

# **Democratic Governance and Economic Performance**

## **How Accountability Goes Too Far in Politics, Law, and Business**

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## **About the Author**

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## Introduction

Washington is broken. The system is rigged. Cronyism and corporate interests prevail over fairness and the best interests of the American people.<sup>1</sup>

Senator Edwards is not alone in observing a lack of accountability in American politics. Indeed, both popular and academic media offer considerable support for this sentiment. The Cable News Network (CNN), for example, has criticized “government, big business, and special interest groups” for enriching themselves at the expense of the common electorate, and characterized elected offices as “accountability free zones” while arguing that “our government no longer works for us”.<sup>2</sup> Important scholars like John Matsusaka have added academic backing to such observations. Measuring government quality as “the responsiveness of public policymaking to the preferences of the mass public”,<sup>3</sup> for example, Professor Matsusaka found evidence that “government responds more to powerful interests than the general public” (2006, p. 1).

Instead of reflecting a weakness in “institutions for accountability”, however, observations like these can reflect a level of electoral influence that is so high that economic performance suffers as a consequence. This conclusion follows from evaluating the responsiveness of policy not against the popular standard of *what people say*, but against the more substantively informative standard of *what people do*. The results can be surprising, and not only argue against blanket calls for increased accountability, but suggest that accountability may have already become too strong in important areas of politics, law, and business. Attempting to strengthen democratic governance in these cases risks a further weakening of economic performance.

In short, institutions that are regularly applauded for aligning the actions of political, legal, and business agents with the preferences of their principals (e.g., campaign finance restrictions, antitrust measures, and shareholder franchise extensions) can also facilitate the taking of economic output for strategic redistributions. And like better-known channels for political expropriation (e.g., the opportunistic incentives of governance agents, rather than their principal constituencies), this one also constrains a society’s economic opportunities. Consequently, while the quality of governance is frequently measured by responsiveness to constituent preferences, institutions that strengthen this responsiveness can

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<sup>1</sup> Former Senator John Edwards during his candidacy for the Democrat’s 2008 Presidential nomination, <http://johnedwards.com/news/speeches/20070726-economic-fairness/>, accessed 23 October 2007.

<sup>2</sup> Quoted from, respectively, Lou Dobbs (2006), *War on the Middle Class*, Viking Adult, Jack Cafferty’s March 12, 2007 commentary from the “Cafferty File” on CNN’s “The Situation Room”, and the back cover of Jack Cafferty (2007), *It’s Getting Ugly Out There*, Hoboken, New Jersey: John Wiley & Sons, Inc.

<sup>3</sup> Robert S. Erikson, Gerald C. Wright, and John P. McIver (1993).

instead compromise governance when evaluated against the standard of economic performance.

This type of political risk regularly threatens economic performance, and the frequency with which even “advanced” political economies realize its adverse consequences may be considerable. Following Hurricane Katrina, for example, political agents arguably responded to electoral pressure by expanding insurance coverage beyond the bounds for which constituent premiums were paid. In particular, protection against wind-related damages was allegedly expanded after-the-fact to cover flood-related losses. Moreover, this expansion appears to have served constituent preferences, as electorates subsequently rewarded political agents who pushed for the expansion while punishing those who opposed it. Accountability may have come at the price of economic performance, however, as insurance providers soon exited the market, in part to escape exposure to political opportunism (James Q. Wilson, 2007).

Electoral pressure to alleviate recent credit market stresses may also ultimately discourage productive economic activity. The US House’s proposed “Mortgage Reform and Anti-Predatory Lending Act”, for example, could let delinquent borrowers sue lenders for having underestimated borrowers’ repayment ability (e.g., see Stuart Saft, 2007). While addressing constituents’ calls for action, opening such a cause of action would likely weaken repayment incentives, and thus further hinder the flow of financial capital to its most productive uses. Given the importance of this intermediation process to economic performance, the adverse effects of “too much” accountability in this case could be quite large.

