

On The Principal-Agent Modelling Of Parties and Electoral Markets

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Abstract

How to account for the recent sharp augmentation in electoral volatility in Western Europe? Parties are basically coalitions of people looking for political power and whatever comes with it. This is the essence of the Schumpeter (1942) model of democracy as competition between party entrepreneurs, or elites in the political market place. It is more suited for understanding party politics in the post-modern society than the classical political sociology model of Lipset and Rokkan (1967). The economic model offers a dynamic model of the party system with an emphasis upon incentives, whereas the sociology model entails a static perspective – the “frozen” party system hypothesis. The concept of voter volatility is central in a theory of elections as principal-agent contracting that restrains the groups of political entrepreneurs we call “parties” in the electoral markets.

Key Words: political parties as coalitions, frozen party systems, electoral volatility, principal-agent interaction, transaction cost minimizing mechanism, multiple equilibria in N-person games, Schumpeter, Lipset and Rokkan.

INTRODUCTION

One could argue that political parties have become the most spoken of actors in well-ordered Rawlsian societies besides government itself. Thus, one can hardly avoid the question: What is basically a political party? Political parties constitute a multifaceted set of phenomena with regard to size, strength of organisation and ideological orientation. But why create and maintain parties? One needs to theorise motivation (micro) and function (macro) in order to explain the fundamental role of political parties in constitutional democracies.

Here, I focus upon the implications of transaction costs for the party system in a country. Transaction cost theory has contributed considerably to understanding economic institutions. It is also relevant for understanding political organisations like the political party. A political party consists fundamentally of two sets of people, the principal (voters, members) and his/her agents (politicians, parliamentarians, officials).

According to the logic of the principal-agent model, the principal offers a set of resources to his/her agents on the condition that their work effort transform these inputs into outputs that are to the benefit of the principal (Rasmusen, 2006). This entails a contractual approach covering the value of the output to the principal against the remuneration of the agents with the underlying question about whether the outputs are beneficial as well as correspond to an acceptable level of work effort and whether the remuneration is just? When this is not the case, the principal will seek out another set of agents.

The principal-agent approach is well suitable for an application upon the politics in a well-ordered society, but one must add some transaction cost saving mechanism hindering too

many parties to be operating in a party system. Transaction cost analysis (Alchian, Coase) is a key to understanding why there is a small finite set of parties as well as why parties maintain government coalitions. It accounts for the basic finding in N-person game theory – multiple equilibria or the general lack of a unique equilibrium (Riker and Ordeshook, 1973), on the one hand and the absence of political chaos in democracies on the other hand. Politicians take transaction costs into account when they create the internal coalitions we call “parties”, and they stick to the external coalitions they made in government for the same reason. Generally speaking, representation democracy would be impossible without a transaction cost minimising mechanism, like the political parties.

POLITICAL PARTIES: COALITIONS IN COMPETITION FOR COALITIONS IN GOVERNMENT

Political parties are not natural entities. Often they are spoken of as if they constitute actors, but that is merely a manner of speaking. Reification, or the fallacy of misplaced concreteness, is involved when parties are given a life of their own, with needs, survival, etc. Parties are just coalitions of people searching for political power by means of support from voters.

Political parties not only make coalitions with each other. They are essentially coalitions among human beings. Each party consists of men and women who make a coalition among each other to stand for a set of policy demands in elections and defend another set of policy supply when in government, more or less similar to the first demand set. The motivation driving these men and women to create a party and maintain it is entirely egoistic, in a narrow or broad sense.

To succeed in parliamentary politics, politicians need the support of a party, i.e. other politicians. Gaining access to the representative assembly opens up numerous accesses to valuable things like power, prestige and wealth. To receive support from other people, politicians seek to further the interests of groups who may vote for him/her. Self-interests and group interests constitute the motivational basis of parties. The key problem is the stability of these coalitions among men and women, which tend to be rather loose.

Internal party politics tends to be messy, involving both bargaining among different subgroups and voting at general assemblies. The risk is that the party is hurt by dissent to such an extent that a subgroup leaves the coalition and sets up its own party, in order to further either the interests of leaders or the subgroup it relies upon. The instability of coalitions within the party is well modelled by N-person game theory, which lacks equilibria.

It has been argued by Riker that solidarity keeps a party together, but this is hardly the case. What reduces the number of party splits is simple the need to minimize transaction costs. Party feuds or splits may be excessive costly and abortive, also for the dissenters. The leadership of a party possesses a set of strategies to employ to protect the integrity of the coalition, given the transaction costs involved: bolstering one platform, clarifying ideological issues, co-optation of opposition leaders, elimination of internal dissidents, etc. Transaction costs are likewise decisive when splinter groups decide to go it alone, which may prove a failure.

