Capitalist Institutions and Political Institutions: Modernization, Mass Politics, and Development

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Abstract

Drawing from a large and dispersed literature, in this paper we suggest a conceptual framework for addressing problems related to the diffuse concept of democracy. Based on the fundamental distinction that political institutions are set up to deal with a particularly severe class of coordination problems, the basic proposition advanced is that well developed economic institutions may be necessary to have well functioning political institutions by providing, (i), general access to governance structures, and, (ii), readily available information. Accordingly, we argue that two states of underdeveloped capitalist institutions, those upholding the "traditional society" and the "informal sector", are suitable applications of our concept in explaining the failure of "formal democracy".

Because all feasible modes of organization are flawed, the strengths and weaknesses of each candidate mode need to be assessed comparatively.
Oliver E. Williamson

1 Introduction

A fundamental distinction between any coordination problems that may be addressed by any parties, is whether efforts to mitigate the costs of these

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problems can be feasibly transformed into properly specified and enforceable claims on the benefits that accrue from such efforts. When this is not a problem, such costly investment gives exclusive rights to the benefits from transactions that then are expected to become realized, and society may be efficiently dealing with this class of coordination problems by simply delegating decision-rights to the parties to the problem and by ensuring the enforcement of the outcome (e.g. see Hart and Moore 1990, Whinston 2003, and Williamson 2002); efficient Coasean bargaining simply is instituted inside the formal governance institution. By introducing free rider problems—that is, a stage of voluntary participation that precedes the focal action of efficient Coasean bargaining—Dixit and Olson (2000) have emphasized how easily coordination failures become elusive to such decentralized social arrangement, since relying exclusively on the provision of efficient commitment instruments that then never may become employed. When the externalities that follow on any action cannot be adequately specified, the formal institution of decentralized decision-rights is an inefficient social arrangement because, in some cases, incentives may be too low to have the commitment technology employed (overwhelming free rider problems for those positively affected), and in other cases, when not, its adoption may represent the exploitation of individuals that are left outside the deal (overwhelming free rider problems for those negatively affected).

The impossibility of specifying precise contracts to deal with some problems of coordination also is the paramount argument for why some coordination failures are taken to the "political markets".[1] The question that then follows is if the specific kind of institutional arrangements that govern and support political markets actually cope with the severe free rider problems that inescapably can be posed for an uncountable number of issues under this category. In the next section we outline a simple conceptual framework, based on Dixit's and Olson's (2000) distinction, to address this question. A fundamental assumption is that, contrary to the Downsian approach—where the political party is seen as an empty formal vehicle exploited by the intrinsically opportunistic politician—in a stylized political system there is a role for coordinating demand-side *and* supply-side actions, in order to influence the political equilibrium. That is, political parties not only respond to voter preferences, they also represent the formal mean for collectively crafting political platforms. Drawing from a large and rather dispersed literature, the basic argument we advance is that well functioning capitalist institutions may be crucially complementary for the workings of political

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[1]From quite different perspectives, this issue is addressed by e.g. Dixit (1996), Laffont (2000), and Wittman (1989).

institutions. Two arguments are stressed. First, voluntary commitment to formally specified governance arrangements that are given mandate to take collective decisions on coordination problems can help overcome free rider problems on issues that are beyond their instituted range of actions. For example, the firm—or the trade union, the association, the private bureau or the religious organization—as a "jurisdiction", should only have constituted right to enforce collective decisions on its (well specified) set of members, but the collective action capacity that such voluntary hierarchical organization has accumulated can be exploited to aggregate information about the specific welfare concerns that this type of organization has been formally instituted to internalize. Assigning such additional role for organized interests represents a more benign or at least more complex view on them than that usually addressed in the lobby literature,[2] but it immediately poses the next challenge of imposing on such organizations incentives to internalize broader welfare concerns. Second, however, when assigning the political party the capacity of effectively settling credible inter-group agreements, as in recent formal models (Caillaud and Tirole (2002), Levy (2004) and Morelli (2004)), electoral competition in popular elections may drive strategically rational actors to offer and implement efficient political platforms.

In section 3 we develop a very simple formal model that accounts for the asserted complementary functions of these two kinds of ("local" and "nonlocal") governance institutions in order to exemplify its importance for supporting the prevalence of efficiency and stability in politics. In section 4 we consider an extension of our concept that allows for comparative predictions by putting the institutional conditions for anonymous market exchange (as compared to close-knit relational economic governance) at center under a suggested notion of "modernization" (Dixit (2003a) and Kali (2003)). Here we also make reference to the industrial foundations of modern mass communication in order to motivate information costs as a possibly severe impediment to settling credible inter-group agreements in mass politics. Two states of underdeveloped capitalist institutions, those upholding the "traditional society" and the "informal sector", are discussed as possible applications of our concept in explaining the failure of "formal democracy". In section 5 we conclude by briefly emphasizing how the very simple but coherent conceptual framework we have offered relates to the literature on democracy, and how this diffuse subject now finally is being addressed by the political economy literature.

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[2]The work by Lohman (e.g. 1994) is the prominent exception, and the real-world relevance is, of course, that organized groups in many ways are not banned from (indirectly) having a say on policy issues (protests, campaign contributions, strikes, official reports, etc.).

2 Mass Society: A Concept

2.1 Coordination problems: A specific context *for* a specific problem

The analysis of coordination problems is often approached in a very specific and applied context, where the restrictions addressing the particular problem typically are derived to a stereotype economic or political context where the relevance of the analysis can be postulated. There is no sharp distinction, however, between "economic" and "political" problems of coordination. One can come up with numerous examples where similar problems are dealt with directly (regulation and public provision) in some cases, and indirectly or not at all in others (legal or extralegal private ordering and private provision), by the at least superficially similar political systems of different societies. Accordingly, it has been argued—from quite different perspectives—that elements of the political system, and some of its characteristic features (i.e., the specific context), should be seen as societies' organizational response to effectively deal with the specific coordination problems at hand (e.g. Krehbiel (1991) (legislatures); Dewatripont, et al. (1999) (bureaucracies); Laffont (2000) (constitution); and Tirole (1994) (government)). And, in fact, the scope for "economic" coordination problems to be addressed properly depends on political outputs; for example on the specification and enforcement of property rights, including the specification, access and instrumental power of the Firm as a formal governance institution. Then it can be argued that the political system is simply approaching existing problems of coordination differently in order to economize on transaction costs (e.g. Breton (1993); Dixit (1996); and Wittman (1989)).[3] If so, a more fundamental distinction must rely on addressing *why* some problems are dealt with in a specific institutional environment, rather than on the fact that a problem is dealt with by either the "public order" (e.g. elections) or by the governance institutions that this order makes available (firms, unions, associations and federations, private bureaus, and so on).

