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**Facing Crises:**  
**Economy, Democracy, and Political Transaction Costs<sup>1</sup>**

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## **1. Introduction**

The groveling crisis that plagues Greece and that is deeply embedded in the European crisis, which is itself rooted in a more global setting of economic and political crises, reveals the complexity of the relationship between economy and democracy. It also shows how fragile both are and how deeply entrenched in politics are the questions raised and the solutions proposed.

This is not surprising if we consider the very nature of democracy, which is “that form of government in which the sovereign power resides in the people and is exercised either directly by them or by officers elected by them.” (Oxford English Dictionary). Indeed, under the apparent ‘neutrality’ of this definition, at least two conditions of viability emerge: there must be *incentives* for members of the concerned community to participate in the exercise of ‘the sovereign power,’ keeping in mind that ‘people’ is a historical construct; and in a world of differentiated preferences, the exercise of power requires building coalitions and implementing mechanisms of transmission (e.g., ‘elected officers’), which involve *political transaction costs*.

The concepts of ‘incentives’ and ‘transaction costs’ are at the core of recent developments in economic theory. Both concepts relate to the existence of market failures or, more generally, to flaws in institutional arrangements. Incentives are needed to motivate participants to an institutional arrangement to make converging decisions, notwithstanding their diverging interests. Political transaction costs come out of the core decision-making processes in a democracy, which cannot rely on

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<sup>1</sup> Some arguments developed in this paper have been initially introduced in a prologue to Toboso & Caballero (2015). I am grateful to these editors and also to the organizers of the *Pan-hellenic Conference on Economy and Democracy*, held in Greece in November 2015, who gave me the opportunity to explore what is for me a new terrain. In doing so, I largely benefited from remarks and suggestions from participants to the conference, and more specifically Geoff Hodgson, Nikolaos Kyriazis, and Michael Zouboulakis. Of course, all opinions and interpretations submitted hereafter remain entirely under my responsibility.

the unique 'voice' that would prevail in dictatorship nor on the unified 'voice' that would result from pure consensus but depend on the capacity to build compromises. The resulting puzzles and tensions that shape the interactions of agents or group of agents embedded in a 'democratic' environment define what for centuries has been considered the object of 'political economy.'

What I would like to do in what follows is to explore some lessons we can learn from these concepts, particularly the concept of political transaction costs, about the complex relationship between economy and democracy. This requires constantly coming back to the institutional background. If one considers the deep changes in which our societies have entered with respect to both economy and democracy, it is amazing how few economists have embarked on this exploration; and those who do so still remain most of the time considered as outsiders by the mainstream. As a consequence, it is shocking how little our way of thinking about policy issues has changed through the ongoing crises. In most recent economic analyses, institutions continue to be inexistent, so that the same recipe would have the same value and relevance everywhere. If institutions are mentioned, it is as a black hole, a mystery box within which policies are designed and decisions are made.

I do not pretend to fill this black hole. More modestly, I would like to introduce and push further the development of some tools that could help understanding the ongoing crises out of the beaten path according to which we should 'put aside the inherently misleading governmental actions and let markets operate the required changes'. In doing so I shall build on and extend concepts rooted in what has been called 'new institutional economics', an approach according to which institutions should not only be incorporated as explanatory variables, but also be considered as endogenous to policy-making process itself, at work at the different levels of governance that impact the production and allocation of resources as well as the distribution of income and property rights, all of which must be assessed in a comparative way. At stake is the identification of dimensions to be taken into account in the much needed reform of our democracies, if they have to survive. 'Reforming' hereafter refers to (1) *adapting* existing institutions to the rapidly changing environment in which they operate; and (2) *adopting* institutional mechanisms that can provide adequate channels of transmission linking policy-makers and actors of the so-called 'civil society.'

This paper investigates these issues. Section 2 digs deeper in the concept of political transaction costs and assesses its relevance for understanding the (often chaotic) running of democracy. Section 3 discusses the conditions framing the formation and implementation of coalitions, pointing out the key

role of ‘meso-institutions’ in making coalitions possible and stable. Section 4 shows the complexity of issues involved in keeping political transaction costs under control, a necessary condition for democracies to survive. Section 5 derives some lessons from this analysis to explore why reforms are so difficult to draw and implement. Section 6 concludes with some comments about the hybrid nature of democratic regimes and the sources of their fragility.

