The Contribution of Public Choice Theory to International Political Economy

Hannelore Weck-Hannemann and Bruno S. Frey

WHAT ARE MAJOR PROBLEMS?

The goal of this chapter is to show that the application of economic analysis allows important and novel insights into crucial problems concerning the interaction of politics and economics in the international sphere. To exemplify what such problems are, three areas are selected: protectionism, international cooperation, and boycotts (trade wars).

Protectionism

Economic theory argues that, under very general assumptions, free trade leads to the most efficient allocation of resources and maximizes a country’s economic welfare. Empirical research confirms that unilateral and bilateral tariff reductions yield significant welfare gains. Reality teaches us, however, that tariffs are prevalent in all periods and countries. There is a continuous danger of ever-increasing protectionism in the world, and there are recurrent phases in which protectionist tendencies take over. Protection is achieved with a variety of measures. In addition to outright tariffs, the most important are the imposition of non-tariff barriers via regulations (for example, quantitative import restrictions) and, increasingly, so-called voluntary export restraints. The attempts made to reduce protectionism are based on the notion of reciprocity—the propositions of trade theory about the welfare-increasing results of free trade do not seem to be accepted.

The glaring gap between theory and reality could be attributed to two causes. First, it might be argued that the policymakers are misinformed or of limited intelligence and therefore do not realize

the welfare-increasing effect of unilateral tariff reductions. It may well be that producers and workers in some export sectors do not fully comprehend that higher import tariffs may threaten export sales because the costs of import tariffs will rise, other nations will retaliate, or foreign income will fall. The same may sometimes apply to consumers who are not fully aware that import barriers increase their cost of living. However, misperception and lack of intelligence can explain only a small part of protectionist activity; detailed studies of debates over trade legislation reveal a rather remarkable degree of knowledge on the part of the groups affected.

The second explanation is more relevant. It notes that the assumptions underlying the pure theory of international trade do not fully pertain in reality. In particular, it must not be assumed that markets are perfect. Real economies are subject to imperfect competition and distorted relative prices; and there are considerable costs for information, transactions, and bargaining. Markets are not perfectly flexible, and it proves difficult and sometimes even impossible to undertake the redistributions necessary to compensate losers from a potentially Pareto-optimal trade-liberalizing measure.

Once the world of perfectly competitive and frictionless exchange is left behind, political forces must be taken into account. This has been neglected in the established international trade theory. The traditional approach neglects the question of how the free trade optimum can be attained. Instead, it postulates the existence of a benign, omniscient government that can use non-distortionary taxes and subsidies to place society on the utility possibility frontier. If these assumptions are not found to hold in reality, a protectionist stand can be interpreted as a rational policy for decision makers in a democracy.

The Public Choice approach to international political economics endeavors to reveal the forces that determine whether a particular branch of a national economy is strongly or only weakly protected. Actual tariffs (and other trade restraints) are determined by the demand for, and supply of, protection on a political market. Capital owners, management, and workers in import-competing industries unite to lobby for higher tariffs because the resulting increase in domestic prices yields them a rent that they can distribute among themselves. The protariff interests are often well organized (there is usually only a small number of relevant suppliers in any particular industry), and their demand for protection against the "cut-throat" competition from abroad is politically appealing to the population and politicians. Econometric evidence (mainly for the United States, but also for other countries) indicates that the drive for protection will be the more successful, the more concentrated the industry is (which facilitates interest group organization). The same applies to declining industries and sectors with a large number of low-wage
employees (which gives more credibility to the demand for protection). It is the consumer sector that would benefit most from low tariffs and increased competition by foreign suppliers; owing to their vast size and fragmentation, however, they are not able to counterbalance the protective demands of the import-competitive domestic suppliers.

Besides tariffs, other forms of impairing competition from foreign suppliers are employed. Empirical estimates for the United States suggest that nontariff barriers are used by protectionist groups not only as a substitute for general reductions in tariffs (agreed upon in international negotiations such as the Kennedy or Tokyo rounds) but also as a complement to tariffs. While strongly concentrated industries (which are therefore well organized and politically powerful) are well able to influence tariffs, less concentrated industries see a better chance in lobbying for nontariff barriers because the rents generated from protection can often be distributed selectively so as to motivate domestic suppliers to take part in setting forth the political demands. Voluntary export restraints (which are compatible with the General Agreement on Tariffs and Trade (GATT) on trade liberalization) are an especially attractive form of protection for the major organized groups of domestic suppliers, the national government, the public bureaucracy, and the foreign suppliers who can appropriate the rents created by the price increase brought about by the supply restrictions. The losers are the rarely organized and badly informed consumers.