*Democratic Governance and Economic Performance* develops economic models and statistical evidence that confront these intuitions with social scientific methods, and in doing so, builds a case that governance institutions at various levels (e.g., federal, state, corporation) likely generate similar risks. At the level of corporate governance, for example, calls for increased accountability to shareholders are building political momentum (e.g., see Lucian Bebchuk and Jesse Fried 2004). But while accountability can better align managerial incentives with those of shareholders, doing so can also take away from other stakeholders (e.g., bondholders, employees), leaving business-stakeholders as a whole worse off. Likewise, at the level of international governance, increasing the accountability of economically powerful countries can facilitate a more productive distribution of life chances, but also ease the opportunistic transfer of inventive products and thus discourage the very type of initiative that tends to raise economic welfare and broadly spread the resulting benefits.

To be sure, this book does not argue that accountability *necessarily* weakens economic performance, but rather that *too much* can diminish performance, and is likely to have done so in applications where accountability has instead been characterized as lacking. The theories and evidence produced here thus equip organizational strategists at various levels of governance (i.e., the firm, state, and country) to see through superficial complexities to a more productive way of building institutions for accountability. In particular, rather than seeing accountability as desirable under *any* circumstance, policy makers, legal professionals, and business

managers can do better by weighing the agency benefits of increased accountability against the distributional costs of policies that favor principal stakeholders at the expense of more general economic performance. Evaluating accountability relative to the standard of “what people get” can ultimately do better at giving them “what they want”.

### **How Does Political Accountability Constrain Economic Opportunities?**

These conclusions follow most immediately from a simple analysis of pressure group politics, where the problem with too little accountability is well known – i.e., monopolists enjoy supra-competitive returns, but leave society with inferior economic opportunities. In this case, making political agents “more accountable” appears attractive when evaluated against *both* the metrics of “what people want” and “what people get”.

But increasing accountability can also go too far, overshooting the objective of constraining producer monopolies and instead fostering consumer monopsonies. In cases like this, a different group benefits from the process of political rent seeking (i.e., overly weighty consumers replace concentrated producers in the analysis), but society loses the same in terms of economic opportunities. Political agents are accountable, since policy aligns with constituent preferences, but government quality (evaluated in terms of economic performance) can be just as bad as when agents lack accountability.

These predictions follow from more formal evaluations, each of which focuses on a different channel through which accountability can influence economic performance, but agrees that performance suffers when institutions overly expose output to the direction of those who consume it (rather than produce it). The above illustration of pressure group politics, for example, can be developed more carefully by assuming that producers and consumers influence policy choices via “menus” of campaign contributions and votes, respectively. Net influence in this formal setting depends on the relative strength of interested parties (e.g., see Sam Pelzman, 1976; Gary Becker, 1983; and Douglas Bernheim and Michael Whinston, 1986).

Where this balance of power comes to rest, in turn, is sensitive to the broader institutional setting in which policies develop. For example, campaign finance laws affect who has a “voice” in regulatory deliberations. When those laws loosely restrict contributions, producers constitute a relatively strong force in regulatory decisions, and can thus create or protect monopoly rents.

-----Insert Figure 1 Here-----

As restrictions tighten, however, consumer welfare increasingly weighs on regulatory objectives. Figure 1 illustrates how this increase can productively check monopolistic ambitions, but also push economic activity below its competitive level. In the latter case, restrictions not only take away the “political currency” with which producers can lobby for regulatory rents, they equip consumers with “too much” power (relative to a standard of perfect competition), and ultimately induce an inefficient outcome that mirrors the Chicago School’s criticism of regulation – i.e., one where regulation creates consumer surplus from infra-competitive returns (as opposed to helping producers gain surplus from supra-competitive returns).

Whether restrictions help economies approach efficient outcomes, or instead cause them to overshoot, can be observed in this model by how quantities relate to the strength of institutions for accountability. Importantly, these conclusions are not artifacts of the pressure group model’s assumptions. If, for example, marginal cost is constant (rather than increasing per Figure 1), then a model of dynamic consistency might instead be salient. But conclusions that can be drawn from how quantities respond to accountability in models like Michelle Garfinkel and Jaewoo Lee (2000) and Nicolas Marceau and Michael Smart (2003) mimic those from static pressure group models. For example, an allowance for campaign contributions in dynamic settings facilitates the punishment of regulators who would opportunistically “re-plan”, and can thus mitigate the potential for commitment failures when investments are sunk. It can also strengthen the protection of “property interests”, as in J. Gregory Sidak (2001), by discouraging political redistributions between shareholding and non-shareholding electoral members. In cases like these, producers who face overly strong institutions for accountability can *again* maintain sub-optimal capital stocks.

