One Cheer for Foreign Lobbying

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Abstract

This paper presents an argument in favor of foreign lobbying. We show how foreign lobbying can help internalize cross national externalities and promote social objectives.

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1 Introduction

Most countries try to restrict lobbying by foreign lobby groups. For example, in the United States, the 1974 amendment to the Federal Election Campaign Act prohibits contributions by foreign nationals to Federal, state or local elections. In practice, however, subsidiaries of foreign companies are considered as "American" if their lobbying activities are administrated by American citizens and that only Americans contribute to their political action committees. Other countries also impose restrictions on foreign lobbying, including the United Kingdom and the European Union, but, as in the United States, there exist many loopholes.

The concern that advocates of such bans or restrictions often express is that foreign campaign contributions subvert the goals of democracy and undermine the legitimacy of government (see, e.g., the discussion by Savrin (1988) or Powell (1996)). In contrast, opponents of restrictions point out that foreign interests often have a legitimate stake in domestic policy making because policy choices made by one country typically affect the welfare of citizens of other countries. Examples of this include environmental policy, trade policy, labor standards etc. Since many policies produce such cross national externalities, a potential benefit of allowing foreign lobbying is that it can help internalizing these externalities. This argument in favor of foreign

2

lobbying is, we believe, important.

The purpose of this paper is to give it a proper theoretical underpinning. To this end, we build on work by Helpman and Grossman (1995), Prat and Rustichini (2003), Damania and Fredriksson (2007) and Fredriksson and Millimet (2007) on common agency models with many principals and agents. Gawande et al. (2006) develop a related model in which they study how foreign firms, through lobbying of a government in a foreign country, can reduce import tariffs in their own industry. Our model is more general in two regards. First, it recognizes that lobby groups will be operating in many different countries at the same time, not just in one, and that foreign agents often are affected by policy choices made in particular country even if they are not directly engaged in economic activity in that country.[1] The situation we study is therefore one with many governments (agents) and many lobby groups (principals) rather than one with one government (agent) and many lobby groups (principals). Importantly, this formulation allows us to show how and when all cross national externalities can be internalized through foreign lobbying. Second, we are not specific about what generates the cross nation externality, so our model applies to a large range of cases, including environmental, competition and labour regulation as well as to trade policy.

The rest of the paper is organized as follows. In Section 2, we introduce

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[1]Environmental externalities are the leading example of this.

the model. In Section 3, we compare equilibrium outcomes in two situations: one with a ban on foreign lobbying and one without. We show formally how foreign lobbying can internalize externalities. In Section 4, we discuss some implications of the analysis.

2 The Model

We consider a world populated by lobby groups and policy makers (governments). The lobby groups offer campaign contributions to the policy makers to influence their policy actions, but may face restrictions on who they are allowed to offer these contributions to. Let the set of lobby groups be denoted M with $m \in M$ and the set of policy makers be denoted N with $n \in N$. Both sets are finite and discrete and have cardinality $|M|$ and $|N|$, respectively. Policy maker n takes a single policy action $x_n \in R$.[2] The payoff of lobby group m depends on the policy actions taken by *all* the policy makers, i.e., $x = (x_n)_{n \in N}$, and is denoted by $u^m(x)$. We assume that $u^m(x)$ is strictly concave. We denote the contribution schedule offered to policy maker n by group m by $C^n_m(x_n; x_{-n})$. The contribution schedules specify a

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[2]In contrast to Damania and Fredriksson (2007) and Fredriksson and Millimet (2007) who study a situation in which each policy maker has veto over a common policy action, we assume that each policy maker has full control over his own policy action. A similar approach is taken in Conconi (2003) and Aidt and Hwang (2008).