International political economics can also throw light on how protectionism varies over time. In the downturn of the business cycle, the high rate of unemployment strengthens the political position of the protectionist interests, which induces the government to increase tariffs and other protective devices. However, when inflation rises in a booming period and the population considers this an evil, a vote-dependent government is motivated to encourage foreign competition in an effort to reduce inflationary pressure.

The study of protectionism illustrates well how the economic way of thinking is applied to the problems of international political economy. It is not only that the jargon of economics (such as demand and supply) is used, but also that the underlying behavior of individuals and groups is carefully analyzed. The uniform methodological approach allows us to consider actions in the economic and the political spheres simultaneously.

International Cooperation

Sovereign nations have great problems protecting global common property resources and establishing mutually beneficial rules and instructions. Important areas are international military alliances (such as the United Nations or NATO), international monetary agreements (such as formerly the Bretton Woods system and currently the European unification movement), international natural resources (such as fishing rights and minerals found in oceans) or the commercial exploitation of the Antarctic. Each nation has an incentive to free-ride in the presence of such international public goods. Countries are therefore well aware that international cooperation in providing such public goods is difficult to achieve. Efforts have been made to overcome or mitigate the free-rider incentive in order to continue to benefit from international public goods. Solutions have been sought in three different ways; they are not mutually exclusive but may reinforce each other under favorable conditions.

Private Goods

Private goods can be offered selectively to the cooperating nations, making it individually worthwhile for a country to join and to participate in the financing of the international public good. Creating such selective incentives is an important prerequisite for governments agreeing to join in international acts of cooperation. For this reason, all participants should concentrate their effort on transforming, as far as possible, the international public goods into private goods.

Not all international public goods can be redefined so that exclusive benefits will accrue to individual countries. An example of where this is partly possible concerns military alliances. An individual country's contribution to the common defense effort (the public good) is partly transformed into a private good if the troops that are contributed to the alliance are used to defend the territorial integrity of the nation concerned and if, under special circumstances, they can also be used in domestic crises — for riot control or helping with the aftermath of natural catastrophes such as floods or storms. It follows that international cooperation will take place if at the same time it serves to produce national goods; collective action is used partly to further individual (national) benefits.

The association of the international public good with national private goods means that it becomes possible for the nations to bargain on a quid pro quo basis; a country will receive benefits only if it is prepared to offer benefits to the other countries in turn. The countries involved do not have to face the grand decision of whether or not to participate in the provision of the international public good. Rather, the creation of associated private goods makes it possible to proceed sequentially in mutually beneficial steps. This quasimarket in terms of private goods produces the atmosphere of trust necessary for the international public good to remain linked with the private goods.

A special type of private good that induces nations to participate in the provision of an international public good is the desire to influence the nature of the public good. A country that free-rides has no say in
this respect. In the case of a military alliance, for example, it cannot influence the size, structure, or geographical distribution of the military forces or appoint nationals to leading positions. This constitutes an incentive for all countries to participate, but it does not reduce the incentive to contribute less than the (marginal) benefits that the international public goods produces.

Coercion

Coercion can be attempted. This possibility for forcing and maintaining cooperation is often difficult or impossible to put into practice in an international context. The member countries are unwilling to give up their sovereignty. Therefore, assuming (as is sometimes done) that coercion is possible neglects the basic problem of international cooperation. For instance, it does not help much to call for a world government that would force the superpowers to disarm, since the superpowers themselves are not willing to yield any of their power to another institution.

Rules or Constitutional Agreements

Rules or constitutional agreements laying down the conditions for cooperation can be sought. Such agreements set out the rules of the game that the participating nations, in a state of uncertainty about the future, are willing to accept. An example is the agreement on the rules for dealing with plane hijackers such as sending them back to the country from which they started. This form of international cooperation may well benefit all countries because they do not know the particular instances of hijacking that could arise in the future. Because the countries have to decide behind the “veil of ignorance,” they agree to the general rule because it allows for the provision of the international public good of air security that is advantageous to each one of them.

The established rule must lead to a Pareto-superior move that meets the expectations of all the actors. Only under these conditions will voluntary cooperation come about among the countries involved. Suitable conditions are not easy to find. Once a rule of constitution has been agreed upon, the problem consists of making sure that the rules are observed in overcoming the incentives of the individual nations to corrupt the agreement. In the above example of hijacking rules, a country that finds it advantageous to support the agreement ex ante may want to break the rule in a particular case, for instance, when the hijacker absconds from another country for political reasons and applies for asylum. The countries interested in this particular form of air security must be ready to bind themselves in an initial state of uncertainty in order not to admit such exceptions, which would destroy the cooperation and the international public good of air security.