External party politics is determined by the parliamentary position of the party, namely its strength in terms of seats and its capacity to attract coalition bids from other parties. Access to the representative assembly, which depends upon voters as well as election rules, presents the party with two strategic options, namely to concentrate upon policy demands or engage in policy supply, the choice between the two policy - demand or supply - being related to the power index of the party (0-1).

Parties with no koalitionsfähigkeit will concentrate upon policy demands to respond to their electorate, whereas parties with koalitionsfähigkeit will manoeuvre in order to form a government coalition so that it may influence the supply of policies. Supplying policies in government allows parties to satisfy its basic goals of rewarding both themselves and their support groups in the electorate.

The problem of instability surfaces again in the external party politics, especially in the multi-party systems in Western Europe. Who to make the coalition with? Rational choice suggests the minimum winning model (Riker), but it has to be expanded to take into account transaction costs, as with the minimum distance principle. The idea of oversized coalitions is difficult to reconcile with these two principles: minimum winning and transaction cost saving. The same actually applies to the principle of minimum sized coalitions that may cover extremist parties.

Party politics in Parliament is basically a zero sum game, which with more than two parties involved becomes an N-person game. The only solution to the game is the power index of a party, where one may distinguish between the ex ante power index after the election and the ex post power index after the formation of a government. Ceteris paribus, parties aim fundamentally to maximise the power index scores, but they are crucially dependent upon their principals. But first a few sentences about the role of parties in policy demand and policy supply.

Although seldom recognized in the constitution of a country, political parties play the major role in demanding policies as well as supplying them. Besides civil society and non-profit organisations, policies are handled by parties in representative democracies. With the exception of major popular decisions to be decided in referenda, West European democracies except Switzerland relies upon the parties to formulate demands for policies and parties in government to supply policies. In fact, political parties are the transaction costs saving mechanism in democratic policy-making.

FIRST ORDER COALITIONS: POLITICAL PARTIES

If one looks upon the political party as a set of men and women in coalition aimed at the political process, then one understands the fragility of parties as well as their fear of infighting and splits. After all, coalitions among human beings tend to be temporary and not always smooth. Often increased volatility goes hand in hand with internal frictions and dissent,

Parties develop different strategies to cope with internal and external uncertainty:

- Mass parties (Rokkan): Since they are fairly large, they are not so vulnerable from internal dissent and personal defections. They try to protect their organisation by underlining huge support groups and outside stable contracts like business communities, trade unions, youth movement, women associations, etc.
- Catch-all parties (Kirschheimer): A large party may try to ride upon the swings in public opinions, searching for support in more than one cleavage structure. This may return a large electoral victory, but also lead to splinter groups.
- Pivot parties (Keman): Small parties in the centre can stabilise their situation by exercising power as a coalition partner, as measured by the power index method. However, they are not always safe against sudden movements in the electorate, with e.g. the flash parties.
- Cartel parties (Mair): This concept was introduced to capture some features of party behaviour when the mass parties faced decline and catch-all strategies failed. A cartel party is basically a coalition of politicians supported by the state (generous funding

programs). Despite this state party support in West European democracies, are they not vulnerable to major changes in voter preferences?

Political parties, small or large, cannot survive without voter support in elections. How dependent are parties upon their electorates? The famous Lipset-Rokkan theory of West European party systems claims that parties are closely connected with social groups. Lipset's and Rokkan's well-known Cleavage Structures. Party Systems, and Voter Alignments: An Introduction (1967) argues that the fully developed party systems in West European democracies are "frozen", i.e.

1. Voters tend to be loyal in one election to another;
2. Voters frame their choice of party on the basis of their position on a cleavage line: ethnicity, religion or class;
3. The cleavages in society are finite and change very slowly, if at all;
4. The central cleavages in the fully blown industrial democracy include: class, religion and region.

In the literature on party systems (Sartori, 1975; Keman and Budge, 1988), the classical focus is upon the number of parties – fractionalisation – and the effects of the electoral institutions – two-partism against multi-partism. However, once one moves to a dynamic analysis of rapid change in party systems, the focal interest will be upon volatility. What restrains too much of volatility is the workings of a transaction cost minimising mechanism. It is costly to change parties entirely from one election to another, both for the politicians involved and the voters.

Table 1 documents the long-run trend towards more and more of volatility.