2.2 Limits to decentralized, exogenously enforced institutional arrangements

If undefined transaction costs represent the potential problem, the Coase Theorem constitutes the efficiency benchmark. That is, if property rights are properly defined and costlessly enforced, Coasean bargaining will take

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[3]Buchanan and Tullock 1962 is the classic reference in economics.

place to internalize any externality as soon as it is efficient to do so net of the transaction costs that accrue. Decentralized solutions to coordination problems are always efficient in this specific transaction costs sense (information, bargaining and enforcement), but only if property rights are properly specified. Thus, where society is capable of instituting third-party verification of any external effects, it should delegate any solution to the addressed problem by simply providing readily available and effective instruments for contracting upon the observed effects. The externalities may be negative, as in Coase's (1960) original example, or positive, but the critical issue is that the externalities are contractible and therefore can be internalized. In particular, when an economic transaction implicates mutual dependencies between the parties to the transaction, costly commitment arrangements may economize on transaction costs by aligning incentives ex ante and to avoid costly bargaining and opportunistic behavior ex post. (e.g. see Hart and Moore 1990, Whinston 2003, and Williamson 2002). By the same principle that drives the exploitation of the benefits from market exchange (mutuality) when property rights are properly specified and enforced, costly hierarchical organization will establish because those bearing its costs also get exclusive right to the expected benefits—Coasean bargaining is instituted in the organization.

A fundamental dichotomy regarding the coordination problems that society has to deal with thus can be made based on the feasibility of properly specifying "property rights". So while there exists exogenously provided governance institutions that essentially represent delegated mandate to solve coordination problems within the group that form the organization, such institutions only constitute part of an efficient overall societal organization *if* given mandate that is strictly restricted to concern issues which generate externalities within the formally specified group. Thus the law allows a firm to exercise fiat to settle internal disputes, but not to change the law that formally specifies its own premises—and those of many others—for carrying out transactions.[4]

When expected coordination problems pose the identification of the relevant group as a problem in itself, the problem turns into a free rider problem that needs to be coped with before mandate to take collective action can be delegated. In the sense of our distinction, property rights are not fully specified if the benefits from costly investments to effectively deal with the coordination problems at hand are not properly linked to the individuals

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[4]Williamson (2002, p. 178) emphasizes that indeed "courts will refuse to hear disputes that arise within firms", and he refers to such "contract law of internal organization" as "that of *forbearance*, according to which a firm becomes its own court of ultimate appeal."

who make these investments. So when this is not the case, "political" institutions may be the efficient organizational response to such problems of coordination.

2.3   The scope of governance and the political context

Information costs in designing the right policies on complex issues constitutes a trivial but powerful motivation for taking some coordination problems to the "political markets". Most elementary, when undisputed pieces of information are readily available, the collection and analysis of information account for transaction costs that motivate a representative decision-making arrangement. If there are no problems in evaluating performance in office ex post, representative policy making turns into an administrative task where the electoral rule, as a contract, specifies and enforces commitment to this task.[5]

The nature of the information problem can be put as far more severe by presuming complexity in some policy issues which rules out the feasibility of simply "collecting" information to implement the right policy. All policy issues may not even be feasibly addressed ex ante and may neither become addressed by simply instituting the delegation of an abstractly defined mandate to do so, simply because a centralized arrangement to make available all the ex post relevant information may correspond to overwhelming costs of information on many policy issues.[6] In relative terms, a decentralized system of information-aggregation may provide information at lower cost. If organized interests are allowed to have a say—i.e., if indirect political influence through e.g. campaign contributions, strikes, official reports and demonstrations are not constitutionally banned—then the proper specification of an electoral mandate (the centralized, exogenously enforced component) may be more easily accomplished.

The problem inherent in such decentralized organization is the early addressed problem of free-riding in politics (e.g. Olson 1965): when influence efforts are costly, the realized set of influence actions may be limited to represent the concerns of organized interests such that policy becomes "misspecified"; and for issues that only concern unorganized groups, these may not even become dealt with by the formal political system. Dixit and Olson (2000) point at the conceptual foundations of this problem by illustrating how easily coordination problems become elusive to an institutional arrangement

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[5]See e.g. Ferehjohn 1986. If the representative cares enough about office (e.g. because of *efficiency wages*), electoral accountability will be efficient.

[6]See Laffont (2000, ch. 1) and especially Dixit (1996, ch. 1) for a related discussion on the infeasibility of specifying precise and enforceable contracts in politics.

that exclusively relies on making available an exogenously enforced commitment mechanism (e.g. the electoral mandate). In other words, by adding the requirement of voluntary participation, the set of problems that can be dealt with efficiently immediately becomes drastically limited. Voluntary participation thus constitutes the critical barrier "towards a presumption of efficiency in politics" (Breton (1993)), given that the political context is intended to be precisely the institutional arrangement that is designed to deal with coordination problems that suffer from non-contractible externalities.

As Laffont (2000, p. 201) points out, participation constraints together with incomplete information constitute the essence of the free rider problem, and it is the combination of these circumstances which implies that the problem grows with the size of the group (Mailath and Postlewaite 1990). A benign view of formally organized interests accordingly is that, since participation constraints are absent, they constitute a potentially effective source of information on relevant policy issues. To the extent that mutuality of benefits is the driving force behind organization by such commitment institutions, formally organized interests are endogenously determined by the exogenous provision, specification and enforcement of these institutions, since determining the benefits from its employment. The immediately following problem, on the other hand, is that, in order to induce voluntary commitment to such governance institutions, the distinguishing principle for these institutions is that they are instituted to take welfare concerns that are strictly limited to include the formally specified members of its organization. In the political context the fundamental problem then can be formulated as whether it can be arranged to induce organized interests to internalize more general welfare concerns when exploiting its superior capacity to take collective action in politics.

