

# THE POLITICAL ECONOMY OF ECONOMIC POLICY

We should pay closer attention to the interactions between politics, economics, and other realms

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**T**he COVID-19 pandemic strikingly illustrates the intersection of politics, economics, and other considerations. Public health experts have long warned that the world was likely to face a major pandemic and called for greater preparedness. Yet policymakers who have to focus on the next election find it difficult to invest the time, money, and political capital to address the abstract possibility of a future crisis. And so most of the world was unprepared for a global public health threat of the magnitude posed by the novel coronavirus.

As the pandemic has raced across the world, the policy response has continued to be tempered by political realities. Some members of the public, and some policymakers, have resisted the recommendations of public health experts, hoping for relaxed restrictions and a return to normalcy before the dangers have passed. At the same time, business interests have pressed for exceptions to benefit themselves, and for substantial subsidies—bailouts—to help them through difficult times.

At the international level, government responses to the pandemic illustrate the difficult politics of worldwide cooperation. A global pandemic requires a global response:

microbes do not respect borders. A coordinated international response is clearly the best way to confront an international public health emergency. Yet policymakers under pressure from their constituents have diverted resources away from other countries, banned the export of food and drugs, and hoarded essential supplies. Each of these measures—popular as they may be to national publics—imposes costs on other countries. In the final analysis, the lack of cooperation makes everyone worse off. Such international institutions as the World Health Organization attempt to coordinate a cooperative global response to the global crisis—but they can be powerless in the face of potent nationalist political pressures (see, for example, Goodman and others 2010).

Every government faces tough decisions about the appropriate measures: what restrictions to impose and when to loosen them, where money will be spent and how it will be raised, and what national concerns can be limited to favor international cooperation. These decisions have to take into account public health recommendations, economic considerations, and political constraints. Just as the policy response to the 2007–08 financial crisis



varied from country to country in line with local political economy conditions, so national policy responses to the COVID-19 pandemic vary for health, economic, and political reasons.

### Politics at play

This hotly contested policy response to a universal threat is no surprise to political economists. It happens all the time. For example, just about every economist believes that small countries would be better off if they removed all barriers to trade. Yet unilateral free trade is practically unheard of, and no country in the world today pursues it. Why not? More generally, why do governments have so much trouble getting economic policies right? Why does the advice of independent observers, analysts, and scholars go so often unheeded?

*Politics* is the usual answer, and the answer is usually right. But that is too vague—like saying that some countries are rich and others poor due to economics. Exactly how does politics keep governments from making better policy, even in the face of imminent crises? What does that tell us about how economic policy can and should be made?

*Political economy* is about how politics affects the economy and the economy affects politics (see box). Governments try to pump up the economy before elections, so that so-called political business cycles create ebbs and flows of economic activity around elections. By the same token, economic conditions have a powerful impact on elections. Political economists have uncovered the simple (perhaps disturbing) fact that the rates of economic growth and inflation are all the information we need to predict quite accurately the results of the

past 100 years of US presidential elections (see, for example, Fair 2018). So why don't elections work to push politicians to choose the best policies?

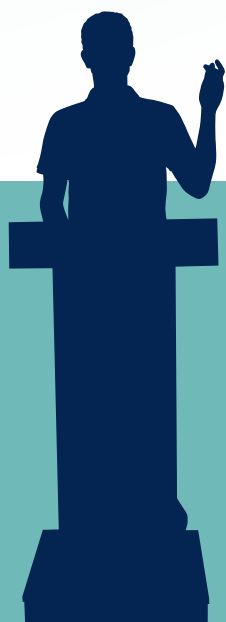
### Where you stand depends on where you sit

A basic economic principle is that any policy that is good for society as a whole can be made to be good for everyone in society, even if the policy creates winners and losers. It requires only that the winners be taxed just a bit to compensate the losers—and everyone is better off. Economists use powerful tools to clarify which economic policies are best for society. So why should economic policy be controversial?

A basic *political economy* principle is that the winners don't like being taxed to compensate losers. And the battle is joined, not over what is best for society but rather over who will be the winners and losers. What is best for the country may not be best for my region, or group, or industry, or class—and so I will fight it.

Even in democracies, plenty of citizens might agree that politics obeys the golden rule: those with the gold make the rules. Special-interest groups do seem to play an outsize role around the world, democratic or not. These include wealthy individuals, powerful industries, big banks and corporations, and formidable labor unions.

How else to explain why Americans pay two or three times the world price for sugar? There are a handful of sugarcane plantations and a few thousand sugar beet farmers in the United States—and 330 million sugar consumers. You'd think that the 330 million would count for a lot more in politics than the several thousand, but you'd be wrong. For



### WHAT IS POLITICAL ECONOMY?

Adam Smith, David Ricardo, and John Stuart Mill are widely regarded as the originators of modern economics. But they called themselves *political economists*, and Mill's *Principles of Political Economy* was the fundamental text of the discipline from its publication in 1848 until the end of the century. These early theorists could not conceive of the economic and political worlds as separate.