Models that account for real options yield qualitatively similar inference. For example, Ian Dobbs (2004) and Robert Earle, Karl Schmedders, and Tymon Tatur (2007) have shown that price capped monopolists can implicitly exercise an option by letting demand-uncertainty resolve itself before sinking resources into capital development.<sup>4</sup> Commitments are feasible in these dynamic settings, but producers maintain an increasingly inferior capital stock as price caps become more binding. If, as in Susan Smart (1994), Guy Holburn and Spiller (2002), Besley and Stephen Coate (2003), and Dino Falaschetti (2003a), caps tighten with increases in the relative weight that regulators place on consumer surplus, then the expropriation of “real options” constitutes another channel through which a negative relationship between contribution-restrictions and equilibrium output can evidence a realized potential for restrictions to diminish economic performance.

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<sup>4</sup> Jerry Hausman (1997) and Hausman and J. Gregory Sidak (1999) highlight the importance of accounting for such options when regulating the price at which incumbent local exchange companies sell unbundled network elements to competitors.

## **Evidence from an Economically Representative “Experiment”**

The US telecommunications sector offers an attractive quasi-experimental setting for examining this relationship. Relevant institutions and quantities are comparable across states, and the potential for confounding variables to bias statistical inference can be readily addressed. For example, because states share “basic rules”, cross-state analyses hold constant potentially spurious forces that correlate with those rules. Timothy Besley and Anne Case (2003) thus characterized cross-state investigations as being able to yield clearer insights to political economy phenomena than might, say, cross-country studies where confounding variables and hard-to-translate institutional measures can be more problematic.

Exploiting design-strengths like these, *Democratic Governance and Economic Performance* uncovers evidence that “institutions for accountability” share a statistically significant, economically large, and negative relationship with output. In addition, this relationship is difficult to dismiss as a statistical artifact – i.e., the institutions under consideration, not something correlated with them, appear to cause differences in output. Interpreted within the robust theoretical framework outlined above, this evidence supports the conclusion that weighting consumer preferences too heavily not only can weaken economic performance, but has weakened performance in a sector whose salient features are broadly shared. This research also implies that, while they may not offer the same quasi-experimental properties as does the telecommunications sector, any sector where institutions expose output to non-market distributional influences may risk facing this type of outcome (e.g., electricity, catastrophe insurance, pharmaceutical).<sup>5</sup>

## **Implications for Political Design, Competition Law, and Business Organization**

These conclusions may interest readers of several academic literatures in politics, law, and economics, as well as policy professionals and business strategists who can more immediately shape organizational channels for influence, and thus want to be careful about affecting economic opportunities in an unintended manner.

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<sup>5</sup> Fred McChesney (1987) offers an early and careful anticipation of this potential.

*Should we “ban contributions from those people”?*<sup>6</sup>

The prospect of reforming US campaign finance laws continually attracts political, legal, and scholarly attention. Anthony Corrado (2000) argued, for example, that after repeatedly failing to implement such reforms, Congress must “again wrestle with an issue that the public continues to rank as a high priority.”<sup>7</sup> Popular arguments for having Congress revisit this issue include “that too much money is spent, that smaller contributions are better than larger ones, that money buys elections, and that money corrupts politicians” (Corrado, Thomas Mann, Daniel Ortiz, Trevor Potter, and Frank Sorauf (1997, p. 96).<sup>8</sup> More forcefully, *Common Cause* president Chellie Pingree characterized organized contributions as the “toxic link between donors who write six-figure checks and people in power.”<sup>9</sup>

In this light, restricting campaign contributions appears to be a dominant strategy – i.e., restrictions are preferable under *any* conditions. Models that I consider in the present book, however, suggest that such reforms can work for *or* against economic performance. While restricting contributions can increase an economy’s total product by checking producer monopolies, it can also reduce output by accommodating consumer monopsonies, weakening regulatory commitments, or diminishing the value of real options. Moreover, the book develops evidence that these latter implications are more than theoretical curiosities – i.e., proxies for economic performance are significantly smaller in jurisdictions that restrict campaign contributions, and this relationship does not appear to be a statistical artifact.