Table 1. Net volatility in Western European elections

Summary of Volatility			
Decade	Mean	Std. Dev.	Freq.
1970-79	10.591514	6.5865799	55
1980-89	10.231104	6.9730458	58
1990-99	11.483612	5.9708036	53
2000-09	11.738517	5.9025244	55
2010-15	18.529448	10.333016	24
Total	11.734261	7.1916167	245

Gross volatility is likely to be twice the size of net volatility. Only the principle of minimising transaction costs restrains the instability typical of election games.

OLIGOPOLISTS AND INTRUDERS

Do we find the very same parties when comparing elections around 1970 with elections about 2005 in West European states? A few attempts have been made to map the existence and strength of various political parties that may be used for evaluating the Lipset-Rokkan theory. One such classification targets the size of Left and Religious parties – the mass or cleavage parties: socialist – left-socialist-communist-agrarian and religious parties.

Diagram 1 shows the combined size of the Lipset-Rokkan cleavage parties 1970 and 2000.

Diagram 1. Mass parties: Left + Religious + Agrarian

Note: LR-ALT measures the support for socialist + left-socialist + communist + agrarian + ethnic parties

Source: Based on data available from Armingeon et al. (2013)

One observes the decline of the cleavage parties in Diagram 1, providing evidence of party system change. Most of these mass parties are to be found below the 45 degree line.

Dynamic analysis of party systems would involve measuring the size of new parties (Diagram 2). The category "Others" designate political parties that are NOT socialist, conservative, agrarian, communist or liberals (Sundberg, 1999). Again, one may note that these parties are mostly above the 45 degree line in Diagram 2.

Diagram 2. New Parties

Note: Following Sundberg (1999) OTH measures the support for new parties as $100 - (\text{socialist} + \text{agrarian} + \text{conservatives} + \text{communists} + \text{liberals})$

Source: Based on data available from Armingeon et al. (2013)

In the political sociology literature, the static approach to party systems in Western Europe has long dominated with the established theory of Lipset and Rokkan. It is a true political sociology hypothesis, linking in a strong and firm manner parties and electoral groups among voters. However, it is not in agreement with predictions from N-person game theory, enlarged with asymmetric information as with principal-agent modelling. In fact, it is strategically naïve, given that the parties have their own agenda, namely the search for power that opens the doors to prestige, wealth and influence. The static theory entails that electoral volatility is low, both net and gross volatility. The same parties – oligopolists – receive much the same levels of support over time and the dominating parties prevail constantly over the minor ones. Moreover, this theory claims that the electorate is permanently structured behind the parties in accordance with social, ethnic and religious cleavages. This cleavage pattern is also frozen, dating back in history long before the democratic dispensation was introduced around the end of the Great War. The parties in West European constitutional democracies were locked in with the groups in the population in a one-to-one set of interactions.

On the contrary, the dynamic framework emphasizes gaming, i.e. strategy on the one hand and autonomy on the other hand. The voter behaviour is influenced by expectations, evaluations and forecasts. A rational expectation voter takes the available information into account, all the time updating his/her information about promises and outcomes. He/she is prepared to become a party-switcher when expectations are dashed. Only transaction costs limit voter shifts from one election to another.

Correspondingly, parties need to be aware of how voter expectations evolve. As loyalty and legacy count for less than intentions and projections with voters, parties have also to update themselves continuously about attitude changes, being all the time prepared to take action in terms of policy demands or policy supply. Despite the fact that voter influence is always proportional to $1/N$, most voters enjoy the election game and thus update themselves on outcomes and new party proposals.

ELECTORAL MARKETS

Parties are similar to enterprises in that they compete for the support of the citizens/consumers. Political competition is as brutal as economic competition, leaving few winners and many losers. Politicians may benefit handsomely from the electoral game, becoming immensely rich, like Tony Blair or Bill Clinton. However, many politicians are not so successful, as they only are able to capture a decent salary and pension, which though often is above their reservation price outside Parliament.

The Lipset-Rokkan model identified a situation in West European politics when the political parties managed to stabilize their fortunes, acting like oligopolists. However, this cosy market structure would not last, as intruders entered the electoral arena from both Right and Left. Understanding political markets, the central concept is voter volatility – gross and net.

Table 2 has the scores for the 1970s against the 2000s. Net volatility has risen considerably, from between 5-10 per cent to 15-25 per cent. Net volatility results from gross volatility, or party switching among voters, being usually or often twice or trice as strong as net volatility.