A qualified "presumption of efficiency in politics"

The endogenous, or circular, principle of democratic representation potentially allows for shaping incentives in this direction, by relating motives for reaching office to the electorate's intrinsic demands. The problem is that in elections strategic considerations are very easily posed, in the sense of allowing for *strategic* actions (as opposed to *sincere* actions) by rational actors under very simple circumstances. When this is the case, political influence is possible by pursuing an action that does not represent the bliss-point alternative for the actor but assures a superior outcome at given alternatives. Typically, then, there is no unique voting equilibrium and thus the efficient

outcome cannot be assured.[7] If strategic considerations are taken one step further, however, the set of alternatives may be structured since there is a role for coordinating actions in order to gain political influence (Austen-Smith and Banks (2005, ch. 8))[8]. This role is now being assigned the political party in formal voting models (Caillaud and Tirole 2002, Levy 2004, and Morelli 2004), where its presumed capacity to allow for credible agreements (bargaining and commitment) in collectively offering policy platforms is a competitive advantage that may push the electoral outcome towards efficiency.[9] However, even if the political party actually is an efficient governance institution, in the sense of instituting satisfactory commitment, the costly supply of a political platform must be matched by benefits which induce the supply of platforms in elections. This is still a negligently treated feature in the available models and thus circumvents the basic issue addressed by Dixit and Olson (2000), as discussed above. Yet if organized interests, which have formed out of the feasibility to commit to credible and "excludable" governance arrangements (section 2.2), are allowed to engage in the supply of platforms, then the political party may be readily available as an instrument for committing to a credible platform within the Pareto set of the specific group (see in particular Levy 2004). In elections, if organized interests can condition transfers on the implementation of a political platform, and platform, and if the political party is instrumental as an institution for credibly committing to an agreed

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[7]The usual context for addressing this problem is that of voting over an exogenous set of alternatives in an open-agenda. This can be easily illustrated when there are three voters and more than two policy alternatives (see e.g. Merlo (2006, pp. 18-19)) (the Condorcet Paradox); and the general result is that "any democratic decision-making process (...) involving three or more alternatives is open to strategic preference manipulation" (Persson and Tabellini (2000, p. 31)). The "pie-splitting" problem, where three voters vote over redistribution schemes which are defined over a two-dimensional policy space, is the standard textbook example illustrating the possibility of non-existence of a Condorcet winner (e.g. in Persson and Tabellini 2000 (pp. 29-30)).

[8]Even though this does not strictly constitute part of their formal analysis, it is explicitly stressed as an immediate implication (p. 387): "There are typically many open-agenda equilibria and the realization of any equilibrium at all is a distinctly non-trivial matter, requiring a high degree of coordination even among a fully aware electorate. In more applied environments, voters cannot be assumed to be so informed and at the very least, candidates and parties provide a coordination role, directing attention to salient issues and alternatives". Regarding the latter, informational remark, see Caillaud and Tirole 2002 for a model of the political party as an information intermediary.

[9]Since viewing the political party as a disciplining device, this is to essentially presume a position at the other extreme as compared to the Downsian view of the political party, where the interest of constituencies is completely captured by the opportunistic politician. Roemer's (see e.g. 2006) Party-Faction model allows for balancing these two standpoints, yet only if interpreting the exogenous preferences of the (professional) "opportunistic" and "militant" factions in this way.

upon then organized interests are induced to reach bargaining outcomes in politics in order to influence (implement) policy. In line with the basic argument of the Chicago School, then, efficient policies inherently carry superior scope for pursuing its implementation.[10]

In the context of elections the proper specification of a political contract relies on both the supply-side (proposals) and demand-side (voting) actions of the electorate. Given that this is the intended context for addressing issues where externalities are nonexcludable, this circular arrangement imply that there is a role for, first, organized interests to make use of their collective action capacity in, (i), allowing for costly engagement in crafting the supply of a platform, and, (ii), coordinating votes by conditioning intra-group transfers on the implementation of a platform. Second, the political party, as a complementary commitment institution, may allow inter-group transfers to be conditioned on the implementation of a platform, thereby inducing special interests to voluntarily commit to a platform that accounts for broader welfare concerns. When there is general access to such organizational forms electoral competition will drive organized interests to offer common platforms, and the specification of the electoral rule will determine the incentives for settling agreements and thus the political outcome. In the next section we illustrate this idea through a stylized example in a majority voting setting where, if the right institutional circumstances are in place, policies are implemented or not according to a Utilitarian (Benthamite) rule.

3 Mass Society: A stylized model

3.1 Coordination problems and coordination

Define a *Neighborhood* (Nbhd) as any group of individuals with an at least ex ante collective need for coordinated action. The population is given by (the *Global Nbhd*) **N** and we have two types of coordination problems that they have to face: *Local Coordination Problems* (LCPs) and *non-Local Coordination Problems* (nLCPs). In line with the discussion in the previous section the defining distinction is that LCPs can be efficiently dealt with by having society providing externally enforced commitment institutions which allow parties to coordinate actions as part of a decentralized arrangement. This is so because such commitment institutions (hierarchy) internalize the benefits from investing in commitment (organization) and therefore such commitment is rationalized by mutuality of benefits. We loosely refer to a *Jurisdiction*

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[10]Becker 1983, and Stigler 1972, e.g., are standard references, but see also Clark and Thomas 1995 for a formal argument based on this logic.

(Jdtn) as any formally enforced institution that is distinctly defined by, (i), a set of members, (ii), rules for collective action, and, (iii), policy space. A *Local Jdtn* (LJdtn) (such as an association, a firm, a trade union or a private bureau) then is characterized by a formally defined set of members which stand in a good position to take collective action by being committed to the formally specified rules of action, yet the policy space is restricted to exclusively contain actions that do not have a negative external effect on individuals outside the defined set of members of the LJdtn.