To be sure, the channels through which lobbying relates to economic performance in *Democratic Governance and Economic Performance* are distinct from the informational and vote buying channels that contributors to the hefty lobbying literature frequently consider. Bailey (2004) reviews this literature and shows that its frequent characterization of lobbying as a welfare-reducing institution lacks robustness. Results developed in the present book corroborate those of Bailey (2004) by supporting qualitatively similar inference with evidence from a very different research design – i.e., one that looks at distributions between consumer electorates and producer lobbyists, rather than between asymmetrically informed electoral groups.

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<sup>6</sup> Referring to corporate lobbyists during his 2004 campaign for the Democrat Presidential nomination, Senator John Edwards argued that “we should ban contributions from those people”.

<sup>7</sup> Also see Robert Greenberger (2003).

<sup>8</sup> Michael Bailey (2004) further documents this “conventional wisdom,” citing Dan Clawson, Alan Neustadt, and Mark Weller (1998) and Elizabeth Drew (1999).

<sup>9</sup> *Common Cause* is a prominent, nonpartisan, “citizens’ lobbying group.” Pingree is quoted (italics added here) in the article “Supreme Court Decision Upholding Soft Money Ban is Major Victory for America,” accessed on March 16, 2004 at <http://www.commoncause.org/news/default.cfm?ArtID=258>.

### *Are elections better than appointments?*

By removing an “insulating layer” between political agents and consumer principals, institutions that elect (rather than appoint) regulators can push policy in a “pro-consumer” direction. In Timothy Besley and Stephen Coate’s (2003) model, for example, elected regulators choose policies on a single dimension, and electorates retrospectively vote on those choices. Policies from appointed regulators, on the other hand, embed themselves in myriad decisions of corresponding appointers. By increasing the number of dimensions that voters must consider when evaluating regulations, this embedding introduces slack to the agency relationship, giving appointed regulators room to depart from consumer ideals.<sup>10</sup>

Besley and Coate (2003) thus formalized the hypothesis that having to face (single-dimension) elections strengthens regulators’ accountability to consumers (relative to producers), a hypothesis that enjoys considerable empirical support. Guy Holburn and Pablo Spiller (2002) and Besley and Coate (2003), for example, found that consumers face significantly lower electricity rates when public utility commissioners come to office via elections. Susan Smart (1994) developed qualitatively similar evidence for telecommunications service prices.

*Democratic Governance and Economic Performance* pushes this “public choice” insight in a “political economy” direction. Here, the effect of accountability on economic performance receives greater attention than does the effect on distributions per se. Received evidence on pro-consumer distributions can tempt inference that electing regulators strengthens performance. This implication need not hold in principal, however, and evidence developed in this book supports the hypothesis that electing regulators rewards consumers with favorable distributions, but does so by sacrificing economic opportunities more generally.

This part of the book may be particularly attractive to readers interested in how delegation of decision-making authority relates to economic welfare. Since at least Thomas Schelling (1960), social scientists have understood that principals can enjoy the product of enhanced commitment by delegating decision-making authority to imperfect agents.<sup>11</sup> Alberto Alesina and Guido Tabellini (2007) refined this understanding by deriving conditions under which policies from delegated bureaucrats dominate those from elected politicians.<sup>12</sup> These conditions include predictable ex-post electoral preferences and a considerable potential for time inconsistency problems, both of which characterize the book’s main statisti-

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<sup>10</sup> The literature on mechanism design in “multitasking” environments also highlights “the difficulties of contracting in a multidimensional outcome setting” (John Hatfield and Gerard Miquel 2006).

<sup>11</sup> The well-developed literature on central bank independence, for example, rests on and extends just such an understanding. Kenneth Rogoff (1985: 1169) observed, for example, that “Society can sometimes make itself better off by appointing a central banker who does not share the social objective function.”