## **2. Political Transaction costs: what are we talking about?**

The concept of transaction costs is now a familiar one among economists, thanks to Coase (1960) and his Nobel Prize from 1991. It designates the costs of organizing the transfer of rights to use goods and services among productive economic entities (individuals, firms, networks, etc.) operating within technologies that determine which activities can be separated, thus making possible these transfer (adapted from Williamson, 1996: 379). Typically, an economy depends on the transfer of property rights, for example selling goods or services; but there are also other rights constantly transferred, for example rights of access to common pool resources. As soon as a technology allows separation in the production or distribution process, the issue becomes: how to organize these transfers of rights and what are the related costs.

The extension of this concept to ‘political transaction costs’ comes out of the idea that political regimes also organize transfer of rights, but rights of a different nature: they are about transferring decision rights (over rule-making and implementation processes) across politically distinct constituencies.<sup>2</sup> For example, a political regime is characterized by the way it redistributes rights among groups of interest, allocating or reallocating rights to vote, negotiating budgets, etc., all of which involve costs (e.g., the costs of bargaining, reaching a solution through coalition building, and enforcing decisions made). Such transfers among political constituencies require institutional supports that play in policy-making a role similar to the one played by different organizational arrangements (markets, firms, hybrids ...) in the transfer of property rights. A direct consequence is that different political regimes entail different political transaction costs, so that there are trade-offs among alternative institutional settings. These settings are those in which transactions, property rights, and contractual arrangements are embedded, defining the so-called ‘golden triangle’ of new institutional economics (Furubotn and Richter, 2005).

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<sup>2</sup> For a pioneering approach, see North (1990) and Marshall and Weingast (1988)

Without getting into the details, let me briefly emphasize some key aspects of the overlapping concepts of economic and political transaction costs. **First**, the very idea of transactions is central to our understanding of the social fabric because what political as well as economic regimes organize is not primarily the transfer of physical objects or virtual services, but rather the transfer of RIGHTS to use resources. This can be done through private sector organizations (for example through markets, within firms, across franchising systems, etc.), through political transfers (for example by taxation, through public entities delivering ‘public services’ like education or health care, etc.), or through hybrid solutions as when network infrastructures or ‘public’ services are delivered through public-private partnerships. **Second**, there are many different types of rights, beside private property rights, that can be transferred either through economic or political transactions, for example access to common pools resources and other forms of ‘collective’ rights (Ostrom, 2014; Libecap, 2014). Economic policies can be understood as a way to allocate and redistribute a significant chunk of these rights among participants to the social fabric. **Third**, contracts are specific mechanisms for transferring rights. Nowadays, contracts are of particular significance for economists, while ‘social contract’ is also a concept highly significant among philosophers and political scientists. In markets economies, characterized by decentralized decision-makers, as well as in democratic regimes, with competing political parties, transfer of rights must be based on forms of mutual consent that contracts formalize. The social contract that provides the foundations of our societies and that is challenged by the ongoing crises illustrates well how incomplete (and potentially fragile) contracts are. This is why institutions such as the judiciary are necessary in order to regulate how individuals or collective entities operate within contracts, and to implement rules regarding the usage of rights thus transferred.

There are important consequences to the centrality of political transactions. One is that mechanisms should be designed that will allow the aggregation of the differentiated preferences of the various groups that compose the ‘people’ of a democratic society in order to reach implementable decisions regarding the definition, allocation, and monitoring of rights. Without such mechanisms, a democratic society would implode! These mechanisms, for example political parties, can be identified as **coalition building arrangements**. The very existence and characteristics of these arrangements depend on incentive to participate, which is central to democracy and its capacity to ‘represent’ groups of interest, and determines in last resort the ‘efficiency’ and ‘stability’ of specific democratic regimes. Of course, political incentives differ from economic ones, at least in the narrow meaning ‘incentive’ takes in standard economic theory, in which it is reduced to monetary benefits and penalties. Among incentives that may motivate citizens to participate let me mention: authority (as when voting is mandatory),

reputation (as in communities where voting is considered a social obligation), advertising (as with television campaigns inviting citizens to vote), or ...patronage (as when an individual or a community depends on 'favors' obtained from its elected representatives). There are of course other, even less formal mechanisms. What I want to point out here is that participation requires institutional mechanisms, all of which involve costs. In that respect, political transactions share similarities with economic transactions: the costs and benefits of the mechanisms necessary for these transactions to exist and subsist must be assessed comparatively. There is no such a thing as an optimal mechanism, or an optimal institutional system: there are always losers! However, a specific democratic regime can be considered superior to another one if it has a comparative advantage in reducing the number of losers and the magnitude of their losses.

