic questions or even diversified to artichokes."

Galbraith makes his real point later in the same piece :

"....at least in the social sciences, specialisation is also a source of error....The world to its discredit does not divide neatly along the lines that separate the specialists."[5]

Galbraith's theory extends over psychology, political communication, macroeconomics and industrial organisation. He is grouped by Bruno Frey with a number of others such as Veblen, Myrdal and Kaldor as representing the "Unorthodox" tradition. Significantly for these purposes, one of the elements which Frey sees as uniting these individuals is that they see the economy as part of a socio-cultural system and so as understandable only in a trans-disciplinary way.[6]

The preceding has attempted to link an admittedly diverse group. That link is simple, but not trivial - the debate between these traditions has occupied human minds and motivated human actions to an enormous extent. As against this, this debate can become entirely unstructured, and often is dominated by ideology run riot at worst and essentially normative disputes at best. Modern welfare economics is sometimes seen as rescuing political economy from endless normative conflict and the next section outlines some of the issues raised thereby.

ECONOMICS AND VIEWS OF SOCIETAL WELFARE.

It could be said that welfare economics has contributed in two ways to this discussion; its concern with the efficacy of the competitive market in achieving social goals and its concern with the normative/positive divide. These two related issues are broadly reflected in the three fundamental theorems of welfare economics. The net result, it is argued, is a set of analytical concepts to guide

the political economist, and which although unable to claim to solve philosophical and practical problems of economic welfare (and thus political economics), does provide a coherent framework in which to approach them.

The first two fundamental theorems of welfare economics establish the Pareto optimality of competitive equilibrium and the possibility of moving to any desired equilibrium by appropriate lump-sum transfer payments. This essentially abstract construct has provided the framework for a debate which is central to political economy: the role and extent of government intervention in the economy. State action is seen as correcting for market failure i.e. the breakdown of the model's assumptions and so can be advocated on an apparently pragmatic case-by-case basis.[7]

However, since questions of distribution arise, the scheme is substantially complicated. A number of compensation criteria/measures of welfare changes have been advanced and critically examined (e.g. Marshallian consumers' surplus, Hicks and Kaldor criteria). The necessity of a social decision still remains and in this context the tradition from Condorcet to Arrow becomes relevant. Thus the third theorem shows that under certain weak assumptions, there is no logically infallible way of aggregating the preferences of diverse individuals. Sketched this way, welfare economics may seem to the political economist as no more than a litany of negative results. Feldman expresses this feeling as follows:

"We feel we know, as Adam Smith knew, which policies would increase the wealth of nations. But because of all our theoretic goblins, we can no longer prove it." [8]

Nevertheless, political economics will probably continue to refer and defer to this body of work, for a number of reasons. As to the previous point, proven negative results act as brakes on over-ambitious system-builders. Thus for example, the modern literature of political economics often specifies objective functions, which are social welfare functions in disguise, and so make implicit assumptions about individual preferences which may or may not be justified. Welfare economics provides secure micro-foundations for societal analysis which are more coherent than the highly aggregated concepts used in most variants of macroeconomics. Also, results and insights from public choice theory can be incorporated into politico-economic models (e.g. optimal tax policy, public good provision) to provide a benchmark form which to evaluate the actual behaviour of government institutions. Above all, welfare economics is, as Little says, a "calculus with an ethical interpretation". [9] The problem of separating value judgements from scientific statements, recognised by Hume's Law, which has ensured welfare economics is both mathematical and philosophical also informs political economics.

It could be argued that as soon as a researcher chooses any area on which to focus, a value judgement is made (i.e. about what is a priori important). However, even accepting this rather austere caveat, political economics could advance two methodological claims, the first of which it owes to welfare economics. This concerns the way in which political economists make explicit their value judgements about the relative importance of social agents, as opposed to the implicit assumptions of economic theory.[10] The second (and related) claim is that political economics is in large measure devoted to actually discovering the operative value judgements of politico-economic participants. This stands in contrast to the dominant economic view of benevolent ministers and altruistic civil servants working in harmony for the well-defined common good of a homogeneous nation of Paretian liberals and "efficient happiness machines". [11]

Welfare economics has thus been presented in this paper as the second major element in the context of modern political economics. Its distinctive rationale provides the theme for the next section.

THE RATIONALE FOR MODERN POLITICAL ECONOMICS.