Table 2. Volatility 1970-2010: Net and Gross

Country	net_1970	net_2000	gross_1970	gross_2000
Austria	2,6	16,6		
Belgium	6,9	15,5		27,0
Denmark	15,6	10,8	23,0	29,3
Finland	7,7	9,9	22,0	24,0
France	17,7	20,6	28,0	42,0
Germany	5,0	9,9	12,0	25,5
Greece	23,1	13,6		17,0
Iceland	12,6	12,9		30,9
Ireland	8,5	21,2		24,0
Italy	6,1	13,4		32,0
Luxembourg	12,3	7,2		
Netherlands	13,2	22,7	20,0	39,8
Norway	15,2	14,2	22,8	33,3
Portugal	11,7	11,4		16,5
Spain	12,1	11,2		10,0
Sweden	6,3	13,5	17,3	33,5
Switzerland	7,7	8,9		27,7
United Kingdom	8,3	7,0	18,3	17,8

Note: Net volatility: The gains and losses of political parties participating at two elections as measured by the Pedersen index. Gross volatility: measured as party switching by voters changing parties over two consecutive elections.

Sources: Net volatility: Based on data presented in Ersson (2012) Gross volatility: See Ersson: Appendix.

One may point out that the rise in volatility is sharp in some countries that used to be well-known for their electoral stability: Sweden, Switzerland, Denmark, the Netherlands and Norway.

SECOND ORDER COALITIONS: GOVERNMENT FORMATION

If political parties are made up of coalitions among politicians in the first place, then it is also true that parties enter coalitions with other parties, mainly to form a government. Such external coalitions could be short or long lasting. They crop up in legislative voting deals between parties, but they also constitute the bedrock for multi-party governments. Very few parties reach the 51 per cent threshold for forming a single party majority government – a party in coalition with itself! Thus, coalition formation is a major type of interaction between political parties in a representative democracy, like in Western Europe.

Figures 3 and 4 show two patterns of government formation. In a frozen party system, PR techniques are bound to result in minority governments at times. No political party receives a majority of seats in Parliament for itself, but a large party may still be reluctant to enter into a coalition due to historically given animosities – a form of path dependency reinforced by the election system. Figure 3 shows that minority governments were more frequent around 1970 than 2000.

Figure 3. Minority governments

Note: MIN measures the per cent of time a minority government has been in power.
Source: Based on data in Andersson et al. (2014)

In Western Europe, PR methods have in a few countries been used as the basis for so-called consociationalism (Lijphart, 1968, 1984), meaning an effort to bring all players, or most of them, on board for consensus policy-making. The creation of grand coalitions would in a cleavage dominated society constitute a tool for the political elite to minimize conflict and avoid any tendency to civil war between the so-called camps (zuilen, pillars). Oversized or grand coalitions make little sense except actually (Figure 4).

Figure 4. Oversized Coalitions

Note: SURPLUS measures the per cent of time an oversized coalition has been in power.
Source: Based on data in Andersson et al. (2014)

When a party system is dominated by two large parties that cannot form a simple majority government or a minimum winning coalition, then they may temporarily resort to the oversized format - Austria. Only Switzerland employs the collegiado as a matter of principle. The Swiss practice of collegiado - “formule magique” - is often explained as an historical legacy, but it may just as well be accounted for strategically, given the obvious need for government to counter-balance the powerful instrument of people's initiative in the referendum dispensation (L. Neidhart).

CONCLUSION

The concept of volatility, gross and net volatility, is a most powerful indicator on party system change, showing the basic rise in the autonomy of parties in relation to social forces/cleavages. When political parties are looked upon from the perspective of the principal-agent model, then sooner or later changing the agents becomes crucial in order to bolster the influence of the principal. As a matter of fact, the more changes of the situation of the agents, the more vital the democratic regime is. Yet, too many changes of the political agents would run up against the basic principle of transaction cost minimisation

Political parties operate in electoral markets under a dynamic principle-agent interaction between the voters and their agents. Politicians set up parties before the election through internal coalitions with others aimed at providing power in the legislative assembly, and serving as tools for government formation. Thus, after the election, these coalitions enter external coalitions with other parties to exercise government power. The micro motivation is influence, prestige and wealth. Yet, the macro force is the minimising of transaction costs in a representative democracy – an unintended and un-recognized function, in the classic language of M. Levy (1952).

Volatility is the break upon Schumpeter's theory of democracy as the competition among elites. When volatility rises, then politicians have all the reasons to tremble.

APPENDIX: DATA AND SOURCES

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Data on gross volatility is measured as party switching:
See enclosed excel file in Ersson (2012).

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