A second consequence relates to the conditions on which the **stability** of political coalitions depends, which is necessary if decisions are to be implementable and accepted by stakeholders. A challenging issue in that respect in all democratic societies, and a particularly challenging situation when coalition building arrangements are weak, for example when a multi-party parliamentary regime ends up in confrontational positions, is the development of 'third party opportunism', that is: the development of groups of interests that tend to short-cut the role of representatives in order to have their agenda prevailing over the priorities that have been chosen through the electoral process. The challenges raised by these forms of opportunism can come from insiders, typically non-members of the leading coalition or even members of that coalition (for example when a political party is an 'umbrella' to diverging regional interests), as well as from outsiders (NGOs, lobbyists, or even institutional actors exogenous to the specific regime, as when more or less formal international arrangements such as the IMF or the 'troika' 'impose' specific policies that do not coincide with the preferences of citizens as expressed through the chosen, elected coalition).

One last consequence relates to the **perceived legitimacy** among citizens of political coalitions and the policies they develop, with political transaction costs varying widely depending on the conditions under which coalitions operate. Indeed, the perception of political coalitions and the decision-making processes they implement as the result of obscure deals coming out of bargaining among the apparatchiks that provide the backbone of political parties is a crucial element of 'anti-parliamentary' movements. Two conditions may help reinforcing legitimacy, although eradicating the risk of manipulation in coalition building (and the negative perception it generates) is impossible because opportunism and bounded rationality are ineradicable components of human behavior. **Transparency** in

the process leading to the outcome is one of these conditions. Transparency concerns *procedures* through which coalitions and, beyond coalitions, political regimes are built and made sustainable. It involves a difficult tradeoff between detailed procedures, which make them easy to communicate and control but introduce rigidities that may significantly hamper the decision-making process and increase political transaction costs (long delays, interminable negotiations, repeated votes...); and flexible procedures that facilitate adaptation but at risk of introducing arbitrariness and opacity. **Accountability** is another condition, which relates mostly to the capacity of assessing ex-post the adequacy between the (electoral) program on which votes have been based and outcomes that necessarily differ, due to the requirements of any coalition building process. Making policy-makers accountable for decisions made and for their implementation, as well as having adequate mechanisms to assess gaps between what has been promised and what is actually done, for example through regular public debates and independent media, thus making room for the 'VOICE'<sup>3</sup> of constituencies, are crucial elements for having coalitions and their action perceived as legitimate and their implementation acceptable.

### 3. Meso-institutions: core mechanisms in democratic societies

The challenges and obstacles that building a legitimate and stable political coalition faces contribute to the 'imperfections' that characterize political markets. It would be misleading to consider these 'imperfections' as primarily due to flaws in formal rules of the game that could accordingly be improved by changing these rules, for example by adopting different electoral rules. Without underestimating the role of formal macro-institutions that designate the general rules framing the political and judiciary system, recent developments in institutional analysis increasingly point out the key role of those institutional arrangements through which rules adopted and decisions made are actually implemented.<sup>4</sup> This is the role of what I have identified in other papers as 'meso-institutions'.<sup>5</sup>

Meso-institutions can be understood as those institutional arrangements through which the rules of the game, defined at the macro level of the political regime (or the judiciary) and framing the action of agents, are translated into specific rules and actually implemented. Cabinets of ministers, bureaus in the