In general, it is easier to find and to maintain cooperation agreements among a small group of nations. Free-riding is not as easy here as in large groups, because the nations find it easier to monitor each other’s behavior. A country breaking a rule is more easily detected and called to account. Norms of reciprocity do exist between nations that interact with each other.

Three areas will be discussed in more detail where cooperation over the provision of international public goods is sought, where free-riding exists, and where rules or constitutions have been used in an attempt to overcome the difficulties.

International Alliances. Because of its more extensive territory, a large country requires higher military expenditure than a small country in order to achieve the same level of protection. Similarly, a rich country runs a greater risk of being attacked than a poor country and will therefore benefit more from defense spending. If such a large, rich country has committed itself to making large outlays for this public good, the small, poor nation (or nations) will have an incentive to spend less on this good than they would in the absence of the large country. In military alliances, the small and poor countries spend a smaller share of their GNP on the provision of the alliance’s collective security than do the large and rich countries.

It has been empirically established that the “average” members of defense alliances such as NATO make a disproportionately small defense effort, while the dominating large countries (such as the United States) carry a disproportionately large burden.

Free-riding behavior can also be observed in the United Nations: the richest members, who presumably have the greatest interest in the maintenance of peace by a collective international organization, are by far the greatest contributors. The United States pays more than one-fourth of the UN budget and had to fight hard when the organization was founded to avoid having to pay one-half or more. The five permanent members of the Security Council (the United States, Russia, the United Kingdom, France, and China) pay half of the budget, and 20 percent of the members contribute almost 95 percent.

International Monetary Systems. All nations engaged in international trade and finance depend on the existence of a monetary order that enables them to make the necessary payments. A monetary order consists of a set of rules, such as the former gold standard or (after World War II) the Bretton Woods system, that have to be kept by all countries.

These rules, if well designed, are advantageous to all, but the incentives to deviate from them are also marked. It is, therefore, necessary not only to devise an international monetary scheme that
is potentially beneficial to all nations, but also to consider explicitly the benefits and costs to the individual participating nations. This aspect has been overlooked by the many proposals made for international monetary reform, which usually implicitly assume that there is an "international benevolent dictator" who will put them into effect.

The historical examples of Germany and Italy support the prediction derived from Public Choice that, because of the public good character of the benefits of monetary systems and, in particular, unions, they are difficult to form and maintain when it is only economic benefits and costs that matter. They also demonstrate the importance of a political entrepreneur — in the case of Germany, Prussia, and in the case of Italy, Sardinia — that is able to reduce the power of the formerly independent political units. Once this is achieved, a combination of coercion and political incentives may be able to bring about a viable monetary system or union.

A more recent example of the importance of a political leader and a small number of participants in overcoming the public goods aspect of the benefits is the Bretton Woods system with its gold exchange standard. This was in danger of collapsing for a long time when countries with large holdings of U.S. dollars had an incentive to convert them into gold (as France actually did). If this conversion had been carried out worldwide, the system would have been thrown into a major crisis of confidence, doing great harm to the functioning of the international monetary system.

The gold exchange standard remained viable under the domination of the United States until the period of massive U.S. balance of payments deficits in the 1970s. Until then, there was only a small number of dollar holders who had an interest in reaching and an ability to reach an implicit agreement in collectively assuring the stability of the system and thereby preventing a crisis. Had the dollar holdings been distributed more equally among the more than 100 countries, it is likely that dollars would have been converted into gold.

A similar situation exists in the international lending crisis that has occurred since 1981. Under the leadership of the United States, the few industrial countries and the few very large commercial banks involved as lenders have so far managed to agree not only to refrain from calling back the loans from the debtor countries (such as Poland, Mexico, and Brazil) unable to pay the interests and to amortize their debt, but also to extend new loans to prevent these countries from declaring themselves bankrupt. Here again, international cooperation for the provision of a global public good was achieved because of the leadership of one country and the small-group setting.

Not all rules existing in the international monetary order have proved to be of equal importance. It is interesting to ask why certain rules have not influenced behavior as much as one would have expected. In the Bretton Woods system, for example, exchange rate changes were used very little and then usually too late. This is because there are forces working against both devaluation and revaluation. Devaluation is believed to be interpreted by the voters as admitting financial failure with negative consequences for the government in power. This is not the case, however, if the blame can be put on the previous government. Devaluations therefore tend to be made soon after a new government takes over following a general election. A revaluation, on the other hand, benefits the voters (consumers) through lower prices for imported goods but generally harms the well-organized group of exporters and import competitors, so that the government may again run into trouble.