Two trends divided the political from the economic analysis. First, governments began to reduce their direct control over the economy. Second, different political forms emerged: Europe went from almost exclusively monarchical to increasingly representative, and highly varied, forms of government. By

the early 20th century economics and political science were established as separate disciplines.

For much of the 20th century this division reigned. With the Great Depression and problems of development, the purely economic issues were daunting enough to occupy economists. By the same token, the political problems of the era—two world wars, the rise of fascism and communism—were so serious as to require separate attention.

By the 1970s, however, it was clear that the separation between the economic and political spheres was misleading. That decade saw the collapse of the Bretton Woods monetary order, two oil price shocks, and stagflation—all highlighting the fact that economic and political matters are intertwined.

## In the final analysis, the lack of cooperation makes everyone worse off.

decades, subsidies and trade barriers have raised the price of sugar to the benefit of the sugar planters and farmers and to the detriment of everyone else.

Why does a tiny group of sugar producers matter more than the rest of the country? A commonplace of political economy is that *concentrated* interests usually win over *diffuse* interests. The sugar producers are well organized and work hard to influence politicians. If they didn't get favorable government treatment they'd go out of business, so it's important for them to organize to lobby and fund politicians. The cost to consumers is estimated at \$2 billion to \$3 billion a year. That's a lot of money—but it comes to a couple of cents a day for the average American. No consumer is going to talk to an elected representative or threaten to vote for an opponent over a couple of cents a day.

The fact that producers are concentrated while consumers are diffuse helps explain trade protection. A few automobile manufacturers can organize themselves; tens of millions of car buyers can't. That's not all. Management and labor in the auto industry may not agree on much, but automakers and autoworkers agree that they want to be protected from foreign competition. Politicians—especially politicians from areas where automobile manufacturing is important—have a hard time denying a common demand of workers and owners in a powerful industry.

Perhaps this is not such a bad thing. Sugar farmers and autoworkers depend for their livelihood on

supportive policies. Who is to say that their jobs are less important than lower prices for consumers? There is no simple, widely accepted way to balance the benefits against the costs—is cheaper sugar important enough to bankrupt thousands of hardworking farmers? Politics is, in fact, the way society adjudicates among conflicting interests, and maybe those with more at stake should have a bigger say.

Political economists don't usually take stands on complicated moral and ethical issues of this sort. They try to understand *why* societies choose to do what they do. The fact that sugar or car producers have much more at stake and are much better organized than sugar or car consumers helps explain why government policies favor sugar and car producers over consumers.

Some consumers are concentrated, though. Sugar is sweet, and the corporations of the Sweetener Users Association want it to be cheap as well. Coca-Cola, Hershey, and the like have pushed hard to change American sugar policy. The fact that there are powerful concentrated interests on both sides of the issue helps explain why prices aren't even higher than they are. The same thing is true of industrial products. Steelmakers want protection; steel users—like the auto manufacturers—don't. Trade policy is not just a battle between big corporations and disunited households; it's also a battle *among* big corporations. Otherwise we'd expect

The economy was now high politics, and much of politics was about the economy.

Over the past 50 years, political economy has become increasingly prominent in both economics and political science, in three ways:

### **It analyzes how political forces affect the economy.**

Voters and interest groups have a powerful impact on virtually every possible economic policy. Political economists strive to identify the relevant groups and their interests, and how political institutions affect their impact on policy.

**It assesses how the economy affects politics.** Macroeconomic trends can boost or ruin an incumbent's chances. At the more microeconomic level, features of the economic organization or

activities of particular firms or industries can have an impact on the nature and direction of their political activity.

**It uses the tools of economics to study politics.** Politicians can be thought of as analogous to firms, with voters as consumers, or governments as monopoly providers of goods and services to constituent customers. Scholars model political-economic interactions in order to develop a more theoretically rigorous understanding of the underlying features driving politics.

All three methods have profoundly affected both scholars and policymakers. And political economy has a lot to offer both to analysts of how societies work and to those who would like to change society.

## Policymakers in democratic societies must always pay attention to the next election—otherwise they are likely to cease being policymakers.

every industry to be protected and trade to be tightly limited everywhere.

In fact, there are plenty of powerful interests in *favor* of international trade and investment. The world's multinational corporations and international banks depend on an open flow of goods and capital. This is especially the case today, when many of the world's largest companies depend on complex global supply chains. A typical international corporation today produces parts and components in dozens of countries, assembles them in dozens more, and sells the final products everywhere. Trade barriers interfere with these supply chains, which is why most of the world's biggest companies are also some of the biggest supporters of freer trade.

### A complex web

Special interests as well as voters on different sides of every issue fight their battles in the political arena. But the rules of politics vary a lot from country to country. The way a political economy is organized affects who wins the battle over policy.

A logical starting point is elections, at least in democracies. Governments that don't satisfy their constituents don't remain governments very long. So we might expect democracies to choose policies that benefit the economy as a whole. However, the economy as a whole doesn't vote.