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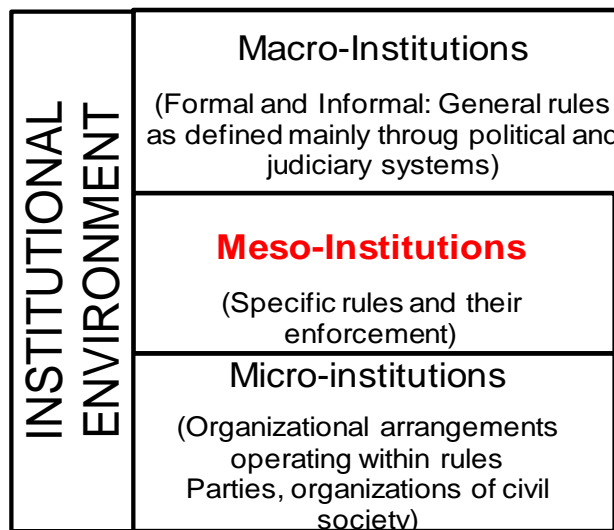
<sup>3</sup> See Hirschman (1970) for a great analysis of the role of 'voice' as opposed to 'exit' in making decisions acceptable and implementable.

<sup>4</sup> For pioneering contributions on these aspects, see North (1990), Ostrom (2005), Greif (2006), Acemoglu and Robinson (2012), and Menard (2014), among others.

<sup>5</sup> Initially I used the concept of 'micro-institutions' (Menard, 2008; De Mariz et al., 2013; Menard, 2014) which was rightly pointed out by several discussants as a potential source of confusion with those organizations at the core of micro-economics (e.g., firms, networks). I consider these comments relevant: hence the change in wording.



administration, agencies in charge of implementing regulation, illustrate the concept. This is the institutional level at which the bulk of political transaction costs emerge because meso-institutions provide links between the macro-institutions (typically the characteristics of the political system: how representatives are selected and elected, how the parliament works etc.) and the micro-institutions (the level at which parties, organizations of the civil society, etc. operate). The figure below summarizes these three institutional layers.



When it comes to the relation between economy and democracy, I shall argue that meso-institutions are central for understanding their articulation. Indeed, meso-institutions provide the ‘bridge’ or, maybe more adequately termed, the ‘transmission mechanisms’ between the general rules and decisions adopted by policy-makers, for example a law allowing privatization of key infrastructures, and the actual decisions and performance of actors operating within the context thus defined (for example, parties interested in buying and operating these infrastructures under specified conditions). In a well-functioning democracy, these transmission mechanisms should run both ways, not only translating and implementing policies adopted by policy-makers, but also transmitting feedback from constituencies and, more generally, citizens. There are many different channels through which this transmission can operate. It can be through ‘command-and-control’, as when a public bureau –e.g., Department of Public Works- is in charge of implementing specific policies; through contractual arrangements between public authorities and private operators, with Procurement Regulatory Authorities supervising compliance with rules and regulations; through specialized regulators monitoring different infrastructures, e.g., electricity or railways; through competition authorities responsible for disciplining parties so as to make markets efficient; through specialized courts in charge of implementing specific laws (e.g., labor laws); etc.

All these ‘meso-institutions’ play a key role in framing the way economic and social policies operate and in determining their actual impact on the society. They do so through their role in: (1) defining specific rules rooted in general policies adopted by parliaments, congress, etc.; (2) implementing policies targeting special issues, which requires being endowed with power and capabilities to do so, for example the existence of an adequate budget for competition authorities or the existence of an appropriate staff for implementing a fiscal reform; (3) controlling the respect of rules and policies by citizens, e.g., having the power to penalize and sanction deviants with respect to traffic regulation; (4) providing channels for feedback and initiatives by concerned constituencies, for example through participative commissions opened to users of ‘public services’ such as water. Because of these multi-dimensional functions that involve the activity of policy-makers as well as that of citizens, meso-institutions are a major source of political transaction costs.

#### **4. How to minimize Political Transaction Costs?**

An important question then becomes that of minimizing these costs, or at least making them tractable. In order to explore this issue, and to benefit from some lessons from economic theory, it is necessary to identify the main sources of these costs. Throughout what follows, it must be reminded that costs differ according to the different types of institutions (including meso-institutions, of course), which must therefore be assessed comparatively.