Modern political economics is predicated on the important (and often growing) role now accorded to government in the economy, even in avowedly market-driven societies. As a consequence, so it is argued, there is a need to explicitly model the behaviour of the public sector and its interaction with the structure of the economy.

In the period 1965-1984 the OECD (unweighted) average of general government expenditure rose from 29% to 50% of GDP, with this indicator varying from in 1984 from 33% in Japan to 64% in Sweden. The OECD comments that such figures imply that general government expenditures had grown on average 2.9% per year faster than the value of economic output over the period in question. This aggregate measure comprises the following five main categories of expenditure:

- Public goods e.g. defence and general government administration.
- Merit goods e.g. education, health, housing and community services.
- Income maintenance e.g. pensions, family allowances, unemployment compensation.
- Economic services e.g. capital transactions and subsidies.
- Interest on the public debt. [12]

The agenda of public involvement is obviously extended by considering the other side of fiscal policy (i.e. taxation policy), the operation of monetary policy and the interrelationships between these two (e.g. interest rate consequences of fiscal deficits). Qualitatively, government also can have substantial regulatory powers, in domestic markets otherwise free of intervention, and with respect to regulating international trading relationships. [13]

Again such a broadly-sketched background, van Winden's quote from Morgenstern is relevant:

" Economic theory assumes the allocation of resources is only through markets...This view completely overlooks the existence of governments, national and local, where allocations are made not through the medium of the markets but by voting... Congress, parliaments, governments vote how much is to be invested in capital goods, when and where the investment takes place. They vote the income of millions of persons... Clearly the movement of these funds - a respectable percentage of national income - sets forth flows of money, determines demand and thus affects the "free economic sector" of the whole economy with its prices, incomes and allocations. " . [14]

Although the idea that political action influences real economic outcomes may seem an unexceptional statement, it is vigorously challenged in one sense by the New Classical School. Borooah and van der Ploeg treat this question in detail, characterising the critics' position as based on complete faith in the market mechanism allied to the concepts of natural rates of real economic variables and rational expectations and asserting "that it is impossible for any policy to systematically alter the outcome of real variables". Borooah and van der Ploeg argue that this policy neutrality position breaks down when for example, market participants do not have complete information, when models are non-linear or when economic policy affects the natural rates. A complete exposition of this debate is beyond the scope of this paper, but one further point may be relevant. To posit rational expectations may be to confuse an a priori assumption with an empirical question. Indeed, many studies in political economics impinge directly on this issue, in attempting to discover, for example, voters' implicit rate of discount for past economic outcomes and other forms of expectations about the future. [15]

Frey and Schneider outline three main aims of politico-economic models. First of all, to achieve better specification of the government sector in macroeconomic models by endogenizing it. Secondly, to produce better overall forecasts by being able to predict government policy reactions. The third aim is then to improve the quality of policy advice from economists through an

awareness of political constraints within a closed system.[16]

The second aim above has immediate relevance to any economic agent whose own outcomes, decisions and expectations are contingent on public policy decisions. Economic forecasters typically make conventional assumptions about these matters, such as the assumption of the continuation of present policies. [17] The example of a recent ESRI macro-forecast to Ireland is illustrative in this regard; their policy assumptions implied Irish governments achieving current budget surpluses for a number of years. It is possible that a reliably estimated policy reaction function for the Irish government might add to this forecast's realism. It should be said that econometric politico-economic models generally make similar statistical assumptions to their purely economic counterparts, and so are open to similar qualifications in this respect.

FEATURES OF SOME GENERAL POLITICO-ECONOMIC MODELS.

(a) Frey and Schneider:

The research programme of the Zurich school, as outlined by Frey and Schneider, has provided an influential framework for general politico-economic models. [18] The starting point is a formal optimisation problem in which the government is seen as maximising its utility, subject to two constraints. First of all, its vote or popularity rating must exceed a certain value at election time, to ensure its re-election. This popularity rating in turn depends on economic performance variables which are related via a conventional economic model. Such an optimisation problem is often insoluble even analytically, so in the real world Frey and Schneider posit a satisficing strategy for government. The implication of this is that if a government has a popularity surplus (i.e. a rating greater than its re-election threshold) it will pursue its own ideological goals (in this context, often the interests of its own core constituency. A popularity deficit, on the other hand is seen as motivating government to pursue policies designed to increase its re-election chances.