<sup>12</sup> Eric Maskin and Jean Tirole (2004) developed a related analysis.

cal application – i.e., the telecommunications sector.<sup>13</sup> Evidence from this application supports Alesina and Tabellini’s (2007) conjecture that, as a consequence, economic performance should be stronger under appointed bureaucrats than elected politicians.

### ***Does democracy necessarily improve economic performance?***

Evidence from the “turnout and distribution” literature suggests that “mobile electorates” (i.e., political principals who exhibit strong voting propensities) recognize relatively favorable policy distributions. V. O. Key’s (1984 [1949]) seminal inquiry, for example, produced evidence that electoral constituents’ policy treatment is sensitive to how institutions influence voting costs. Extending this work, Rob Fleck (1999, 2001) found that depression-era distributive policy favored high-turnout constituencies, while Timothy Besley and Robin Burgess (2002) developed related evidence on government-responsiveness in India. Similarly, James Hamilton (1993) reported that mobile North Carolinians faced a significantly reduced probability of having hazardous waste facilities expanded within their counties. In each case, increases in the capacity for electorates to produce political support (e.g., votes) appear to have mitigated associated agency problems.

Perhaps it is this appearance that motivates democracy-advocates to argue that electoral mobility necessarily increases welfare. Prominent organizations such as the Institute for Democracy and Electoral Assistance (IDEA), for example, characterize strategies that would increase electoral participation as being dominant.<sup>14</sup> The International Foundation for Electoral Systems (IFES) similarly offers an unqualified assessment of participation’s capacity to produce “government responsiveness and accountability”.<sup>15</sup> Popular outlets, such as the *Wall Street Journal*’s editorial page, frequently offer concurring assessments.<sup>16</sup> Even more, the American Political Science Association (APSA) announced a research award for “concrete contributions to solving social *problems*,” a major theme of which was “Promoting Democracy”.<sup>17</sup>

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<sup>13</sup> First, policies by which relevant prices are set appear “pliable” in that consumer preferences point in the same direction (i.e., toward lower prices). Second, whether producers sink capital into this sector is sensitive to the prospect of opportunistic expropriation.

<sup>14</sup> The IDEA conference on “Building Electoral Participation” is illustrative. Associated details are available from <http://www.idea.int/whatsnew/whatsnew.html>, accessed July 31, 2003.

<sup>15</sup> See, for example, [http://www.ifes.org/civil\\_society/description.html](http://www.ifes.org/civil_society/description.html), accessed October 30, 2003.

<sup>16</sup> See, for example, “Power to the People,” which credits Californians for telling “the political elite who’s boss,” and thus with taking the state’s economy on a “marked turn for the better” (March 15, 2004, p. A16).

<sup>17</sup> Source: H-PolMeth Discussion Network, accessed July 6, 2004 at <http://h-net.msu.edu/cgi-bin/logbrowse.pl?trx=lm&list=h-polmeth> (emphasis added).

But while popular accounts tend to view “responsiveness and accountability” as strictly desirable properties of polities, decreasing the cost of politician-electorate agencies can weaken economic performance. The present book shows that this proposition creates a robust and readily observable implication – i.e., if electoral mobility enhances economic performance, then proxies for mobility and output should share a positive relationship. It also develops evidence, however, that opposes this implication – i.e., output in the US local exchange sector decreases significantly with increases in the capacity for electorates to pressure regulators. Moreover, the normative inference that this empirical relationship makes available (i.e., accountability can dampen economic performance) appears robust to modeling assumptions, and the relationship itself is difficult to dismiss as a statistical artifact.

Robert Barro (1996) argued that democracy’s net effect on economic growth is theoretically ambiguous, and found some cross-country evidence that this relationship is non-monotonic. There, democracy and growth share a positive relationship when evaluated at low levels of democracy and a negative relationship when evaluated at high levels.<sup>18</sup> In addition, Dennis Mueller and Thomas Stratmann (2003) developed evidence (also in a cross-country setting) that democratic participation can diminish economic performance by encouraging political (rather than competitive) markets to direct resources. Evidence developed in the present book adds weight to that from Barro (1996) and Mueller and Stratmann (2003) by not only offering corroboration from an independent empirical setting, but by also developing from a research design that may be more amenable to controlling for statistical biases.<sup>19</sup>

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<sup>18</sup> The mobility-output relationship also appears non-monotonic in my pressure group model – i.e., political participation dampens economic performance *after* achieving a critical level. My empirical analysis suggests, however, that at least for the interval over which I observe this relationship, output monotonically *decreases* with mobility (e.g., quadratic terms do not enter significantly into my regression specifications).

