Journal of Comparative Economics 44 (2016) 982–1001

Contents lists available at ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

On the optimal social contract: Agency costs of self-government☆

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ARTICLE INFO

Article history:
Received 12 January 2015
Revised 11 November 2015
Available online 21 January 2016

JEL classification:
D73
H11
H26
O43

Keywords:
Social contract
Democracy
Economic development
Principal-agent problem
Self-enforcing political regime

ABSTRACT

Kim, Sang-Hyun—On the optimal social contract: Agency costs of self-government

In a typical study of political economy, citizens are regarded as the principals, and government as the agent. In contrast, classical theorists of democracy such as Jean-Jacques Rousseau and James Madison were deeply interested in the dual nature of people; they are the principals (citizens sharing the sovereign power) and, at the same time, the agents (subjects under the laws). Government, in their framework, is an intermediate body which helps people solve their self-control problem. Equipped with tools of modern economics, this paper explores the classical problem to see how economic development and political institutionalization relate to the structure of government and the quality of public sector. In particular, I consider repeated games with a large population and incomplete information, in which players decide whether to sacrifice private consumption to provide public goods. Because both people and the executive of the public projects are subject to moral hazard, the people spend resources to monitor the executive and the people themselves. The optimal self-enforcing contract, which can be interpreted as an efficiency upper bound of political systems, is characterized. An analysis of the contract shows that as a country gets more economically developed and politically institutionalized, the agency problem on the people's side becomes negligible and that poor economic performance of a country might prevent the citizens from establishing a more efficient public sector. *Journal of Comparative Economics* **44** (4) (2016) 982–1001. School of Economics, University of East Anglia, Norwich NR4 7TJ, UK.

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1. Introduction

It has been well noted in the literature of democracy and development that the political systems of poor countries differ markedly from those of rich ones. Evidence shows that a low level of economic development is strongly correlated with low levels of civil liberty and public good provision, poor government accountability, and more regulations on economic activities.[1] Economists and political scientists have rightly identified causal mechanisms from one side, the quality of public

☆ This paper is based on a chapter of my PhD dissertation. I thank Jay Pil Choi, Christian Ahlin, John D. Wilson and Andrei Shevchenko for warm guidance, and the participants of the seminars in Michigan State University, Seoul National University and University of East Anglia for valuable comments. I am also grateful to the anonymous referee and Gérard Roland, the Editor for constructive comments which greatly improved the paper.

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[1] See for example Keefer (2007), La Porta et al. (1999) and references therein.

http://dx.doi.org/10.1016/j.jce.2016.01.002
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sector, to the other, economic performance, while the possibility of reverse causality has rarely been explored.[2] It is partially because in the modern literature of political economy, individuals are typically regarded as the principals, and government as the agent.[3] In the standard principal-agent models, wealth of the principal (i.e., citizens' wealth in political economy models) does not affect the outcome much, because regardless of whether they are poor or rich, the principals want to extract the maximum surplus from their agent.[4] This contrasts sharply with the fact that the agent's *pre-contract* wealth level, which affects the marginal utility of monetary compensation, the reservation value, etc., is one of the key determinants of the outcome. This paper, analyzing models in which citizens play the role of agents as well as that of principals, shows that poor economic performance of a country might prevent the citizens from establishing a more efficient public sector.

The idea that citizens are agents as much as they are principals in their political lives is by no means new. It is firstly formalized by classical theorists of democracy such as Jean-Jacques Rousseau and James Madison. For instance, Rousseau identified individuals differently depending on the role that they play.

> "Those who are associated in [the republic] take collectively the name of people, and severally are called citizens, as sharing in the sovereign power, and subjects, as being under the laws of the State." Jean-Jacques Rousseau, *On the Social Contract*, Book I, Chapter 6.

By this distinction, Rousseau made it clear that building a political association (i.e., a republic) is at the most fundamental level to solve the self-control problem; in other words, to avoid "the war of all against all" (Thomas Hobbes). So, we can say, using the language of the modern economics, that in Rousseau's social contract, individuals appear twice in completely different positions, once in the position of the ultimate principals (citizens) and in that of the ultimate agents (subjects).

> "What then is government? An intermediate body set up between the subjects and the Sovereign, to secure their mutual correspondence, charged with the execution of the laws and the maintenance of liberty, both civil and political." Book III, Chapter 1.

The relationship of citizens and their government is more complicated than what a simple principal-agent model assumes. It resembles a "hierarchy," a chain of principal-agent relationships, but differs from the usual hierarchies in that the principal at the top and the agents at the bottom of the chain are the same people. This *circular hierarchy* was also identified by James Madison who wrote:

> "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this." Alexander Hamilton, John Jay and James Madison, *The Federalist Papers*, No. 51.

Because men are not angels, they hire an agent to be a principal. But this principal is also subject to agency problem which would reduce the efficiency of the people's self-control. In short, the social contract creates multiple principal-agent relationships which potentially exacerbate each other.

Starting with a simple repeated game with a continuum of players who decide whether to sacrifice their private consumption to provide public goods, I describe properties of Rousseauian social contract. The social contract differs from the usual contracts in that it lays the foundation of the law and order. Because it cannot rely on pre-existing laws, the social contract must be self-enforcing, i.e., the players must find it optimal to voluntarily give their private goods up so as to enjoy the public goods. This means that the social contract is not perfectly enforceable, which is a source of the agency problem. One of the main results of this paper is that this requirement of self-enforcement (or more generally imperfect enforcement) makes any changes in the agency costs endogenously amplified. Section 3 illustrates the amplification mechanism under the assumption that the agency cost on the government side is exogenously given. Suppose that by an exogenous factor, the quality of the public projects is improved. This change increases the value of the citizenship, i.e., the continuation value of following the law. Hence, now a smaller amount of resources is required to incentivize the citizens; in other words, the state needs fewer police officers and fewer bureaucrats, which means the overall efficiency of public good production is further improved. This, of course again, increases the value of the social contract, and allows the republic to further reduce the cost of watching over the private sector.

This positive feedback mechanism can also amplify the changes which negatively affect the value of the social contract. An increase of the agency cost on the government side reduces the value of the social contract, which in turn increases the amount of resources required to incentivize the citizens. That is, the agency costs on the citizens' side also increases, which further triggers reductions in the value of the social contract.

In Section 4, the optimal social contract, which allocates resources to maximize citizens' expected utility, is characterized in a setup where the agency cost of the government is also endogenously determined. This contract can be interpreted either

[2] There are a few studies empirically investigating the reverse causal effects. Kaufmann and Kraay (2002) finds a negative effect of average income on the quality of government. Dixit (2004) conjectures that this result may reflects the increasing rent-seeking activity in natural-resource abundant countries. Kurtz and Schrank (2007), on the other hand, claim that there are more reasons to believe that economic growth drives improvement in governance than vice versa.

[3] For studies applying principal-agent framework to the problem of government accountability, see Laffont (2000) and Besley (2006) among others.

[4] Of course, this is not true if the principal is financially constrained. But typically, the political principals are not financially constrained, because the agent is incentivized not by a direct monetary transfer but by the promise for a privileged position.

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