*First*, the structure of the political system itself generates costs. Because all political systems involve multiple layers in decision-making, the definition and implementation of policies usually depends on ‘multiple principals’, which raises the issue of the delicate equilibrium among different centers of power, the significance of which varies across countries, according to the degree of decentralization embedded in their institutions, etc. For example, voters may elect a political party at one level of government and its opposition at the other level. This multiple layers’ problem can be even more complicated if different voting rules apply at different levels of government. To illustrate, senators can be elected along rules that differ from those prevailing for the House of Representative (the US model), or can be appointed by the government (the British model), the respective chambers having very different power in different systems. This makes political transactions and their costs very different, of course, as well illustrated by the repeated paralysis of the US Congress as opposed to the relative fluidity in that respect of the British political system.

*Second*, democratic regimes are characterized by the existence of competing political parties as well as different groups of interest. Each has its own strategy and agenda, so that decision-making is a complex

process of building compromises. For historical as well as cultural reasons,<sup>6</sup> some countries have parties more prone to building compromises (e.g., the Dutch political system) while others have a more confrontational tradition (e.g., the French political system). The same can be observed with groups of interest prone to what has been called ‘third party opportunism’: unions, environmentalists, religious groups, etc., lobbying to have their agenda prevailing over that of duly elected representatives. This might well make coalition building among political parties submitted to these ‘influence’ much more complex, as so well illustrated by the radicalization of the Republican Party under the influence of the so-called ‘Tea Party’ in the US, the result being a peak in political transaction costs.

*Third*, there is the credible commitment issue. Economic policies take time to be defined and implemented, shifting their impact over time, often over long periods. The problem is that political cycles are disconnected from business cycles. The pace of these two cycles very rarely corresponds, making it difficult for policy-makers, even if well-intentioned, to adopt and maintain policies that may be perfectly sounded but potentially conflicting with the political cycle which in a democracy is related to elections. Building credible commitment with respect to economic policies is a long shot game that does not go easily with the requirements of political life. This raises a fundamental trade-off: representatives need legitimacy, which they obtain through repeated elections, so that they have to deliver satisfactory measures to their constituencies in a relatively short delay, while efficient economic policies may impose long term decisions that must not be easily rescinded if they are to be credible and have therefore the expected effect.

These different sources of rigidities and distortions impose political transaction costs that may be high, to the point of challenging the very existence of a democratic regime, which is what happens when ‘voice’ leaves way to this radical form of ‘exit’: a revolution. In that respect, there are some lessons we have learned through economic theory about these transaction costs and about ways to keep them under control ... up to a certain point! (1) From incentive theory, we have learned that relying on monetary incentives to have agents reaching expected goals, or simply accepting policies adopted, is a very limited tool. Transferring financial resources to selected beneficiaries, a common policy along the welfare state logic, has limited effect in aligning agents to what is hope they would do or accept, because of the ratchet effect (among other factors): once gains have been obtained, e.g., some ‘exceptional’ reduction in specific taxes or ‘exceptionally’ favorable pension plans, it is very difficult to reverse the trend. This provides policy-makers incentives to use side and opaque measures (e.g., monetary policies) that are at high risk of challenging legitimacy. Providing adequate information and finding ways to motivate parties to endorse

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<sup>6</sup> Some participants to the conference also pointed out, I think rightly so, that whether it is a bi-partisan system or a multi-parties system also makes a difference.

decisions made, typically by transferring responsibilities and delegating, for example with respect to fiscal policies, may well be a more efficient strategy.<sup>7</sup> More generally, recent developments in incentive theory suggest the importance of motivations that by far exceed the role of monetary components (Benabou and Tirole, 2003, 2006; Benabou, 2015). (2) From organization theory, we have learned that there are alternative solutions when it comes to the efficient usage of scarce resources, beside the hierarchical approach that requires centralization of strategic decisions in the hands of a small number of decision-makers, and the market approach that militates for relying on the price mechanism to balance supply and demand even when it comes to social needs. There is an increasing literature about the advantages of hybrid arrangements, for example public-private partnerships, when it comes to lowering coordination costs and building stable coalitions (Menard, 2013 for a survey on hybrid arrangements; De Vries and Yehoue, 2013; and a special issue of the *International Public Management Journal*, 17(3) 2014, on Public-Private Partnerships). (3) From path dependence theory, we have learned that institutions, particularly macro-institutions, are very sticky so that changing the trajectory of general rules and global policies is very difficult and can be extremely costly, which speak in favor of incremental changes combined with complementary measures (North, 2004). For example, increasing the productivity and efficiency of fiscal administration may require reducing staff, which affects mainly less qualified employees, so that acceptance will depend on the capacity to simultaneously implement policies that helps requalifying affected personnel and being supportive to the weakest. This also means the adoption of redistributive policies that must be sell to the wealthiest!