At a particular point in time, two nLCPs $H = 1, 2$ arise for two distinct but unspecified (incomplete information) combinations of individuals among the population, the *non-Local Nbhds* (nLNbhds) $\mathbf{N}_1, \mathbf{N}_2 \subset \mathbf{N}$, respectively. The problem posed is whether to take policy action, $D_H = 1$, or not, $D_H = 0$, on each of the addressed problems; and the challenge is to do so when it maximizes the sum of utilities and otherwise not (Utilitarian rule). nLCPs are expected but here members of the nLNbhd cannot be identified ex ante and therefore a decentralized arrangement is inefficient, because it means delegating coercive mandate before a more precise specification of the coordination problems. Consider instead the following arrangement (*Global Jdtn*) to deal with nLCPs: subject to a majority voting rule, all individuals in the population (the Global Nbhd) are allowed to propose a platform and to vote for a platform among those proposed. The policy space of the Global Jdtn is mutually exclusive with respect to that of any LJdtn.[11]

Our point of departure is that, while individuals are allowed to propose a platform in response to their individual private information regarding $H = 1, 2$, this is a costly action and to significant extent overwhelming at the individual level. LJdtns therefore are instrumental in this regard by allowing for compulsory share of the costs of such actions (no free rider problems within the LNbhd), and we thus assume they are allowed to supply or contribute to the supply of a political platform (i.e., such actions are part of the LJdtns policy space). Following this framework we next use a simple example to illustrate the crucial importance of LJdtns, as well as that of institutions (such as the political party) that allow coordination between different LJdtns in the supply of platforms.

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[11]While we have motivated the limits for the policy space of LJdtns before, in a related manner the policy space of the Global Jdnt should not extend to allow actions which exclusively affect a specific LJdtn (e.g. investment decisions) because this would undermine the perceived benefits from investing in the organization of a LJdtn. Informational rationales apply as well, and in Sweden, e.g., the Government neither is allowed to intervene in the executive actions of public bureaus (*Ministerstyre*). Finally, we think of the policy space of the Global Jdtn as constitutionally defined, whereas the very definition of the policy space of LJdtns to some extent constitute part of the Global Jdtn's policy space.

3.2 An example of efficiency in politics

Consider the population $\mathbf{N} = \{1, 2, 3, 4, 5, 6, 7, 8, 9\}$, it is split into three LNbhds that also are organized into three separate LJdtns. We have the LNbhd $\mathbf{n}_1 = \{1, 2, 3\}$, which also are the members $\mathbf{j}_1$ of the LJdtn 1; the LNbhd $\mathbf{n}_2 = \{4, 5, 6\}$, which also are the members $\mathbf{j}_2$ of the LJdtn 2; and the LNbhd $\mathbf{n}_3 = \{1, 2, 3\}$, which also are the members $\mathbf{j}_3$ of the LJdtn 3. Let the two vectors $\mathbf{P}_1^+ = (P_{11}^+, P_{12}^-; P_{14}^-, P_{15}^+; P_{17}^-, P_{18}^+)$ and $\mathbf{P}_2^- = (P_{22}^-, P_{23}^+; P_{25}^-, P_{26}^+; P_{27}^-, P_{29}^+)$ describe the coordination problem at hand, where P_{Hi}^+ denote the effect for individual $i \in N$ of implementing $D_H = 1$. The superscript index denote if the effect is positive or negative at the individual and aggregate level (such that $D_1 = 1$ e.g. has a negative effect for 2 but implies that $\sum_{N_1} P_{1i} > 0$).

Now consider a more detailed specification of the coordination problems $H = 1, 2$ that have to be dealt with by the Global Jdtn: for $H = 1$, $P_{11}^+ + P_{12}^- > 0$, $P_{14}^- + P_{15}^+ < 0$, and $P_{17}^- + P_{18}^+ < 0$; for $H = 2$, $P_{22}^- + P_{23}^+ > 0$, $P_{25}^- + P_{26}^+ > 0$, and $P_{27}^- + P_{29}^+ < 0$. We assume that LJdtns can credibly commit to Paretian transfers (through its jurisdiction) that are conditioned on the implementation of any platform, such that members of the LJdtn can be induced to vote such as to maximize the welfare of its members. By employing such transfers we have that $(D_1, D_2) = (1, 1)$ is the preferred platform for $\mathbf{j}_1$; $(0, 1)$ for $\mathbf{j}_3$; and $(0, 0)$ for $\mathbf{j}_3$. If the offered alternatives were $(1, 1)$, $(0, 1)$ and $(0, 0)$, then since the least efficient policy-pair $(0, 1)$ is the second-best alternative for both 1 and 3 it would be the implemented platform.

To stress the role of coordination between LJdtns in politics, as a complement to coordination within the LJdtn, now assume there are two stages. In the first stage, as above, each LJdtn publicly proposes its preferred policy-pair as a platform. After observing the alternatives, however, in the second stage a *non-Local Jurisdiction* (nLJdtn) is available which allows credible commitment to Paretian transfers *between* different LJdtns that are conditioned on the implementation of a collectively proposed platform. When the employment of a nLJdtn is available at low cost it is likely to push the political game towards efficiency. To illustrate this, assume these costs are zero, and assume that $P_{11}^+ + P_{12}^- > P_{22}^- + P_{23}^+$, $|P_{14}^- + P_{15}^+| > P_{25}^- + P_{26}^+$ and $|P_{17}^- + P_{18}^+| < |P_{27}^- + P_{29}^+|$. Since $(1, 0)$ is the efficient platform, after the first stage the question is whether a transfer from $\mathbf{j}_1$ to $\mathbf{j}_3$, $t_{\mathbf{j}_1\mathbf{j}_3}^1$, effectively can be conditioned on bilaterally proposing the policy $D_1 = 1$; and whether a transfer from $\mathbf{j}_3$ to $\mathbf{j}_1$, $t_{\mathbf{j}_3\mathbf{j}_1}^2$, effectively can be conditioned on the policy $D_2 = 0$. Given the collective preferences of the different LJdtns, in considering the possibility of a coalition $J_{13} = \{j_1, j_3\}$ that employs a nLJdtn to supply the platform $(1, 0)$, j_2 may consider strategically proposing the competing

alternatives $(1,1)$ or $(0,0)$. Both are preferred to $(1,0)$ by j_2, and both can make the coalition J_{13} unsustainable since corresponding to the bliss-point platform for j_1 and j_3, respectively. Clearly, if only

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\begin{aligned}
t^1_{\mathbf{j_3 j_1}} &\geq P^+_{2\mathbf{j_1}}, and \\
t^2_{\mathbf{j_1 j_3}} &\geq\mid P^-_{1\mathbf{j_3}} \mid,
\end{aligned}
\tag{1}
$$

coupling such transfers to the proposition of $(1,0)$ makes the coalition sustainable to any competing alternatives that j_2 may propose. The rationale for efficiency then is that this transfers are feasible precisely because they support the efficient pair of policies. Since being the efficient policy, it must hold that $P^+_{11} + P^-_{12} > |P^-_{17} + P^+_{18}|$ and that $P^-_{22} + P^+_{23} < |P^-_{27} + P^+_{29}|$, and thus Paretian transfers (within the nLJdtn) supporting the credible supply of the efficient platform are feasible and rationalized.

