Reforms, lobbies and welfare: A common agency approach

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Accepted 26 July 2004

Abstract. Citizens with heterogeneous tastes delegate to policy makers the authority to choose public policies. They may try to influence legislators in various ways. In this paper we assume that monetary lobbying and direct threats are the only instruments private individuals can use to influence the legislator. We model the relationship between the citizens and a single policy maker as a common agency game. Lobbies offer a policy and a payment according to a truthful contribution schedule, and the government takes the policy decision. In the truthful equilibrium, the government implements the social surplus maximizing policy. Introducing also direct threats, we find that, as far as both groups have an instrument to influence the legislator, the efficiency result is robust. We also show that when the lobby groups have asymmetric interests and political power, not all groups necessarily participate in the auction. In particular it turns out that one-lobby or non-lobby equilibria may arise, and those equilibria are also efficient.

1. Introduction

In democratic systems citizens delegate to policy makers the authority to take economic decisions that affect the well being of the entire community. Citizens may have different preferences for public policies, and conflicts of interests over particular policies may arise. Hence, the issue of which interests are represented by actual policies and to which individuals or groups of individuals governments respond, is an important question in any analysis of public decision making.

The focus of our analysis will be on the instruments available to private individuals to sway public decision making, and on the relative effectiveness of those instruments. Private citizens may try to influence legislators in various ways. First, citizens elect legislators. Voting is therefore an essential mechanism to appoint policy makers as well as an instrument to provide incentives to governments.1 Also, monetary transfers can be offered to the decision-makers both in the campaign stage preceding elections, and during the political mandate to influence legislators.2 Information is another source of influence, since individuals can have some important private information relating to the public policy that they can reveal to legislators to orientate their choice. Finally, citizens could use forms of violent threat, like social unrest and revolutions to pressurize incumbent legislators.
In this paper we propose a simple model of public decision making where lobbying in the form of monetary transfers and direct threats are the only instruments private individuals can use to influence the legislator. The model of public decision making is based on common agency theory, where a single decision maker chooses a policy on which two groups of citizens have conflicting interests. To illustrate the policy choice with an example, we consider a price liberalisation process. We suppose that the price liberalisation is a reform creating winners and losers. We also assume that non-distortionary redistributive transfers can be used to compensate losers. Therefore, the reform package consists of a price liberalisation decision and a compensating transfer scheme. The pre-reform regime is characterized by fixed prices and rationing, i.e. the level of prices is too low, hence the demand side is rationed. The rationing is uniform, which means that each individual can only access the same fixed amount of the rationed good. We assume that individuals are heterogeneous with respect to their income, therefore the actual rationing they perceive is different since rich individuals are more rationed than poor individuals. Given their income level, there are two types of individuals, rationed and unrationed. The policy maker himself is a citizen who can be either rationed or unrationed.

Price liberalization is necessary to eliminate rationing. When the reform is implemented, given the excess demand of the pre-reform regime, prices increase to clear the market. In the Walrasian equilibrium we observe higher prices and higher output. If we represent the economy in terms of its utility possibility set, price reform shifts the Pareto frontier outwards. The reform is therefore efficient, in the sense that it increases social surplus. On the other hand, the reform is not Pareto-improving. Since not every individual is actually rationed prior to the reform, there is a group of winners from liberalization (rationed) and a group of losers (unrationed). We assume that lump sum transfers can be used to compensate losers. Hence, clearly there are opposing interests on the reform package. The rationed citizens gain from reform but lose from redistribution, for the unrationed the opposite is true. The two types of citizens are organized in two lobby groups and try to obtain their preferred reform package offering the policy maker a payment that is a function of the policy.

In formal terms, we model the relationship between the citizens and a single policy maker as a common agency game, where the citizens, organized in lobby groups, are the principals and the policy maker is the agent. We employ a theoretical framework similar to that of Dixit–Grossman–Helpman (1997). Lobbies offer a policy and a payment according to a truthful payment function. The government, given all the offers, takes the policy decision. However, we modify the Dixit–Grossman–Helpman framework allowing also groups to exert direct pressure on the policy-maker, besides the truthful monetary payments. The possibility of other direct sources of influence, such as social