## 5. Why is it so difficult to reform?

This last remark already indicates that reducing political transaction costs through adequate reforms is not easy task. At the empirical level, almost all political institutions are hybrids: neither dominated by pure hierarchy (as a 'pure' dictatorship would be) nor by pure consensus (as a version of Pareto-optimality applied to political markets would suggest). It means that building coalitions based on compromises within the political system is crucial ... and particularly difficult since political markets are very imperfect, so that there will always be some groups left worst off. For example, representatives are not elected for very specific policies but rather for 'packages' of policies, which introduces distortions when it comes to adopting and implementing actual measures and makes control by citizens very problematic.

It also means that links between economy and policies adopted by policy-makers are quite complex. Indeed, the political rationality is not identical to economic rationality. On the one hand, as I already

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<sup>7</sup> However there is the risk of drawbacks, for example delegation may feed local corruption. This raises the issue of the desirable degree of delegation and the type of control mechanisms needed.

pointed out, business cycles, which are determined by economic activities, do not follow political cycles, which are determined by elections. On the other hand, political choices are often embedded in norms and social values that prevail over formal rules, and the gap between informal and formal rules tends to be the widest when meso-institutions are ill-defined, poorly designed, or nonexistent since this is the level at which general rules and norms should be translated in specific guidelines and in which constituencies should be able to pass their messages. When these institutional links are missing, 'voice' yields to 'exit' which may take various forms, from peaceful forms as when citizens abstain from voting to more violent ones as in protests or even revolution.

This gap between political logic and economic rationale raises problems that make in-depth reforms particularly difficult. Let me refer briefly to three major issues that result from this gap and that hamper reforms.

*First*, there are **coordination problems**. On the political side, changing rules involve the coordination of different layers of government. This difficulty feeds the vivid and continuing debate about the virtues and flaws of federalism vs. unitary political regimes. Even when there is a general agreement among citizens that institutional changes are required to face a crisis, preferences about the goals and means for doing so are rarely homogenous or even susceptible to converge on satisfying outcomes for all concerned groups. Some constituencies may fight to implement changes in specific domains and potentially for specific areas while opposing similar changes in other territories or political arenas. A centralized government may facilitate consistency in policies adopted but face resistance from local interests; a federal system may make more room for 'voice' but can also open the way to the prevalence of local interests over the benefits of more global policies. On the economic side, an important coordination problem comes out of the diversity of policies that need being implemented and on their consistency with respect to the multiplicity of interests involved. As North (1990: 16) and others have emphasized, economic policies often consist of adopting and enforcing new rules that protect vested interests of specific groups while increasing transaction costs for others!

*Second* and partially related to the previous issue, there is the question of the costs and benefits of **delegation** of decision-making from macro-institutions to the other layers, particularly meso-institutions. Delegation can be about rules, for example by transferring the responsibility of translating general rules into specific ones to local, regional, or even national levels, as illustrated by the subsidiarity principle in the European Union, which obeys a political logic; or by transferring the implementation of competition rules to independent competition authorities, which follows an economic logic. Delegation can also be about content, as when regional states or provincial governments have the capacity to implement different

economic policies, which may open room for experiences that push the economy uphill, as it has been argued about the role of federalism to explain Chinese exceptional growth (Qian & Weingast, 2006). However, delegation can also challenge the credibility of political commitments, thus making well-intentioned economic policies inefficient, a problem pointed out as one possible element coming out of the federal system of Argentina to account for the continuing decline of the economy of that country since World War I (Spiller & Tommasi, 2007). A lesson from these somewhat diverging views is that comparative political and economic costs and benefits of delegation need to be assessed empirically, a task that remains amazingly low on the research agenda of social scientists.