3.3   Departures from efficiency and stability

Now assume there are two types of transaction costs in this stylized game for policy implementation. At the local level we have free rider problems which imply that only individuals organized in a LJdtn will influence the supply-side of politics (i.e., no single individual can supply a platform in elections); and at the nonlocal level there are transaction (bargaining and information) costs of employing a nLJdtn (i.e., of arranging credible Paretian transfers between LJdtns). In the first stage, then, only LJdtns will propose (bliss-point) platforms at some rationalized cost. At this stage the aggregate support for different policies is revealed, and at the second stage any LJdtn either proposes a platform unilaterally at no additional cost, or employs a nLJdtn to craft the proposition of a common platform with one or two other LJdtns at some shared additional cost.

The role of inter-local organization (nLJdtn)

The critical role of the nLJdtn as an effective commitment device in politics is apparent by ensuring that the political outcome is well defined (transitivity requirement) and rules out departures from the efficient outcome. Given that $P^+_{11} + P^-_{12} > P^-_{22} + P^+_{23}$, $|P^-_{14} + P^+_{15}| > P^-_{25} + P^+_{26}$ and $|P^-_{17} + P^+_{18}| < |P^-_{27} + P^+_{29}|$, we have the following preference relations (an underlined entry denotes that it is the preferred choice for the LJdtn, such that both entries are underlined when it is the preferred platform for the LJdtn): $(\underline{1}, 0) \succ_{j_1} (0, \underline{1})$, $(\underline{0}, 0) \succ_{j_2} (1, \underline{1})$, $(1, \underline{0}) \succ_{j_3} (\underline{0}, 1)$. Without ready access to a nLJdtn, platforms are proposed

independently, and when there is scope for strategic considerations, voting cycles will follow:

$(1, 0) \succ_{j_1, j_3} (0, 1)$ but $(0, 0) \succ_{j_2, j_3} (1, 0)$, whereas $(0, 1) \succ_{j_1, j_2} (0, 0)$; and while $(1, 1) \succ_{j_1, j_2} (1, 0)$, $(0, 0) \succ_{j_2, j_3} (1, 1)$.

In addition, even when there is a well defined equilibrium platform, it may be an inefficient equilibrium. As long as there is a majority (two LJdtns) in support of a policy, the policy may be part of the equilibrium platform, irrespective of wether it is inefficient or not. In our particular case, we have a majority $\{\mathbf{j}_2; \mathbf{j}_3\}$ in favor of $D_1 = 0$, and a majority $\{\mathbf{j}_1; \mathbf{j}_2\}$ in support of $D_2 = 1$. The policy platform that results depends on how the welfare effects attached to the nonlocal coordination problems that appear are distributed across the population, not on the overall effects. By contrast, in the above example costless access to a nLJdtn assured that the efficient platform was implemented.

The role of local organization (LJdtn)

Inefficiency. If the organization of individuals into LJdtns is necessary to rationalize the (partial/unilateral and complete/multilateral) proposition of a costly platform in elections, then the use of nLJdtns to coordinate the proposition of platforms in elections may lead to the implementation of inefficient platforms there are types not organized in LJdtns. Obviously, if nLJdtns are only available for an organized subset of the population, policies maximizing welfare for this limited group may not do so on the aggregate.

Voting cycles. Less apparent, when there are unorganized groups the introduction of transaction costs to become a member of a nLJdtn (i.e., to arrange credible Paretian transfers between LJdtns) may interact with this circumstance to generate unstable political outcomes. If we extend the population in our basic example to include unorganized individuals, the presence of unorganized interests may allow $\mathbf{j}_2$ to (strategically) propose a platform that beats that offered by $\mathbf{j}_1$ and $\mathbf{j}_3$. Since the Pareto scope for reaching an agreement is greater between $\mathbf{j}_1$ and $\mathbf{j}_3$, positive transaction costs may rationalize the choice by $\mathbf{j}_2$ to propose such competing platform, rather than to enter into an extended three-part coalition to share the surplus net of the transaction costs that then will accrue.

For example, assume there are four additional individuals $\{10, 11, 12, 13\} \subset \mathbf{N}_1, \mathbf{N}_2$, with none of them organized in a LJdtn. More specifically, assume P_{1i}^- and P_{2i}^+ for $i \in \mathbf{n}_4 = \{10, 11\}$, such that $D = (0, 1)$ is their preferred platform (as for $\mathbf{j}_2$); and that P_{1i}^+ and P_{2i}^+ for $i \in \mathbf{n}_5 = \{12, 13\}$, such that $D = (1, 1)$ is their preferred platform (as for $\mathbf{j}_1$). Now also assume there are transaction costs $c > 0$ that must be invested by each member in effectively

employing a nLJdtn. Even though we may have that $P_{1i}^+ > P_{2i}^+$ for $i = 12, 13$, such that $(1, 0) \succ_{J_{13}, \mathbf{n}_5} (0, 1)$, the efficient platform may not result. When transaction costs of also including j_2 into J_{13} are large enough, $\mathbf{j}_1$ and $\mathbf{j}_3$ will not be capable of conditioning a transfer on the implementation of $D = (1, 0)$ that would induce $\mathbf{j}_2$ to agree on the collective supply of the efficient platform. This is necessary to still have $D = (1, 0)$ as the Condorcet platform, because $(1, 1) \succ_{j_2, \mathbf{n}_4, \mathbf{n}_5} (1, 0)$. So, at given benefits $P_{2\mathbf{j}_2}^+$ and a given scope for making Paretian transfers to settle an agreement on $(1, 0)$, for higher transaction costs considered at some point $\mathbf{j}_2$ cannot be induced to become part of such agreement. Thus while $\mathbf{j}_1$ and $\mathbf{j}_3$ may feasible agree to do so, $\mathbf{j}_2$ (or $\mathbf{j}_1$) can count with the support of $\mathbf{n}_4$ and $\mathbf{n}_5$ and offer the platform $D = (1, 1)$ in elections, at no additional cost, to then improve upon $D = (1, 0)$ by $P_{2\mathbf{j}_2}^+$. But $D = (1, 1)$ cannot be the equilibrium platform, because $(0, 1) \succ_{j_2, j_3, \mathbf{n}_4} (1, 1)$, and indeed a Condorcet platform does not exist at all, since it is true as well that $(0, 1) \succ_{j_2, \mathbf{n}_4, \mathbf{n}_5} (0, 0)$ (and $(1, 0) \succ_{J_{13}, \mathbf{n}_5} (0, 1)$).