In view of this resistance to adjusting exchange rates, a government may find it advantageous to bind itself by signing an international agreement, establishing freely fluctuating exchange rates. The interest groups then know that the decision about devaluation and revaluation is taken out of the hands of the government (and central bank), which removes some of the political pressure. The government's decision to reduce its discretionary room by voluntarily binding itself may increase its power, because it is easier to refuse the demands of pressure groups to manipulate the exchange rates in favor of particular interests.

Agreements on Global Common Property Resources. The fundamental cause for the excessive exploitation of natural resources, such as fish and oil in the oceans, is the difficulty of defining and policing property rights. There are three ways in which the overuse and destruction of common property resources can be prevented.

The first procedure is to assign newly created property rights. Individual nations are given the right to allocate the access to well-defined parts of the resource in the way they think fit. An effective allocation method under competitive conditions is to sell the permits for exploiting the resource on an open market. The sales price of the license is a user fee that reflects the scarcity value of the natural resource. This ensures that those firms that exploit the resource are the most efficient at doing so. This procedure is used in the United States to allocate the right to drill on the continental shelf and to exploit public forests.

The property right over a natural resource need not be assigned to a particular nation but may implicitly be given to an international body. This is the case if liability for damage to the natural resource is imposed and monitored by an international agency. If the liability charges correctly reflect the social value of the damage, this procedure also ensures an efficient allocation of resources. This method has been suggested for preventing the pollution of the oceans.
by tankers. However, it requires considerable information, and it is again doubtful whether the monitoring agency would have sufficient incentives to undertake its task effectively.

The second approach to prevent the destruction of common property resources is through regulation. An international organization could establish the optimal rate of use and determine to what extent each nation or firm might participate in the exploitation. For example, the orbit spectrum is a global common property resource the use of which would be regulated by international organizations following a proposal. The orbit spectrum resource consists of the electromagnetic spectrum through which satellites are placed. For a long time, resources were not scarce, and no common property problem arose. Lately, however, the electromagnetic spectrum as well as the orbit for placing satellites have become increasingly congested. A UN agency, the International Telecommunications Union, awards frequencies on the principle of first come, first served — and free of charge. No such organization yet exists for the allocation of orbit space, but national governments have begun to claim sovereignty over the outer space lying above their territories.

The main problem with the regulatory approach is that the international organizations have little or no coercive powers and therefore find it difficult to effectively constrain the overexploitation of this particular part of the global common property.

A third approach to the problem of the destruction of international natural resources is one of noninterference and the hope that the nations and firms in question will themselves be able to prevent overuse by suitable cooperation. This is often a vain hope. But the strategy of inaction recognizes that the existence of a market failure (here, the international public goods problem) does not necessarily constitute a case for supranational action. International agencies are faced with a great many administrative and political problems, such as the frequent intervention of governments in the national interest. Supranational action is thus subject to governmental and administrative failures. As a consequence, active interference by an international organization may be worse than market failure. More often, a solution may be sought that does not require the establishment of an international organization but is based on direct bargaining between the nations concerned.

Boycotts and Trade Wars

Boycotts are used to disrupt trade and finance in order to influence the targeted country’s political position. A recent example is the severe import and export restrictions imposed by the UN Security Council at the instigation of the United States against Iraq because of its invasion of Kuwait. Such economic sanctions have rarely proven effective because the necessary administrative, economic, and political conditions were not met. One of the main reasons why economic sanctions generally do not work to any satisfactory degree is that the production and consumption patterns of the boycotted nations are quite flexible. An adjustment is possible and imports and exports can be undertaken by nations not participating in the sanctions or by illegal trade that opens up in response to the high profit opportunities created. Moreover, the administration of the sanctions by the boycotting nation or nations is usually slow and leaves sufficient leaks to allow the targeted country to remain relatively unharmed. Finally, the political reaction in the boycotted country may be counterproductive, tending to raise nationalist feelings and thereby crippling opposition against the government. At least in the short term, this cements the political position taken so far.

Economic sanctions are costly to the nations imposing them because benefits from international trade are given up and competing suppliers may establish themselves in the market instead. Despite these costs and the probable ineffectiveness of trade wars, governments are often compelled to engage in them because they constitute the only means available short of inaction (which the population would not tolerate in most circumstances) or going to war.

WHAT IS DISTINCTIVE ABOUT THE PUBLIC CHOICE APPROACH?