<sup>19</sup> Barro (1996) employed Gastil’s subjective measure of democracy as a regressor, but did not have access to a good instrument with which to address that measure’s potential endogeneity (e.g., that which might emerge from observer bias). Mueller and Stratmann (2003), on the other hand, attempted to address the potential for endogeneity bias by instrumenting for their proxy of political participation. In doing so, however, they treated measures of education and population growth as instruments for political participation *and* as controls when estimating participation’s relationship to economic performance (e.g., see their discussion in Section 2.4). The potential for these instruments (and others, e.g., *GDP / working age population*) to violate the exclusion restriction (i.e., to share an independent relationship with performance in structural regressions) thus appears considerable. Adam Przeworski and Fernando Limongi (1993) reviewed the difficulties that this literature’s authors have more generally faced in building convincing identification strategies.

### *Can competition policy go too far?*

By following a consumer welfare standard, competition policy can discourage abuses of market power. Political influences on how surpluses are distributed, however, can work against the expansion of general economic opportunities. It is well known, for example, that regulatory processes risk being captured to create excess (rather than optimize) producer rents. In cases like this, competition policy may not go far enough to improve economic performance.

Less popular, however, is the argument that competition policy can go too far. By overly weighting consumer welfare, for example, competition policy can cartelize consumers, thereby silencing the other side of democratic capitalism and giving rise to inefficient monopsonistic outcomes. In this case, political conditions favor consumers over producers, but sacrifice total surplus all the same.

Among other scholars, Peltzman (1976) and Arthur Denzau and Michael Munger (1986) developed models where electoral pressure can mitigate “Stiglerian” regulatory capture (George Stigler, 1971). The pressure group model considered in this book is both simpler, and in some ways more general, than those of Peltzman (1976) and Denzau and Munger (1986). In short, this book’s model not only lets consumer pressure mitigate regulatory capture, it highlights the potential for such pressure to reverse capture theory’s conventional implication – i.e., it shows that consumers, as well as producers, can capture regulators.<sup>20</sup> More importantly, it yields robust normative implications that are readily observable and thus facilitates conclusions about economic performance (as opposed to distributions per se). This distinction is important since related empirical work (e.g., see William Schwert, 1977 and Gilbert Becker, 1986) offers evidence that consumer pressure can dissipate producers’ rents, but does not address how this dissipation affects total surplus.

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<sup>20</sup> Thomas Lyon (2003) develops a similar implication to distinguish whether the historical migration of electricity regulation from municipalities to states reflects a growing ability of utilities to “capture” regulatory processes (and thus transfer surplus from consumers to producers while increasing dead-weight losses) or a strengthening of regulatory commitments against opportunistically expropriating sunk investments (and thus an expansion of total surplus). In addition, David Card and Alan Krueger may have had this type of model in mind for rationalizing their provocative finding that raising the minimum wage can have a small, and sometimes positive, impact on employment (see Card and Krueger, 1994 and Douglas Clement, 2006). There, if employers are monopsonists in the labor market, then raising the minimum wage will increase the quantity of labor supplied and expand total surplus. Finally, this model can rationalize other price ceilings that may have been set too low (e.g., see Sharon Tennyson’s (2007) review of insurance price regulation).

### *Should we tie the hands of principals (rather than agents)?*

Following scholars like Douglass North and Barry Weingast (1989), social scientists deepened our understanding of how rules and organizational structures that “tie the hands” of political *agents* can mitigate problems of dynamic inconsistency and thus expand an economy’s production possibilities.<sup>21</sup> There, constraining the discretion of agents receives considerable credit for pushing economies toward superior outcomes. Researchers appear to have thought less, however, about how institutions for accountability might facilitate these agents’ principals (e.g., electoral constituents) to encourage opportunistic expropriations.<sup>22</sup> *Democratic Governance and Economic Performance* develops evidence that constraints on this ultimate source of opportunism can be a productive feature of governance institutions.<sup>23</sup>

### **Outline of the book**

The following chapters develop these contributions more fully. Chapter 1 carefully builds a model of pressure group competition where electoral influence not only expands economic opportunities by checking the monopolistic ambitions of producers, but also contracts opportunities by facilitating consumers’ monopsonistic ambitions. Which of these implications plays out empirically can, in turn, be observed in how consumer pressure relates to output.

