Preface

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

Senator Edwards is not alone in observing a lack of accountability in America's democracy. Indeed, both popular and academic media offer considerable support for this sentiment. The popular *Cable News Network* (*CNN*) 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."[2] Important scholars like John Matsusaka have added weight to this type of argument. Building on Robert Erikson et al.'s (1993) measure of government quality as "the responsiveness of public policymaking to the preferences of the mass public", for example, Professor Matsusaka found evidence that "government responds more to powerful interests than the general public" (2006, p. 1).

Instead of evidencing an undesirable lack of accountability in governance, however, observations like these are also consistent with democratic influences being so strong that economic performance suffers as a consequence. This conclusion follows from evaluating the quality of governance not against the popular standard of what people say but against the more revealing standard of what they do. The results can be surprising, and not only argue against blanket calls for increased accountability but also suggest that accountability may have already become too strong in important areas of politics, law, and business. Attempting to strengthen democratic governance in cases like these risks a further weakening of economic performance.

Understanding this risk, and how institutional and organizational strategies can productively address it, should interest students and scholars who work at the intersection of social science and the law and can help professionals improve their own performance in policy, legal, and business settings. In short, democratic institutions

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[1] Source: former Senator John Edwards during his candidacy for the Democrat party's 2008 Presidential nomination, http://johnedwards.com/news/speeches/20070726-economic-fairness/, accessed 23 October 2007.

[2] Quoted from, respectively, Dobbs (2006), Jack Cafferty's March 12, 2007 commentary from the "Cafferty File" on CNN's "The Situation Room", and the back cover of Cafferty (2007).

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, competition laws and regulations, and shareholder access to the corporate ballot) can also facilitate the taking of economic output for strategic redistributions. And like more widely appreciated sources of political expropriation (e.g., powerful governance agents rather than principal constituents), this one also constrains a society's economic opportunities. Consequently, while democratic governance is frequently measured by the responsiveness of policy to the preferences of principals, institutions that tighten this responsiveness can instead reduce government quality when evaluated against the standard of economic performance.

This type of political risk regularly threatens economic performance and the frequency with which even the most advanced economies realize its adverse consequences may be considerable. Following the devastation of Hurricane Katrina in the United States, 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 and punished those who opposed it. Accountability may have come at the price of economic performance, however, as suppliers of important insurance services soon exited the market (Wilson 2007).

Electoral pressure to alleviate recent credit market stresses may also ultimately discourage productive economic activity. The US House of Representatives' proposed "Mortgage Reform and Anti-Predatory Lending Act", for example, would let delinquent borrowers sue lenders for underestimating borrowers' repayment ability (e.g., see Saft 2007). While addressing constituents' calls to serve consumers (rather than financial service firms), however, creating this litigation opportunity could very well weaken repayment incentives and thus further the reluctance of intermediaries to channel credit. Given the importance of financial intermediation to general economic performance (e.g., see Levine 1997), the adverse effects of too much accountability in cases like this 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 democratic institutions at various levels of governance (e.g., federal, state, corporation) can generate similar risks. To be sure, the 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 is popularly characterized as lacking.

The theories and evidence produced here thus equip organizational strategists in politics, law, and business to develop more productive institutions for accountability. In particular, rather than simplistically treating accountability as desirable under *any* circumstance, policymakers, lawyers, and managers can do better by weighing the agency benefits of increased accountability against the distributional costs of institutions and organizational arrangements that favor principal stakeholders over more general economic performance. Evaluating accountability relative to the standard of what people get, in this sense, can ultimately do better at giving them what they want.

A Note on Method

This book builds, from the ground up, a sound theory and evidence about a relationship that popularly rests on informal conjecture; that is, democratic governance, at various levels of social and economic organization, generally improves welfare. It starts by formally *modeling* the phenomenon of interest. Done well, this type of research design can yield more firmly grounded and robust conclusions than do less-scientific approaches and, as we will see in this case, point to important empirical regularities that might have otherwise remained hidden.