Public Choice, sometimes called the economic theory of politics or the new political economy, seeks to analyze political processes and the interaction between the economy and the polity by using the tools of modern (neoclassical) analysis. On the one hand, it provides an explicit positive approach to the workings of political institutions and to the behavior of governments, parties, voters, interest groups, and public bureaucracies. On the other hand, it seeks normatively to establish the most desirable and effective political institutions. Public Choice is part of a movement that endeavors to apply the rational behavior approach to areas beyond traditional economics. Political scientists are frequently concerned that the rational behavior approach has a tautological character. Public Choice scholars do indeed try to explain behavior by assuming that individuals act consistently on the basis of known and well-ordered preferences. However, they are well aware of the danger of simply introducing some new element into the preference function in order to be able to remain faithful to the rationality assumption. Indeed, one of the main purposes of Public Choice is to produce testable propositions amenable to empirical analysis. In recent years, an increasing number of political scientists, sociologists, and social psychologists
have taken this approach. It thus constitutes one of the rare successful examples of interdisciplinary research.

Both the rational behavior approach to social problems and the Public Choice theory are characterized by three major features. First, the individual is the basic unit of analysis. The individual is assumed to be rational in the sense of responding in a systematic and hence predictable way to incentives; courses of action are chosen that yield the highest net benefits according to the individual’s own utility function. Contrary to what nonspecialists often believe, it is not assumed that individuals are fully informed. Rather, the amount of information sought is the result of an often implicit cost-benefit calculus. Indeed, in the political arena it often does not pay the individual to be well-informed. This is known as rational ignorance.

Second, the individual’s behavior is explained by concentrating on the changes in the constraints to which he or she is exposed; that is, the preferences are assumed to be constant. Individuals are assumed to be capable of comparing alternatives, of seeing substitution possibilities, and of making marginal adjustments.

The third characteristic is that the analysis stresses rigor and is sometimes formal. The results must yield a proposition that, at least in principle, can be subjected to econometric testing.

One of the great assets of the Public Choice approach to international political economics is its emphasis on human behavior. While the relationships studied may sometimes be abstract, they gain life by the fact that they do not exist in isolation but are always the result of human interaction. The actions taken are attributed to individuals pursuing their own advantage within the constraints imposed by other actors, by institutions, and by the scarcity of resources. Individuals make their decisions by comparing the benefits and costs of the alternatives open to them. They are assumed to be rational in the sense that they are able to perform such an evaluation and to draw the correct conclusions in such a way that there is a systematic and hence predictable relationship between the expected net benefits and the behavior revealed.

The economists’ methodological individualism does not mean that individuals are the only actors considered. Indeed, actions often have been attributed to groups of individuals (for example, to interest groups lobbying for protection) or to organizations (for example, to the government or even to countries in the case of donors and recipients of foreign aid). If there is a sufficient amount of homogeneity within such aggregates, it is helpful to use them as the acting units as long as one is prepared to relate the actions to individual actors if deemed necessary.

Another major strength of the Public Choice approach to international political economics is its explicit analysis of institutions. The existing institutional conditions play a major role in the analysis. Institutions are understood in a broad sense, covering decision-making mechanisms (for example, concerning the use of global common property resources) and organizations (such as the World Bank).

The analysis of institutions sets international political economics strongly apart from the pure theory of international trade, which explicitly considers only a single institution, the price system, or the market. This is one of the main reasons why orthodox international economics is considered by many students and researchers as a rather bloodless, abstract, and possibly rather irrelevant endeavor. International political economics is also quite distinct from applied international economics. In contrast to this field (which is concerned in particular with monetary aspects), the working of the institutions is not simply described but is also analyzed. Theoretical propositions are derived that can be tested empirically. This has been done, for example, for the case of the World Bank.

This leads to a third major strength of the Public Choice approach to international political economics, the integration of economics and politics. This is made possible because one methodological approach is applied to the economic and the political spheres. Individuals, groups, and organizations are assumed to pursue their goals simultaneously by economic and political means and are subject to both economic and political constraints.

Within the political scientists’ approach of international relations, there is also an endeavor to integrate political and economic aspects in the international sphere. Four major perspectives of international political economy may be distinguished:

1. The mercantilist or neomercantilist view, stressing the central role of the nation-state as the sole basic actor and the only source of security for its citizens.
2. The liberal view, which is associated with neoclassical economics. This economic approach is regarded rather skeptically by proponents of international political economy. For example, one writer argues “that the corpus of liberal theory rests not upon sound simplifying propositions about reality but upon simplifications which require evasions, or even distortions, of reality if they are to be useable, or a priori assumptions which are quite simply unwarranted.”
3. The radical or Marxist view, which takes the structural inequalities of the international system to be the inevitable product of capitalism. It is taken as a matter of course that the developing countries are exploited by the developed, capitalist ones.
4. The structuralist perspective (associated with Raul Prebisch), which recognizes the fundamental structural
disadvantage of developing countries in relation to industrialized countries but remains reformist by seeking corrective arrangements through negotiations.