3.4 Discussion

Our stylized concept have identified three types of transaction costs that must be coped with by the political system in order to function well. Basically, there is a role for commitment institutions at the local and nonlocal level (LJdtns and nLJdtns, respectively), and for institutions capable of coping with the transaction costs (bargaining and information) of employing the commitment institution at the nonlocal level (the nLJdtn). This categorization can be addressed by Figure 1, where "nonpolitical" institutions (SO) are allowed to have an influence on political organization (PO), and where both SO and PO eventually determine the electoral outcome (EO). The figure illustrates the circular, or endogenous, nature of a stylized political system, and inherent in such societal arrangement is the peculiarity that it posits incentives for groups in society to engage in both the provision and choice of a political platform (SC and DC, respectively).

We have stressed the role of two types of formal governance arrangements, LJdtns and nLJdtns, and their complementary roles as commitment devices in coping with transaction costs. At the local level, first, LJdtns cope with transaction costs in two directions: the organizational capacity of LJdtns (free rider problems have been overcome) allow them to undertake costly political action (arrow from SO to PO), and in addition, by credibly committing to reallocations within the LJdtn that are conditioned on the implementation of a platform, votes are being coordinated/mobilized (dotted arrows).[12]

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[12]Even though norm-ruled motives seem to be the most satisfactory explanation for

Second, the nLJdtn has been assigned a crucial role by representing a commitment device that allows for inter-group agreements to be settled, and given that it is instrumental in this respect, the nLJdtn also internalizes the incentives of different groups to invest in the mobilization of voters (DC).[13] When these commitment devices are readily and generally available, SO may complement PO by effectively forcing the EO to be efficient.

The third type and origin of transaction costs thus posited concerns those arising in actually managing to establish PO (bargaining and information costs of employing a nLJdtn). As illustrated by our previous example, such transaction costs may interact with restricted access to LJdtns to generate voting cycles and departures from efficiency. In the recent political economy literature mainly the role of information aggregation in politics has been emphasized.[14] Accordingly, under this third category we stress the costs of information as a crucial transaction cost, with the basic premise being that these costs are overwhelming at the individual level such that there is a formal system acquiring, analyzing and disseminating information that decision-making in modern societies significantly needs to rely on (SO).[15] Even with free market-based mass media, it has been emphasized that capture of information is possible without explicit regulation since market outcomes may depend on political decisions, and so market motives may become political motives (Besley and Prat (2006)). In the analysis by Besley and Prat, concentration of ownership (e.g. large state-ownership and few private actors)

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voting in mass elections (i.e. the *group rule-utilitarian* motive (see Coate and Conlin 2004)), the paradox of voting has not yet been given any conclusive, commonly agreed-upon explanation. Grossman and Helpman (2001, p. 86) make reference to empirical studies showing that voter turnout among union members is significantly higher than among others, and argue it may be so because individuals that work closely together are more likely to impose effective norms. In our framework the emphasis would be that, whereas some norm mechanism probably need to exist, it must originate in substantial gains of collectively doing so that the organizations commitment capacity gives currency for.

[13]See e.g. Shachar and Nalebuff 1999, and Uhlaner 1989 for models and empirical evidence stressing this role of the political party.

[14]Constitutional measures to ensure political representation along ethnolinguistic and religious lines, as recently in Iraq and Rwanda, can be seen as a way of instituting formal procedures for overcoming particularly severe bargaining problems. Yet it can also be seen as a way of promoting self-enforcing agreements in the absence of formal political contracts (see Dixit 2003b (p. 121-5)).

[15]See Strömberg (2001) for applications to policy making where heterogenous information is rationalized by the logic of market based mass media. World Bank 2002 offer a number of studies which all emphasize the importance of mass media under the broad heading of economic development, and Piketty (1999) briefly stresses the complementary role of on non-voting institutions (political parties, public debates and opinion polls) to national elections in aggregating information.

makes more likely collusion that will link the efficiency of mass media, as a technology for communication, to media ownership. Thus potentially an entry barrier to electoral competition by amounting heterogenous costs of information, both in establishing the common benefits of organizing the collective supply of a platform by different groups (i.e. the employment of a nLJdtn (PO)), and, when feasible, in communicating the superiority of its content (arrows from SO and PO to DC). Empirically, the existence of such relation is of particular relevance for LDCs, where state-ownership of the media is greater (Djankov et al. (2003)). Djankov et al. indeed find that greater state-ownership of the media is found to correlate with bad government performance, a less free press, and fewer political rights for citizens.[16] Although not able to establish the causal relation, they argue their results support the (public choice) view that media ownership by the state can be used to "distort and manipulate information to entrench the incumbent politicians, preclude voters and consumers from making informed decisions, and ultimately undermine both democracy and markets" (p. 342).[17]

In sum, we have stressed that to assure an efficient political outcome there must exist effective coordination devices at the local and nonlocal level (LJdtn and nLJdtn, respectively), and that these governance institutions must be generally available. In the next section we stress two application of our concept to development, where the absence of properly working capitalist institutions may prevent general access to LJdtns by definition, but may as well preclude ready access to nLJdtns by corresponding to the presence of largely overwhelming costs of information.

4 Mass Society: Extended Concept and two Applications to Development

In the outlined concept the complementarity between governance structures for "markets" and "politics" has been advanced as the crucial and basic insight. Overwhelmingly, if not critically defining, the existence of formally

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[16]See Krug and Price 2002 for a detailed study of the regulation of mass media (news gathering, content and the protection of journalists) and its role in supporting an independent mass media.