Even when they are done well, however, formal investigations of human sociality are sometimes dismissed with statements like "that's just a theory." But an inescapable condition is that *everything* we do rests (often implicitly) on "just a theory;" that is, necessarily incomplete accounts of the "real world" that guide our actions. Gravity is just a theory. But it carefully rationalizes enough of what is "real" to land spacecraft on Mars – a world that (at least initially) revealed its truths to us not through intimate experience but through personally detached, firmly grounded, and logically developed *theory*.

Now, most of us are not physicists. However, we do seem to use good-enough models of gravity to lift ourselves from chairs or descend stairs without falling. Likewise, we implicitly use models of inertia to decide when and how hard to use our brakes and thus stop ourselves from crashing into cars ahead of us. Examples like these could easily go on, but the point is we do not need doctoral degrees to succeed at what we do – we need, and comfortably use, models! The important question is not whether we should tackle the task at hand with a model but rather how we can be confident that our model is a "good" one.

What, then, counts as "good" in this context? Any model must have a starting point, an initial condition that cannot be tested (otherwise, the condition would not be a starting point). Our set of standards for a good model thus begins with requiring assumptions to be self-evident and, to the extent that our assumptions are not obvious from introspection, our conclusions should not be overly sensitive to them. Second, we will want any such conclusions to logically build on our assumptions. A transparent statement about our assumptions and a mathematical derivation of hypotheses from those assumptions can serve these objectives well. Finally, we will want our hypotheses to highlight something that is empirically important but not trivially obvious. In other words, we will want to evaluate our hypotheses against data, while being careful that our conclusions are robust to possible statistical artifacts. Success on each of these margins can then let us confidently go forward with our model, not only in the empirical application where it was tested but also in any application in which the theory's assumptions are salient.

Overview of the Book

Ultimately, a good model simplifies a superficially complex reality so that we can better understand the fundamental forces that may be driving it. This understanding, in turn, is necessary (though certainly not sufficient, as we will see) to govern those forces in a manner that expands, rather than strategically distributes, economic opportunities. Part I of this book attempts to build such a model of how democratic governance influences economic performance. Part II, then, uses this model to make sense of applications in politics, law, and business, and highlights individually attractive strategies for strengthening performance through each of these governance levels.

Theory: What Should We Observe if Democratic Governance Weakens Economic Performance?

Part I begins by developing a model of "pressure group politics." The idea here is that producers and consumers compete for policies that yield individually attractive, but socially inferior, distributions. Conventional wisdom warns us about producers that would naturally accumulate economic power or enjoy political advantages that can be leveraged to accumulate power. The flipside of that wisdom, however, is that similarly situated consumers would also favor themselves over the greater good. And in a model that consistently characterizes individuals as being self-interested, whether they are producers or consumers, this latter outcome becomes a logical possibility.

In addition to assuming that everyone is self-interested, however, the model of pressure group competition assumes that bargaining power does not change over the life of (perhaps implicit) contracts. But relaxing this assumption does not change our conclusion, that is, consumers, like producers, will renegotiate what were originally win-win bargains whenever they can get the upper hand. In both of these models, and others, the observable implication is the same – when governance mechanisms overly favor a group of individuals (any group!), the favored group enjoys an attractive distribution not from expanding economic opportunities in general but from taking at the expense of others.

The important question for this book, then, is whether this principled risk is empirically important. Conventional wisdom seems to agree that too much producer power is a widespread difficulty, and careful scholarly studies have found evidence of producers being problematic in this important regard. But this book's theory does not say that one group naturally wins over the other, at the expense of economic performance more generally. Rather, it implies that "who wins" is sensitive to the structure of underlying politico-legal institutions. Put simply, when democratic governance becomes too strong, it facilitates "taking" by the masses and thus discourages producers from "making" in the first place. Here, the distribution of economic benefits opposes that which gives rise to conventional concerns (i.e., concerns about overly favoring producers), but constrains general economic opportunities all the same.