Political scientists do not hesitate to claim international political economy as their proper and exclusive domain. Power and authority, not market relations, are taken to be the central concepts with which to study the problems. In addition, the analysis has to be dynamic and has to take historical processes into account. Accordingly, there is a marked tendency to reject economic theory.

This rejection does not, however, always seem to be based on sufficient knowledge of the literature. The classical writers on Public Choice (Arrow, Downs, Buchanan, Tullock, & Niskanen) are rarely if ever quoted, let alone their specific contributions that may be relevant for international political economy.

From the Public Choice point of view, political scientists’ international political economy is deficient in various respects. The most serious shortcoming is its little-developed analytical structure. It lacks a well-spelled-out theory of behavior from which to derive nonobvious testable hypotheses. The approach is descriptive, historical, and sometimes anecdotal. Little effort is made to put up clear propositions and to subject them to empirical testing. The political scientists’ approach is, however, useful in giving general insights and in helping to grasp the particular forms of institutions and political processes relevant to international political economics.

OTHER APPLICATIONS

Over the past few years, the Public Choice approach has been applied to many different phenomena beyond those mentioned at the beginning of the chapter. In order to give an impression of the possible uses of the economic or rational choice approach in this area, further examples are provided.

Foreign Aid

The amount of official aid given by an industrial country to a developing country is decided to a large extent by the government and its bureaucracy, because neither voter nor interest groups have a strong and persistent interest in this particular issue. The discretionary room accorded to the politicians and public officials is used to further their own goals, in particular to undertake a desired foreign policy. The promotion of their country’s international standing yields benefits to members of a government and to public officials in terms of prestige and, possibly, influence in the diplomatic world. A recipient country can actively influence the amount of aid received by choosing an appropriate political position vis-à-vis the donor country. A developing country that always or never aligns itself with the donor (for example, when voting on issues in the UN) is likely to receive less aid than one that makes it clear that it will be prepared to support the donor’s position in return for financial aid. The interrelationship becomes more complex if two competing donors and one recipient country are involved. The amount of aid and the distribution of its sources then depend on whether or not the donors are prepared to tolerate a neutralist position and on whether the developing country has a preference for a particular position on international issues or simply wishes to maximize the amount of aid received.

Empirical evidence suggests that a donor country tends to react when the amount of aid given by other donors is increased because it is afraid of losing influence. In such a situation, foreign aid is increased to check the other donors’ influence. Foreign aid is therefore no international public good, rather, the developing countries benefit from the aid competition among donors.

Foreign Direct Investment

Multinational enterprises are prepared to provide both the capital and the entrepreneurial knowledge (that is, to invest directly) in a developing country if they can expect a positive return compared to alternative investment outlets. This expected return depends on both economic and political conditions in the countries to be invested in. A developing country will attract more foreign direct investment the higher its real per capita GNP and the lower its balance of payments deficit is.

One of the most important political factors influencing the expected rates of return of multinational firms is political risk. Empirical studies suggest that the risk of being expropriated or of being forced to divest (without adequate compensation) is not as large as is often thought and that the risk differs strongly between the sectors invested in. It is shown, however, that this risk in the form of political instability does significantly reduce foreign direct investment and that a developing country attracts more of such investment, the more bilateral and multilateral aid it receives. The host government’s political ideology is of little importance because it does not directly affect the expected returns of carefully planning multinational firms.

International Organizations

In the media as well as with insiders, quite clear views exist about the performance of international organizations. Thus, the United
Nations is often claimed to be inefficient and to produce a huge amount of waste (especially UNESCO). However, the financial institutions of the UN, the World Bank and the International Monetary Fund (IMF), are often more favorably considered; they are commonly said to perform their tasks quite efficiently.

Various studies have sought to determine the efficiency with which international organizations act. However, the term efficiency has various meanings and ranges from the narrowly defined input-output relationship to the concept of efficiency as the fulfillment of the individual's preferences. Scientific analyses on the efficiency of international organizations are almost nonexistent because of the fundamental difficulty of defining and measuring what the output is.