[17]Adserá et al. (2003) offer evidence in favor of this causality using newspaper readership as a measure of the level of information available to the electorate in testing for its role on government performance. Similarly, empirical evidence on the role of mass media in shaping political outcomes have been found on targeted government spending (Besley and Burguess 2002 (newspaper circulation), and Strömberg (2004a) (access to radio)) and bureaucratic corruption (Brunetti and Weder (2003) (measures of press freedom)).

specified and enforced governance structures are societal innovations encompassed by the common notion of "capitalism" and "democracy". Regarding the former, for example the firm and the trade union are stereotype organizational forms in this respect, whereas regarding the latter, the political party is seen as the pivotal governance institution in modern elections. If the existence of this type of formal institutions follow by definition or as the prevalent observation, access becomes the focal point. Next we discuss an extension of our concept in an attempt to encompass the notion of "modernization". Thus we attempt to address the limits of governance and information transmission in the context of development, and we then stress two stereotype characterizations of poorly working capitalist institutions that should entail poorly working political institutions as well.

4.1 Modernization: Governance and Mass Communication

Dixit (2003b), Li (2003) and Kali (2003), using very different theoretical approaches, all point at similar fundamentals for the limits of self-governance: if valuable outside-options are available and/or if Cheat-behavior is hard to verify, then the economic value of exclusion from trade within the group, as a threat to Cheat, is less effective. This implies a strict limit in the size of a group that can manage self-governance if information transmission within groups is less efficient when being large.[18] In particular, the transition from "traditional society"—with small, self-governing communities—to "modern society"—with anonymous, rule-based market interaction—then is driven by the (exogenous) provision of a formal system for transmitting information and punishing deviation from Honest behavior. Conversely, when outside options become available, cooperative behavior breaks down in the absence of a formal monitoring system.[19] In terms of efficiency, by allowing individuals to make a "better match" outside the relational neighborhood, "modernization" is the provision of a formal system that, (i), lowers costs of information, and, (ii), ensures proper specification and enforcement of

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[18] As commented on previously, Mailath and Postlewaite's (1990) more general analysis addresses this point. Dixit's (2003a) model is closest to this analysis since there the value of the outside options as well as the information asymmetries grow with the size of the group.

[19] There is a number of interesting applications that have been discussed and stress the relevance of the results. For example, the Maghribi traders relative inability to expand their trade opportunities (see Dixit (2003a)); the relation-based economic structure behind the East Asian miracle and the Asian crisis (see Li (2003)); and the break-down of cooperative behavior among the Orma tribe upon the emergence of a number of exogenous factors (see Kali (2003)). See Dixit 2004 (ch. 3) for a thorough discussion and references.

property rights (Dixit (2003a) and Kali (2003)). In modern society, then, formal information transmission (search) and governance (enforcement) arrangements critically support efficient matching of preferences, needs and capabilities.

The presence of formal governance institutions was addressed previously as part of our basic concept (LJdtns (SO in Figure 1)), but in order to address the potential magnitude of information costs in establishing political coalitions (nLJdtns (PO)), some elementary foundations for the very existence of a mass communication system can be fruitfully considered. The fact that the provision of mass media *content* ("news")—an extremely complex good that can be differentiated along an uncountable number of dimensions—to significant extent is financed by, and bundled with, *advertisement* induces a bias in content to cater to the preferences of groups that are large and valuable to advertisers (Owen (2002) and Strömberg (2004b)). The fundamental distinction, as argued by Owen, is that content is a public good whereas advertisement is a private good.[20] Given that the information provided as content has a value, however, Owen argues that if only the size of the market is large enough, the industrial organization of mass media carries the potential of efficiently exploiting a combination of, (i), intellectual property rights to content, and, (ii), advertisement financed provision of content: "The relative welfare loss from pricing above marginal cost diminishes as the growing market and increased crowding of content space reduces the number of consumers inefficiently excluded" (p. 173). Although stressing market size as a crucial condition, Owen (2002) nevertheless argues that public intervention is an inferior alternative if "political freedom" is an issue (consistent with the analysis by Besley and Prat (2006)), and because centralized provision of content requires detailed knowledge of consumer preferences.

Because the value of market information critically depends on the presence of effective formal enforcement devices, a formal mass communication system is rationalized by the notion of modernization referred to above. When effective formal enforcement devices are in place, in principle information (search) costs completely account for the transaction costs of making "ideal matches" in markets. Thus the demand (market) driven scope for rationalizing a comprehensive mass communication system depends on the presence of an efficient formal system for enforcing property rights, and since mass media as an industry is characterized by "enormous economies of scale" (Owen (2002, p. 168)), there is a nontrivial critical market size that must be reached before rationalizing the provision of basic informational infras-

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[20]It is not generically true that advertisement is a private good, but it is arguably so in general and certainly to significant extent.

tructure. When modernization also posits the importance of complementary "global" information (news/content) as exchange opportunities effectively emerge outside the relational neighborhood, the bundling of advertisement and content is rationalized by economies of *scope*. Similarly, then, to the extent that the scope for mass communication then specified also identifies some market value in providing "political" news or content, this information will be bundled with advertisement and "nonpolitical" content. The important point is that this type of information—addressing government performance and common or similar policy preferences in mass society—may not be available unless there is enough scope for providing information that supports large scale market exchange. In addition, if the enforcement of intellectual property rights is similar to that of property rights in general, "media that cannot rely chiefly on advertising revenue, such as motion pictures, specialized periodicals, and book publishers" (Owen (2002, p. 172)) face even harsher conditions in surviving as mass media.

Finally, informal means of transmitting information may accordingly be linked to the modernization process, where information transmitted through relational links may be limited to address issues of local character in the traditional society. According to Kali's (2003) Random Graph approach to model the modernization process, social networks in modern society are highly "random" in the sense of irregularly traversing society (as opposed to the "regular" clusters in the traditional society). As commented on above this can be an efficient equilibrium because the implausibility of upholding Honest behavior through relational governance is complemented by a formal governance system, but in addition relational or informal transmission of information is rapidly and readily accomplished since distances in society, as a global network, are very low.[21] As complementary sources of information, then, a formal mass communication system develops in parallel with an informal system of communication as part of the modernization process.

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[21]This is the strength of "weak ties", early stressed by sociologists, which, as opposed to "strong ties", cannot impose "socially embedded" actions but do allow rapid transmission of information in society. This is a central feature of the "small-world" phenomenon/approach, often realized in the encounter of two persons that find out a common acquaintance that they spontaneously consider to be unrealistic ("it's a small world!"). The phenomenon was given a scientific reference through experiments in the 1960s and 1970s showing that any two citizens in the US could be expected to be connected through about six direct social connections. See Kali (2003) for further discussion and references.