Politicians need votes from the people who decide elections. The decisive or pivotal voters vary with a country's electoral institutions and social divisions. In most political systems, the best targets are swing voters, who might change their vote in response to the policies of an incumbent or the promises of a challenger. If the poor vote for the left and the rich vote for the right, for example, the middle class could be decisive. In recent American presidential elections, the most important swing voters have been in distressed industrial regions of the Midwest. Many voters in these areas believe that foreign competition

contributed to manufacturing decline. This helps explain why presidential candidates have become increasingly protectionist, even though most Americans support openness to trade.

In addition, policymakers in democratic societies must always pay attention to the next election—otherwise they are likely to cease being policymakers. This helps explain why it can be difficult for governments to pay money now for policies whose benefits will be realized only in the long run—such as pandemic prevention and preparedness.

The mass of special and general interests in society is overwhelming. *Institutions* help make sense of them. First are *social institutions*—the way people organize themselves. Some businesses, farmers, and workers are well organized, giving them more political clout. Farmers in rich countries are relatively few, are well organized, and are almost universally subsidized and protected. Farmers in poor countries are many, rarely organized, and almost universally taxed. Where workers are grouped into centralized labor federations, as in some northern European countries, they play a major role in national policymaking. The ways in which societies organize themselves—by economic sector, region, ethnicity—affect how they structure their politics.

*Political institutions* mediate the pressures constituents bring to bear on leaders. Even in authoritarian countries, rulers have to pay attention to at least some part of public opinion. Political economists call this the “selectorate,” that portion of the population that matters to policymakers. In an authoritarian regime, this could be an economic elite or the armed forces. In an electoral democracy it would be voters and interest groups. No matter who matters, policymakers need their support to stay in office.

In democracies, the variety of *electoral institutions* affects how policymakers feel constituent pressures. Organized political parties can help extend the time horizons of politicians: while an individual politician may worry only about the



next election, a party has to be concerned about its longer-term reputation. On another dimension, where politicians are elected by the country as a whole, as in Israel or the Netherlands, the focus is on national policy. Where politicians represent narrower geographic locations, as in the US House of Representatives, the general view is that “all politics is local” (usually attributed to 1970s–80s Democratic Speaker of the House Tip O’Neill). These different electoral systems can drive politics toward more national or more local concerns.

Electoral institutions affect the identity of the people politicians need to attract to win an election. The US Electoral College makes middle-of-the-road voters in the Midwestern industrial states pivotal in presidential elections, driving the emphasis on protection for manufacturing. In a multiparty parliamentary system, the pivotal voters may be the supporters of a small party that can swing back and forth between coalition partners, such as the fringe parties for the formation of Israeli governments. Whichever voters the electoral system makes pivotal are likely to have outsize influence over politics and policy.

The character of *legislative institutions* also matters. For example, while a unitary parliamentary system can deliver big and fast change, in the US separation of powers system change is more modest and slower. Federal systems—in Australia, Brazil, Canada, Germany, the United States—give provincial or state governments a lot of power, while centralized systems allow the national government to rule unchallenged. Some governments have handed off control of important policies to independent bodies that are less subject to day-to-day political pressures—such as central banks and public health agencies.

These institutions matter because they affect the weights that politicians give to different groups in society. Some sociopolitical institutions give labor unions a great deal of influence; others privilege farmers; still others are dominated by business associations. Political economists analyze the interests in play and how the institutions of society transmit and transform them into government policy.

## Second-best can be best

All this matters to policymakers or observers or even just people who care about the economy because it can profoundly change the way we think about policy and policy advice.

The policy that economic analysis indicates is best for the economy may not be politically feasible. To go back to free trade, virtually all economists would recommend that a small country’s best bet is to remove all trade barriers unilaterally. Yet it is almost certain that a government that attempted to move to unilateral free trade would face massive opposition from special interests and from many in the public who would regard such a move as dangerous. The result might well be the collapse of the government and its replacement with one that could be relied on to maintain and even expand trade barriers. In this case, pursuit of the first-best policy could lead to a much worse outcome.

Politicians, analysts, observers, and just regular people who are interested in economic policy are well advised to evaluate not only the economic implications of policy initiatives but also their political feasibility. If the pursuit of a first-best policy is bound to fail and perhaps provoke a backlash, then truly the cure may be worse than the disease. It makes more sense to consider the political realities the government faces and to structure policy with those realities in mind. It is better to settle for second-best than to insist on first-best and end up worse—or, as folk wisdom has it, to let the perfect be the enemy of the good.

## Bottom line

Political economy is the integration of political and economic factors in our analysis of modern society. Inasmuch as just about everyone would agree that politics and economics are intricately and irretrievably interwoven—politics affects the economy and the economy affects politics—this approach seems natural. It has proved itself powerful in *understanding* governments and societies; it can also be a powerful tool for those interested in *changing* governments and societies. Policymakers should hold these important lessons in mind today as they tackle the COVID-19 pandemic. **FD**

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