

LECTURE NOTES ON INTEREST GROUPS AND REFORM

Preliminary -- Note for Quotation

January 24, 2002

1. Consider a “stage-two” reform that is not adopted because a politically influential interest hurt by the reform blocks it.

A stronger claim (Olson, 1982) is that this possibility is likely to be a common outcome, since dynamic processes create vested interests, who then have a strong interest in blocking reform

There is little formal work in this approach, though it is quite important for certain types of reforms.

Krusell and Rios-Rull (1996, *REStudies*) on technology adoption.

2. Remember our Fernandez-Rodrik example with two sectors, one uncertain about benefits, the other unambiguously gaining. The structure stressing *ex-ante* heterogeneity was meant to stress how uncertainty can “block” reform.

Modify it to have one sector as a clear economic loser to stress the above issue. Note how this change would change the whole conceptual focus of the example.

Whether losers can block the reform all depends on their **political power**.

3. Hence, much greater focus on nature of political system and what allows these interest groups to politically block reform.

Note difference in emphasis from “stage-one” reforms (where nature of political system could often be in background).

4. Veto players.

Agents who have the power to veto policies they find not in their best interests. (Compare with War of Attrition.)

Government chooses policy subject to the constraint that each veto player’s utility under the adopted policy is no less than it would be under some “reversion level”, say utility under the status quo.

For simplicity, consider first the case of a single interest group that has veto power, policy has two dimensions, e and τ .

$$\begin{aligned} & \text{Max } W(e, \tau) + \lambda [V(e, \tau) - V^{SQ}] \\ & e, \tau \end{aligned} \tag{1}$$

where $V^{SQ} = V(e^{SQ}, \tau^{SQ})$.

The maximization problem yields first-order conditions:

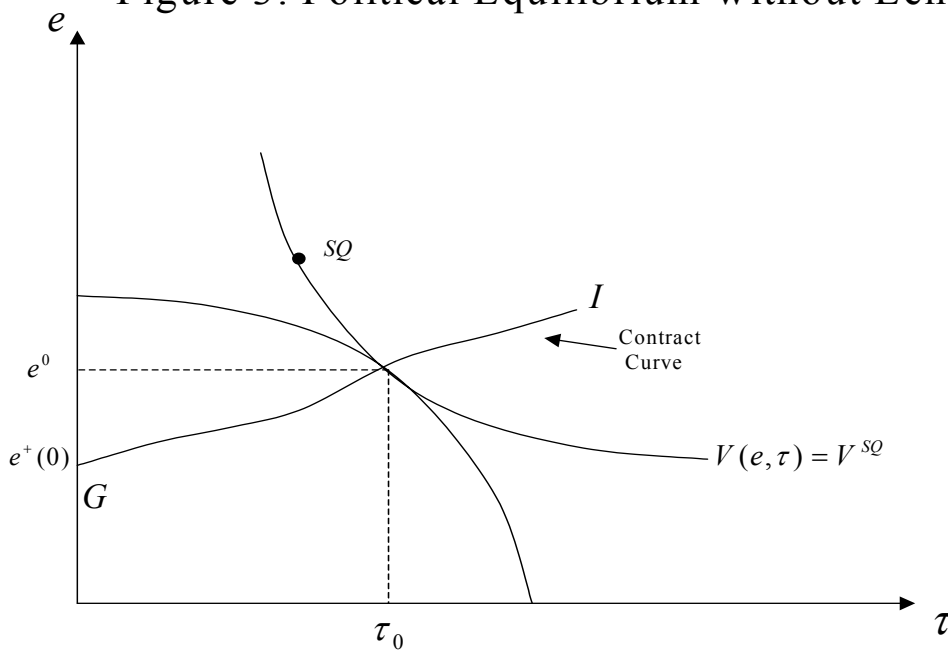
$$\frac{W_e(e, \tau)}{W_\tau(e, \tau)} = \frac{V_e(e, \tau)}{V_\tau(e, \tau)} \tag{2}$$