(b) Hibbs:

Another important interpretation is given by Hibbs. The concept of constrained supply and demand of economic outcomes is central to this analysis. The estimable form of such models usually comprise three elements. A demand for economic outcomes function relates mass political support to macroeconomic performance variables and thus "implicitly reveals information about the public's relative economic priorities and preferences". This function can embrace dummy variables representing the influence of non-economic factors and its structure may be lagged or contain special terms to infer voters' rate of discount of past outcomes.

The second element is an essentially conventional economic model with an orientation towards relating outcomes to changes in quantitative policy instruments. Finally, a policy reaction function brings these objective and constraint relationships together, relating changes in policy variables to changes in outcomes and preferences, often specifying the satisficing behaviour outlined above. Particular interest in this area has been focused on the evidence for and against political business cycles, whereby politicians are thought to operate policy to artificially generate growth as elections approach. [19]

The preceding material has briefly sketched some features of politico-economic models. It remains to be seen whether work of this kind will become part of mainstream thought in the discipline. At the very least, it will have encouraged some elements of dogma to be challenged and explored.

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References

- [1] Many terms have been used to describe political economics as understood here, including "contemporary political economy", "an economic theory of

politics" and even "polito-metrics". The precise meaning and scope of these labels vary from author to author.

[2] See Andrew Skinner's introduction to the 1974 Penguin edition of Smith's "Wealth of Nations", pp12-13.

[3] e.g. the Communist Party of the Soviet Union in pre- Gorbachev days.

[4] Schumpeter, Joseph A. in "History of Economic Analysis" (1954), George Allen and Unwin, p22.

[5] Galbraith, J.K. "An Addendum on Economic Method and the Nature of Social Argument" in "The New Industrial State", 2nd Edition (1974) Pelican.

[6] Frey, Bruno S. "Modern Political Economy", (1978) Martin Robertson, pp53-65.

[7] e.g. John Andrew, Ch 2 "Primary Policy Objectives" in O'Hagan John W., "The Economy of Ireland" (1984) p38:

"In itself, the theory gives no indication of whether government policy should be highly interventionist or based principally on laissez-faire; that decision requires judgement on the empirical evidence of the different problems noted and the costs of intervention. In this sense - but perhaps in this sense only - the argument is politically neutral."

[8] Feldman, Allan M. - entry on Welfare Economics, "The New Palgrave", Macmillan (1987) p894.

[9] From Chapter XIV, Welfare Theory and Politics, in "A Critique of Welfare Economics" by I.M.D. Little, 2nd edition, Oxford (1957), p258.

[10] e.g. Sen, Amartya, entry on Social Choice, "The New Palgrave" p389;

"Social choice theory also provides a method of analysis, in which the insistence on the explicitness of axioms and the clarity of assumptions imposes exacting formulational demands....(this interpretation) is nevertheless broad enough to permit different types of axioms to be used and different political, economic and social beliefs to be incorporated into the axiom structure."

[11] For example Andrew John, in discussing primary policy objectives from a welfare economics perspective, presents policy-makers as seeking to maximize the welfare of society, although conscious of the limits to this "useful simplification" -in O'Hagan (ed) "The Economy of Ireland" 4th edition 1984.

[12] OECD "Control and Management of Government Expenditure", Paris (1987), p19.

[13] See O'Hagan "Government Intervention" in O'Hagan op. cit.

[14] Van Winden, Frans - "On the Interaction Between the State and the Private Sector", North-Holland (1983) p4, quoting von Morgenstern "13 Critical Points in Contemporary Economic Theory", Journal of Economic Literature (1972) 10.

[15] Borooah, Vani and van der Ploeg, Frederick - "Political Aspects of the Economy", Cambridge University Press (1983), p87.

[16] Frey, Bruno S., and Schneider, Friedrich, "Recent Research on Empirical Politico-Economic Models" in Hibbs, Douglas A., and Fassbender, Helno, "Contemporary Political Economy", North- Holland (1981).

[17] The assumption of no policy-change is also conventionally used in annual public expenditure plans, to provide a benchmark from which to assess the real effects of actual policy changes proposed.

[18] Frey and Schneider op cit.

[19] Hibbs, Douglas A., "The American Political Economy" Harvard (1987) and "The Political Economy of Industrial Democracies", Harvard (1987)