Because the performance of an international organization cannot be uniquely determined if individual preferences are to count, an output-oriented analysis is not feasible (especially since it cannot be empirically handled). A different approach must be sought - the performance of an international organization must be seen to emerge from the action of the relevant decision makers. Such decision makers are the organizations' directors and other groups and bureaucracies and the individual voters and taxpayers. The view thus shifts from the (vain) attempt to determine output to an analysis of the interaction of the decision makers relevant in an international organization. The only way to evaluate and influence performance is to analyze and set the rules under which the interaction takes place. Particular outcomes are connected with particular rules through the behavior of the decision makers. Provided an adequate theory of behavior is used, rules may be chosen in order to determine the resulting outcome. It follows that no output or efficiency of an international or governmental organization exists independent of the prevailing rules or institutions. When the rules are changed, the concepts of output and efficiency change, given the preference of the organization's members. Rules must therefore be the cornerstone of any analysis.

The relationship between the citizens and the international organizations is only indirect, and the citizens have little incentive and few possibilities to control the behavior of international organizations. The citizens have little say on what policy their government pursues with respect to international organizations. The national representatives have a large amount of discretionary power, enabling them to deviate from the government's goal and to push for more funds and an extended role for "their" international organization. As a result of the largely ineffective principal-agent relationship between citizens and international organizations, the latter act to a considerable extent independently of, and often contrary to, the preferences of the citizens as voters and taxpayers.

Since the fulfillment of individuals' preferences is the normative founding stone of economics, the question now arises as to what rules would serve the citizens' interests. International organizations may be induced to take the citizens' preferences into account by establishing appropriate rules in two areas.

The first is to induce the national representatives to fight for the interests of the consumers and taxpayers and to restrict them in pursuing their own interests. This can be achieved by introducing the rule that the delegates are to be elected by the citizens or at least by parliament in a public session. Another possibility would be to regulate the career pattern of national representatives by rewarding them for pursuing the citizens' interests and punishing them for not doing so. Such a compensation scheme is, however, extremely difficult to devise. The individuals also want to make sure that the national interest groups do not exert undue influence on the delegates. This may be achieved by imposing rules on the national political process to restrict their activity or, preferably, by supporting the formation of otherwise unorganized groups.

The second way to ensure that international organizations act according to individual preferences is via rules that facilitate their control. In addition to the possibility of holding a citizens' referendum on whether to join or leave, the following rules that govern the international organization's behavior are of prime importance.

1. Competition is to be allowed and, possibly, created so that the international organization is forced to serve the individuals' interests. Competition may not only exist from rival international organizations but also from alternative institutional arrangements for providing internationally produced goods. While at first sight such competitive institutions seem rarely to exist, there are in fact many instances in which several international organizations are active in the same field and where there is at least some competitive pressure. Examples are the American Red Cross and Amnesty International (a nongovernmental international organization), which are both active in the care of and bringing about the release of political prisoners; the United Nations General Assembly and the Summit meetings, where heads of government of industrial nations meet for consultations; or ad hoc banking consortia, which are active in international public debt negotiations together with the UN's financial institutions. In all these cases, competition is weak and always tends to be restricted by the international organizations involved; it nevertheless forces the international actors to perform better than they otherwise would. The citizens have an interest that rules are established that prevent the restriction of such competitions and, above all, do not give a monopolistic position to any one international organization.
2. Exit is to be made easy. Such rules weaken the possibility of the international organization's administration disregarding the interests of the citizens of any member state. However, the citizens of a particular country would not profit from too lenient exit rules because the international organizations would have an incentive to define as public a wide range of goods that do not share the characteristics of nonexclusibility and nonrivalry. The more international private goods are produced, the more lenient the exit rules should be formulated from the point of view of individuals.

3. Output is to be partitionable. Such a rule allows the delegates of a member country to support those undertakings that are beneficial to the residents of that delegate's country and to resist those that are detrimental. In extreme cases, this rule makes it possible to "exit in steps," as has been done, for example, by the United States and France in the United Nations.

Conversely, it is in the individuals' interest to prevent the international organization from confronting the member countries with an all-or-nothing budget proposal. As has been shown in the theory of bureaucracy, fixing the options to be decided between gives an organization the possibility to exploit the willingness to pay those demanding its services and enables it to expand its budget far beyond what is desired by the demanders.

4. There is to be fiscal equivalence. Those nations with a larger financial contribution should also have a larger say in how the money is to be used. If this equivalence is not guaranteed, an inefficient use of the scarce resources is programmed. A country, for instance, that makes only a minor financial contribution but that has the same voting power as all the other contributors will logically vote for the expansion of the budget, even if it benefits only a little from that vote (for example, only by the fact that some additional nationals are employed).