and

$$V(e, \tau) = V^{SQ}, \tag{3}$$

These conditions have a simple interpretation. Equation (2) is simply the condition that the indifference curve of the government over e and τ is tangent to the indifference curve of the interest group over e and τ . The set of tangencies of these indifference curves yields the “contract curve” of Pareto optimal points from the viewpoint of the two agents. Equation (3) determines which point on the contract curve is the equilibrium. For the interest group’s reversion (or “threat”) point being the status quo, the government role as the chooser of policy implies that it “captures all the rents” in that policy in a political-economic equilibrium policy leaves the interest group no better off than in the status quo.

Figure 3: Political Equilibrium without Lending



4. Bargaining

5. Menu-Auctions -- Bernheim and Whinston (1986), Grossman and Helpman (1994)

Condition (2) is basically equivalent to the first-order condition in the Grossman-Helpman (1994) menu-auction model when one of the arguments e or τ enter linearly and of opposite sign and there are many interest groups. Specifically, let τ be a campaign contribution from the group to the politician. The difference is in (3), where a menu auction model with campaign contributions has a reservation utility constraint given by the requirement that the government's utility with positive contributions under the policy it chooses is the same as what it would get if it ignored the contributions of the interest groups. In terms the Figure, the equilibrium in the menu auction model may be represented by the point on the contract curve giving the same utility to the government (for a linear formulation for τ) as the case where $\tau = 0$.

Dixit-Grossman-Helpman (1997) present a generalization.

6. Many Players

(Ignore S for now)

$$\begin{aligned} \text{Max}_{e, \bar{\tau}} \quad & Y(e, \bar{\tau}, S) + \sum_j \lambda^j [V^j(e, \tau^j, S) - V^j(e^{SQ}, \tau^{SQ}, S)] \\ & (4) \end{aligned}$$

One obtains $l + 1$ first-order conditions for the $l \leq n$ constraints in (4) that bind. First, there is:

$$Y_e(e, \bar{\tau}, S) = \sum_{j=1}^l \frac{Y_j(e, \bar{\tau}, S) \times V_e^j(e, \tau^j, S)}{V_j^j(e, \tau^j, S)} \quad (5)$$

where Y_j is the partial derivative of Y with respect to the j th element of $\bar{\tau}$, V_j^j is the partial derivative of V^j with respect to τ^j . This condition defines a "contract curve" of Pareto optimal points between the government and the interest groups. For each of the constraints that bind:

$$V^j(e, \tau^j, S) = V^j(e^{SQ}, \tau^{SQ}, S),$$

7. Application –Foreign Aid

Let S be foreign assistance. "Conditionality" in lending can address a "moral hazard" problem in lending. The interest group may benefit from economic reform packages, but loans or aid, once given, reduce its willingness to agree to reform. Consider a reform package (e', τ') that the interest group prefers to the status quo if lending S' is

received, but where lending itself makes the status quo less onerous. That is, suppose that the welfare of the interest group displays the following characteristics:

$$V(e^{SQ}, \tau^{SQ}, 0) < V(e', \tau', S') < V(e^{SQ}, \tau^{SQ}, S'). \quad (6)$$

meaning that the interest group prefers reform with lending to no reform without lending, but prefers lending with no reform to lending with reform. If lending S' is made without any policy conditionally, and the interest group can veto reform programs, it is clear that once the loan has been received the interest group will veto any program (e', τ') relative to the status quo if (6) holds. On the other hand, if receipt of the loan S' were made conditional on adopting the program (e', τ') , that is, if the policy configuration (e^{SQ}, τ^{SQ}, S') were not an option, the interest group would support the program.

8. Interest groups Lose Political Power

If vested interest loses its economic power, but retains its political power, why not tax the economic winners?

Vested interests lose political power, which may be correlated with economic power.

Acemoglu and Robinson (2000, *AER Papers and Proceedings*)