Natural Experiments: State Telecom Sectors Offer Attractive Labs for Studying Politics, Law, and Economics

This model appears to be "good" in the sense that conclusions logically build on self-evident assumptions and appear rather insensitive to assumptions that may not be as agreeable a priori. To further evaluate whether we have a "good" model, then, we must empirically evaluate its implications. Here we want to learn whether the model lets us see something that less-formal methods may have left undiscovered, for example, whether democratic governance can indeed weaken economic performance.

To conduct this type of investigation, we need to find a naturally occurring "experiment" or conditions that approach those of a controlled setting. The goal here is to build assurance that our empirical inference is really attributable to the relationships that our model hypothesizes, rather than a statistical artifact. Chapter 2 thus asks what type of economic sector offers a good "lab" for evaluating whether democratic governance weakens economic performance only in principle, or whether it has actually done so in consequential applications.

For a number of reasons, state-level US local exchange sectors offer an attractive "quasi-experimental" setting in this regard. Importantly, each sector shares the same federal rules, but also works with different democratic institutions across states. Some states preclude campaign contributions from regulated utilities, for example, giving consumers a stronger voice in policy deliberations on the margin. States also vary in whether they elect or appoint utility regulators as well as in how they register voters. This oftentimes independent variation in democratic institutions, coupled with statistical tools that help us move even closer to experimental conditions, facilitates comparisons (again, on the margin) of how sectors perform when they are "treated" with democratic governance.

Statistical Evidence: Democratic Governance Probably Went Too Far in At Least One Important Sector

Results from this statistical exercise speak strongly against the conventional wisdom; that is, evaluated on several margins where democratic governance varies, local exchange sectors exhibit inferior performance when consumer electorates enjoy stronger policy influence. To be sure, this result does not imply that a strengthening of democratic governance always leads to inferior social outcomes. Rather, it says that accountability appears to have gone too far in at least one important economic sector (a sector where the effects of that influence are relatively easy to discern).

At the same time, these results do not imply that the risk of too much democracy is particular to the sector in which it was empirically evaluated. The telecommunications sector offers a relatively controlled setting in which to consider whether this principled risk might become practically important. Indeed, that sector receives formal treatment in this book because of its quasi-experimental properties, not because our theories are particular to the sector. The statistical analysis reported in Chapter 3 thus suggests that other sectors with similar fundamentals (e.g., policy processes that are sensitive to pressure-group politics) may also be at risk of having democratic governance go too far, even if those sectors are less amenable to a formal empirical investigation.

Implications for Political Bureaucracy, Competition Law, and Business Organization

Part II of *Democratic Governance and Economic Performance* investigates how this type of political risk can be realized at different levels of governance (e.g., federal, state, corporate) and thus weaken performance in other substantively interesting areas. Chapter 4 looks at how qualitatively similar forces play out at the macro-governance level, where overly democratic governance can compromise the productivity of monetary, fiscal, and trade policy. Chapter 5 then looks at an intermediate level of governance, namely antitrust laws and competition policies that (externally) govern business activity, and finds that markets like that for catastrophic risk insurance may also be underperforming because governance receives too much democratic pressure. Finally, Chapter 6 applies the theory at a micro-level of governance, that is, corporate governance. There, we also discover serious risks of democracy going too far, especially with respect to growing pressures for corporate law to strengthen the voice of shareholders.

At each level of governance, this book's robust theory says that the conventional wisdom about democratic governance can be wrong, and its empirical evidence says that this risk has plausibly been realized in important applications. To reiterate an important point, it does not say that democratic governance can never improve matters. Rather, its conclusion is that democratic governance probably deserves a more balanced evaluation. To that end, Part II also sketches some ideas on how political, legal, and business entrepreneurs can do better for themselves by facilitating this more widely attractive, but not always expedient, approach.

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