Conclusions from this relationship are, moreover, robust to the pressure group model’s particular features. Considering this relationship through models of dynamic consistency and real options, for example, yield normatively identical inference – i.e., a decrease in output with consumer pressure is consistent with accountability having gone too far.

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<sup>21</sup> See, for example, Gary Miller (1993) and Daron Acemoglu, Simon Johnson, and James Robinson (2001).

<sup>22</sup> “Customer” opportunism receives mention in the economics literature on industrial organization. But even there, scholars tend to focus on whether “the *regulator* and the firm” can commit against playing time inconsistent actions (e.g., see Daniel Spulber (1989: 612, emphasis added)). Indeed, commitment mechanisms that draw attention in this literature appear to be those that proximately tie the hands of regulators (e.g., “used and useful rate-of-return regulation” in Gilbert and Newbery (1994)). My focus for the present article is on mechanisms that influence electoral *sources* of opportunism.

<sup>23</sup> To be sure, the potential for electoral opportunism plausibly grows as associated agency costs decrease, and the above cited public choice literature (i.e., Smart (1994), Holburn and Spiller (2002), and Besley and Coate (2003)) suggests that electing (rather than appointing) regulators facilitates just such a decrease. Moreover, evidence for “principal opportunism” already exists for the qualitatively similar agency problem between shareholders and managers (e.g., see Charles Knoeber (1986), Andrei Shleifer and Lawrence Summers (1988), Mike Burkart, Denis Gromb, and Fausto Panunzi (1997), and Dino Falaschetti (2002)).

Chapters 2 and 3 formally evaluate this relationship’s empirical plausibility by looking at data from the US local exchange sectors. Chapter 2 provides an overview of the sector with an emphasis on features that create a quasi-controlled setting for considering the efficiency effects of political accountability. Ideally, such a setting would be one where institutions that influence electoral accountability randomly vary, and the manner in which associated quantities respond to this variation can readily be observed. The local exchange sector approaches this ideal on both dimensions. States exhibit considerable variation in their institutions for accountability, and various statistical methods are available to isolate the portion of this variation that can confidently be treated as random. In addition, the nature of the local exchange technology precludes output from being distributed outside of the jurisdiction in which the institutions of interest are located, and the Federal Communications Commission (FCC) reports measures of output that are comparable across those jurisdictions. Features like these make the local exchange sector an attractive “laboratory” for examining how output responds to “random” variation in accountability.

Chapter 3 begins this examination in earnest by carefully measuring how output responds to differences in the ability of utilities to lobby their regulators. Here, output is significantly smaller in states that restrict campaign contributions. This result is inconsistent with restrictions improving economic performance by constraining producers’ monopolistic opportunities. Instead, it finds a robust explanation in standard political economy models – i.e., restricting campaign contributions can retard economic performance by facilitating consumers’ monopsonistic ambitions, weakening regulatory commitments, and easing the expropriation of real options.

The chapter also carefully checks this result against alternative explanations. Particularly concerning is any remaining potential for non-random variation in the institutions of interest. A number of auxiliary results offer confidence that the negative relationship between output and institutions for accountability is not an artifact of this type of bias. For example, to increase confidence that states received a “random treatment” of contribution restrictions, the empirical examination employs Joseph Altonji, Todd Elder, and Christopher Taber’s (2005) method for gauging “selection on unobservables” when otherwise attractive data lack interesting time series variation, or when theory is relatively silent about what constitutes a good instrument.<sup>24</sup> The results imply that even the lower (absolute)