4.2 Two applications to development

The basic proposition we have advanced through our concept of society is that conventional market or capitalist institutions can be critical for how a severe class of coordination problems are addressed in society, namely those dealt with by "political" or "democratic" institutions. Two arguments have been stressed. First, the presence of effective and generally available governance arrangements at the local level is a prerequisite for addressing this kind of coordination problems and at least potentially in an effective manner. Second, then, focusing on the severity of information costs in mass societies, we have argued that effective (formal and informal) channels for mass communication develop in parallel with the establishment of institutional conditions for large-scale anonymous market exchange, and that this in turn determines access to the kind of information required for settling agreements on complex issues concerning multiple constituencies and masses of individuals. Put differently, we have argued that conventional notions of "democracy" may be too entrenched by denying the problems of ex ante coordination—in accordance with the conceptual distinction addressed by Dixit and Olson (2000)—that are crucial in this context because the very nature of these problems constitute the normative motivation for setting up "political" institutions.

"Democratization"

Recent empirical studies indeed show that the instrumentation of standard definitions of democracy in general do not yield any significant effects in explaining differences in economic performance and public service provision by democratic countries as compared to nondemocratic countries (Keefer forthcoming, Mulligan et al. 2004, and Przeworski et al. 2000).[22] According to our arguments well-developed market institutions may be crucially complementary to the performance of conventionally defined democratic institutions (national elections, universal franchise, etc.). This is in line with the finding that the sequence of the implementation of economic and political reforms matter for triggering growth: democratization has a significantly and considerably larger impact on growth if economic liberalization reforms already

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[22]Keefer find that according to different measures of public service delivery governments in poor non-democracies perform as well or better than poor democracies, but also argues that "young" democracies perform better than "old" democracies. Mulligan et al. similarly find that there is no significant difference in the production of economic and social policies along the distinction. The only difference found is that non-democracies do systematically adopt policies that can be described as efforts to maintain political power. Przeworski et al. find that democratic countries do not seem to adopt more growth promoting policies.

are in place (Giavazzi and Tabellini 2005, Persson and Tabellini 2006).[23]

The traditional democracy literature have put emphasis on two perspectives that at least tentatively are in line with this finding and our argument. On the one hand, many case studies have illustrated the failure of exogenously implemented "formal democracy", predominantly in African countries, by resulting in capture of the political system through authoritarian rule of different degrees (e.g. Berman (1998), and Bratton and van de Walle (1997)).[24] Another empirical regularity that has been stressed is the "institutional memory" in some countries, and has been asserted to be one success factor in allowing a vital role for political parties in managing the transition from authoritarian rule to democracy. Grugel (2002) takes Chile, Uruguay, Brazil and Spain as suitable examples by virtue of their rapid recovery from authoritarianism in the sense of quickly re-establishing relatively strong party systems after the fall of dictatorship. According to our approach, the emphasized differences in succeeding with "democratization" can be accounted for by differences in the level of development of economic institutions in different countries, since, if well-developed, they formally institute powerful governance arrangements at the local level, and support formal and informal means of mass communication that lower the information costs of addressing competitive political coalitions in mass society.

The "informal sector"

The "informal sector", a remarkably prevalent and persistent phenomenon of the developing world,[25] clearly represents a fundamental difference in the workings of market institutions in less developed countries as compared to how economic activities are organized in developed countries. As has been

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[23]The (same) definition of economic liberalization used in these studies focuses on international openness rather than on the institutionally determined extent of the internal market, and therefore does not perfectly apply to our argument. Yet it is quite reasonable to expect significant overlap between this measure and our ideal one, and indeed it is claimed explicitly that the used definition "seeks to capture discrete and comprehensive policy changes that increase the scope of the market in allocating goods and services" (Giavazzi and Tabellini (2005, p. 1300)).

[24]Berman argues that essentially empty reforms have allowed the exploitation of such institutional innovation by local powers by involving patron-client networks which allow for personalist state-rule. Bratton and van de Walle argue that these kind of "neopatrimonial" relations are strongly enough instituted to in general resist any substantial impact from narrow democratic reforms.

[25]According to recent estimates that Chen (2006) refers to "informal *employment* comprises one-half to three-quarters of *non-agricultural* employment in developing countries: specifically, 48 per cent in North Africa; 51 per cent in Latin America; 65 per cent in Asia; and 72 per cent in sub-Saharan Africa." (p. 82) (emphasis added).

found in a number of case studies, with de Soto (1989) as the prominent example, the "informal sector" typically is a complex, highly heterogenous, but surprisingly well organized socioeconomic phenomenon. Basically, these studies identify an extensive share of economic activity organized around entities that are completely unofficially at work, in an environment characterized by inefficient resource allocation that can be derived to the sector's institutional premises, and with many segments and facets of the informal sector often perfectly observable as an integrated part of every-day economic life.[26] The informal sector, by typically referring to an urban context, comprises economic activities in the context of a "modern society", with externally provided physical, legal and informational infrastructure. Thus, since lacking formal means of organization (e.g. the Firm and the trade union), in contrast to the "traditional society" concept informal entities are faced with "global match" incentives that then undermine the possibilities of endogenously grouping into local neighborhoods capable of managing relational governance (Dixit 2003a and Kali 2003). Accordingly, information costs may be relatively low by resembling the formal and informal structure for mass communication of modern society, so instead the problem of organization is posed at the local level as a prisoner's dilemma.[27]

5 Concluding Remarks

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[26]See e.g. Castells and Portes 1989, Chickering and Salahdine 1991, Gërxhani 2004, Guha-Khasnobis, et al. 2006, and Tokman 1992 for general characterizations of informality in LDCs.

[27]The now rather well-established finding by de Soto (1989) (see e.g. Djankov et al. 2002), that perverse bureaucratic obstacles obstruct access to formal means of economic organization, is clearly necessary for making this argument relevant.

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Figure 1

Socioeconomic Organization (SO)

Political Organization (PO)

Demand-Coordination (DC)

Supply-Coordination (SC)

Electoral Outcome (EO)

Legal and physical infrastructure, regulation, public services, bureaucracies, etc.