*Third*, the gap between political interests and economic requirements raises *governance problems*. Governance concerns the choice of organizational modalities: (1) to define actions to be undertaken with respect to certain goals; (2) to allocate capacity to make decisions across the different layers of institutions and the different levels of government; and (3) to establish and implement accountability which, in a democracy, is the foundation of legitimacy. In our democracies, a substantial chunk of governance is in the hands of the administration, which as a whole can be considered the central meso-institution that largely determines political and, even more significantly, economic transaction costs. Hence the importance of ‘good’ governance, which can be defined as the capacity of a public administration to align outcomes with goals established by policy-makers at the general macro-institutional level with the lowest possible transaction costs (both political and economic ones). In that respect, good governance is a critical step in implementing and monitoring policies expected to be in the economic interest of the majority of citizens, mitigating their problems and enhancing their well-being, which can be viewed as the central political requirement of democracies. However, as pointed out long ago (Niskanen, 1968), bureaucratic opportunism often makes the specific interests of bureaucrats prevailing over general interest, pushing political transaction costs upwards, even to the point where it challenges the legitimacy and credibility of policy-makers. The resulting distortions can well make economic policies inefficient or perceived as unfair, even challenging the very foundations of a democracy.

To sum up, political and/or economic transaction costs that can come out of failures in coordination, delegation, and governance may well end up in situations in which the organization of a democratic regime or, even worse, democracy itself is perceived as not suitable for promoting the interest of the majority and meeting its expectations. This challenge, which the European Union and its member states are now clearly facing, points out the urgent need to identify and assess the underlying transaction costs, in their political as well as their economic dimension, a necessary condition (if not a sufficient one!) to escape the often sterile ideological debates that tend to pollute these issues. As noted by Eggertsson

(2015), understanding the links between economy and democracy in that perspective requires ‘knowledge intensive activities’

## **6. Conclusion: central messages**

A central message delivered in this paper is that democracy is fragile. It is so because, besides the economic transaction costs associated to the decentralized organization of production and distribution that is one of its major characteristics, it faces high political transaction costs. Indeed, as pointed out by Arrow (1974) and Buchanan and Tullock (1962), democracies must navigate in the blurred area between pure consensus, which would involve very high decision costs, and pure dictatorship, which translates into very high ‘external’ costs (that is: the costs an agent expects to endure from collective decisions that diverge from his favorite<sup>8</sup>). At the same time, as emphasized by North et al. (2009), the existence of this blurred area is precisely what demarcates ‘open access societies’ from ‘limited access societies’.

A second message is that institutions framing democracies are differentiated and operate at different levels. In this paper I have argued that meso-institutions are at the core of democracy and that the quality of their design and rules are central to the actual exercise and stability of democracies. I have defined meso-institutions as those intermediate arrangements that provide the essential links between the macro level at which general rules of the game are defined (mainly the political regime and the judiciary) and the micro-level at which agents operate (through markets, within firms, among networks and hybrids).

Therefore, beyond issues regarding the appropriateness of public policies to the needs of citizens and the capacity and motivation of the public administration to implement more or less adequately these policies, there is a more general problem, which relates to institutional design. When analyzing the implementation of reforms in the delivery of essential services, or the means needed to fight corruption coming out of how political parties are financed, or the changes necessary to make financial systems less speculation-oriented, it is misleading to focus exclusively on, and blame solely, politicians or bureaucrats. It is essential to also take into account support and distortions coming from the existing meso-institutions linking general rules of the game, as established through the political or judicial regime, and the domain of actions these rules delineate for economic agents.

Taking this perspective into account could provide a different approach to the now classical question (and likely impossible to solve at a purely theoretical level) of the links between economy and democracy.

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<sup>8</sup> According to these authors, external costs are nil under unanimity rule since each participant can block any unfavorable decision, positive under majority rules since minorities might end up with a worst situation than under status quo, and reach a maximum under “dictatorship or unique control.”

Most analyses so far have interpreted this issue and focus in their answers on the relationship between democracy and growth, with ambiguous results, since so many authoritarian regimes are associated to high rates of growth ... at least for a certain horizon (but this is true also for democracies!). My point is that this focus can be misleading in that it does not take into account the institutional conditions under which economy and democracy can sustain the well-being of citizens. The 'benign' neglect of this dimension by analysts as well as policy-makers may well contribute to the fragility of democracies.

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