In the financial organizations of the UN system, the rules on the distribution of votes and the voting rules are more in the spirit of fiscal equivalence than in other UN organizations. This may explain why the World Bank and IMF are often considered to be efficient. In the IMF, each member country receives 250 basic votes (but these make up only 4 percent of the total vote) and one vote for each 100,000 units of special drawing rights contributed. The resulting distribution of contributions stands in close relation to the voting power. For instance, in 1969 the United States contributed 19.9 percent of the budget and had a voting share of 19.1 percent. In the World Bank, the situation is quite similar. The United States contributes 23 percent of the total subscriptions and has a voting share of 20.8 percent.

5. The government or board of managers of international organizations is to be elected by popular vote. This may be done either directly (this may, for example, be envisaged for the commissioners of the European Community) or by some more indirect procedure. Such a voting rule would give the leaders of a international organization an incentive to pay attention to the preferences of the populations of the member nations.

These rules with which to induce international organizations to care for the wishes of national citizens are not exhaustive. Others may well be imagined and designed. What matters is to show that several effective avenues exist. The question remains, of course, how to put such rules into practice. In a democratic setting, such rules cannot simply be imposed but can only be arrived at behind the partial veil of uncertainty in a constitutional context. The fact that the constitutions in different democratic countries differ so considerably with respect to the voters' rights in national decisions concerning international organizations shows that there is indeed a choice among such rules. The differences existing among the constitutions of international organizations show that a choice is possible in that respect, too. The economist's task is to analyze the properties of rules that lead to citizens' preferences being met by international organizations and to suggest ways of putting them into practice. The voters and taxpayers have to be informed of the effective rules that may be introduced; but in a democracy, it is, after all, they themselves who have to decide.

PROSPECTS

The aim of this survey has been to show that Public Choice has made considerable and valuable contributions to international political economy. The approach has shed new light on the field and should be of interest to all social scientists concerned with bridging the gap between international economics and international political relations.

The Public Choice approach to international political economy has both strengths and weaknesses, a proposition, of course, true for any approach, including that adopted by political scientists. Five points merit amplification:

1. The Public Choice view provides fresh insights into the area in the same way that the economics-based approach illuminated general politics. This is not to say that the approach is superior to any other; rather, it is able to illuminate particular aspects of international political economy (while being unable to contribute much in other areas). The specific strengths of the Public Choice view are also responsible for its specific weaknesses. There is a tendency to use theoretical and empirical methods without paying sufficient
attention to the particular historical and institutional conditions existing in the field of study. A quick application is tempting because it is seemingly easy to undertake, and the shortcomings of the analysis may not be obvious. It is necessary, however, to investigate thoroughly whether particular theoretical concepts such as public goods and free-riding really capture the essential features of reality.

2. An advantage of the Public Choice approach to international political economy is that the analysis is based on an explicit and unified theory of human behavior and on a technical apparatus capable of producing theoretical solutions and empirically testable propositions. This technical elegance leads, however, to a tendency to sacrifice relevance to rigor. There are already some areas of this type of international political economy where the heavily formalistic apparatus used is out of all proportion to the resulting advances in knowledge.

3. The Public Choice approach concentrates on specific aspects of international political economy, making it possible to isolate and analyze relatively simple relationships. The high degree of abstraction allows Public Choice scholars to gain major insights into complex problem areas. But it also involves the danger of leaving out relevant aspects of keeping constant (by the *ceteris paribus* assumption) variables that are so closely and importantly connected with the problem being studied that they should be considered an endogenous part of the model.

4. The emphasis on deriving propositions that are, at least in principle, amenable to empirical testing is healthy because it forces reality on the researcher. Econometric or, rather, polometric analyses also provide factual knowledge about the relationships among the variables being studied. The disadvantage of this empirical orientation is that aspects difficult or impossible to measure quantitatively are easily excluded. Thus, the relationships for which data are easily available are those that tend to be studied. A common shortcoming of empirical economic research is that the operationalization of individual theories is often done in a rather cavalier manner. In that respect, economists could certainly learn from quantitative political scientists as well as from other social scientists.

5. Finally, the Public Choice view is interdisciplinary in a specific sense of the word; it combines the economic and political aspects of international political economy but uses a single theoretical approach. (Usually, interdisciplinarity is understood to mean that theoretical approaches have to be combined.) This has the advantage that the two areas can be fused together, but it carries the already mentioned danger that only selected aspects of their interrelationship will be treated. There can be little doubt, however, that economists engaged in research on international political economy can gain from the work done by political scientists, especially from their experience of the institutions and political processes encountered in the international sphere. Up to now, there has been relatively little contact between Public Choice researchers and other scholars in the field. This survey will have achieved its goal if it has convinced the reader that political scientists would benefit from considering and studying the Public Choice approach to international political economy.

NOTE


REFERENCES