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<sup>24</sup> Altonji, Elder, and Taber’s (2005) method appears well-suited to aiding identification in the present application. First, while campaign finance restrictions exhibit considerable cross-state variation, they appear more stable when evaluated within states across time. In addition, the considerable cost of adjusting sunk telecom investments means that my proxy for output (i.e., land-line connections to telecommunications networks) likely exhibits noisy time series variation (e.g., variable lags in responding to stimuli) that can cloud evidence of causal relationships (even if they truly exist). Insight to whether campaign finance restrictions can strengthen economic performance thus appears unlikely to come from the time series dimension of relevant variables. Finally, because my regressors of interest are institutional proxies, and theories of endogenous

bound of the estimated relationship between contribution restrictions and proxies for total surplus is considerable – i.e., unobservables would have to rationalize an implausibly large share of the variation of interest to dismiss this negative relationship between campaign finance restrictions and associated output as wholly artifactual.

Looking at how different proxies for electoral accountability relate to output offers additional confidence in this regard. These proxies (namely, the ease of electoral participation and an indicator of whether regulators are elected or appointed) also share a large and negative relationship with output, but can vary independently of campaign finance laws. A number of alternative rationalizations would thus be necessary to dismiss this relationship as being due to a confounding variable rather than institutions for accountability. Even more, the availability of instrumental variables for these alternative proxies offers an independent methodological opportunity to isolate the “random” variation in relevant institutions. Results from this analysis largely confirm those from other methods and measures.

Taken together, these results confidently support the hypothesis that electoral accountability can decrease output in local exchange sectors, and this decrease reflects a weakening of economic performance. This conclusion also creates implications beyond the telecommunications sector. Indeed, the theories that this book tests are general with respect to their implications for economic performance. Evaluating those theories in a relatively controlled setting like the telecommunications sector, in turn, facilitates a careful evaluation of whether those implications are empirically plausible. The resulting evidence suggests that they are, and thus highlights the potential for similar forces to diminish the quality of governance at different levels and to weaken the performance of other sectors (even if those sectors do not lend themselves to a quasi-experimental investigation).

The book’s second half considers this potential. Chapter 4 looks more broadly at the relationship between democracy and economic performance, with an eye toward generalizing the conditions under which institutions for accountability can diminish economic opportunities.<sup>25</sup> Chapter 5, then, begins to focus on lower levels of governance. In particular, it examines institutions that govern market competition, and how those institutions’ exposure to consumer influence can compromise economic performance in important sectors like insurance and financial services.

Chapter 6 turns to an even more immediate level of governance, namely that which takes place inside corporations. There, shareholder accountability can expand the firm’s opportunities by checking the potential for self-indulgent manag-

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institutions are not very well developed, good instruments are difficult to find for the present application.

<sup>25</sup> Additional directions to explore here include whether merger activity is associated with an expansion of economic activity in relevant sectors (as it would be if the consequent increase in concentration productively counters too much consumer pressure), and illustrative examples from interviewing legislators and other interested individuals about overly burdensome price caps on Florida catastrophe insurance (see notes from 2007 State of the Florida Insurance Market Summit, Orlando, FL, December 12-14).

ers, but also increases the risk of having shareholders act in a similarly destructive manner. Giving shareholders a louder voice in corporate matters, for example, can weaken other stakeholders' claims to the firm's output, and ultimately leave the firm with a higher cost of capital or a weaker incentive structure for employees.

Finally, chapter 7 concludes by summarizing this investigation's results, and considering its potential to inform other important governance debates. Extending the analysis to international applications, for example, economic performance should be similarly sensitive to whether governing organizations influence distributions between different electoral groups or distributions between producers and consumers. In the former case, accountability appears desirable in that a more inclusive political process can facilitate a more productive distribution of "life chances". Accountability can put social welfare at risk in the latter case, however, tilting distributions toward the politically influential and away from the economically efficient.

In each of these applications, institutions for accountability have been applauded for their potential to help organizations exploit economic possibilities. Far less attention has been paid, however, to the tradeoffs that these institutions must make (perhaps implicitly). And ignoring these tradeoffs does not let organizations escape them. Instead, it turns engineering problems that permit systematic successes on a number of dimensions into political processes that instead succeed in rare instances of luck. If this book succeeds, it will be in encouraging a more balanced assessment of how accountability influences the quality of governance at any level, and thus discouraging what can be superficially attractive but ultimately destructive policy prescriptions and organizational strategies.