particular payment to be made to policy maker n if he takes policy action x_n. We assume that the contribution schedules are differentiable. We allow for the possibility that the payment offered to a particular policy maker for action x_n may indirectly depend on the policy actions taken by the other policy makers, $x_{-n} = (x_k)_{k \in N, k \neq n}$. This interdependency arises naturally in many contexts. Contribution schedules that are locally truthful, for example, reflect the marginal value to the lobby groups of the policy favors bestowed. In many applications, these marginal values depend on the policy actions taken by *all* policy makers. Suppose, for instance, that the policy actions are environmental taxes implemented in different jurisdictions. Then, the marginal value to, say, an environmental lobby group of an increase in the tax in one jurisdiction depends on the taxes implemented in the others. This is simply because marginal environmental damage depends on the entire tax vector. We assume that policy maker n cares only about the contributions that he collects from the lobby groups, i.e., $\sum_{m \in M} C_m^n(x_n; x_{-n})$.

The relationship between the policy makers and the lobby groups is modelled as an agency game. The game has two stages. In the first stage, given the institutional constraints on the types of contributions that are allowed, each lobby group offers contribution schedules to the policy makers taking the schedules offered by the other lobby groups as given. In the second stage, each policy maker implements the policy action that maximizes his total

contribution income taking as given the policy actions of the other policy makers.

To focus on the question of foreign lobbying, we assume that each policy maker represents a national government. We can then partition the set of lobby groups into $|N|$ disjoint sets, with $M = \cup_{n \in N} M_n$. The set M_n is the set of lobby groups located in country n. We assume that each country has at least one lobby group. Since the payoff of each lobby group depends on the entire vector of policy actions, the policy action taken by any given government affects the welfare of the lobby groups in all countries. Thus, the policy actions produce cross national externalities.

3 Analysis

We denote the socially optimal policy vector by

$$\{x_n^*\}_{n \in N} = \arg \max_{(x_n)_{n \in N}} \sum_{n \in N} \sum_{m \in M_n} u^m(x). \tag{1}$$

The outcome in political equilibrium may differ from this because of lobbying. We compare two scenarios: one with a ban on foreign lobbying and one without.

3.1   Ban on Foreign Lobbying

In this scenario, the national lobby groups can offer contribution schedules only to their own government. Formally, if $m \notin M_n$, then $C_m^n(x_n, x_{-n}) \equiv 0$. The game between the national lobby groups and their government is a common agency game. Using the equilibrium characterization provided for this case by Grossman and Helpman (1995), we can state (without proof) the following result.

Proposition 1 *(Ban on foreign lobbying). The equilibrium policy vector is $(\widetilde{x}_n)_{n \in N}$ where $\widetilde{x}_n = \arg\max_{x_n} \sum_{m \in M_n} u^m(x_n, \widetilde{x}_{-n})$ for all $n \in N$. Moreover, $(\widetilde{x}_n)_{n \in N} \neq \{x_n^*\}_{n \in N}$.*

With a ban on foreign lobbying, each policy action is chosen in isolation. It maximizes the sum of the payoff of the government responsible for the action and the national lobby groups, taking as given the policy actions of the other governments. As a consequence, the cross national externalities are not internalized. The vector of equilibrium policy actions is socially inefficient.

3.2   Foreign Lobbying

In this scenario, the lobby groups can offer contributions to all governments. Formally, the game between the governments and the lobby groups becomes

a multiple principal, multiple agent game. Prat and Rustichini (1999, 2003) provide an equilibrium characterization for this case that can be adopted to a setting with a continuous action space, as in Damania and Fredriksson (2007). As mentioned above, we allow for the possibility that the contribution schedule offered to a particular government may depend indirectly on the policy actions taken by other governments. This complicates the characterization of equilibrium. Suppose, however, that each government only observes the contribution schedules offered to itself and that it forms beliefs about the contribution schedules offered to the other governments that do not depend on the offers it receives itself. Under these assumptions, Prat and Rustichini (1999, Theorem 8) show that the following equilibrium characterization applies.

Lemma 1 *(P-R) A pair $((\widehat{C}_m^n)_{n \in N, m \in M}, x)$, consisting of a vector of feasible non-negative contribution schedules and a vector of policy actions, constitute a pure strategy equilibrium outcome if and only if the following three conditions hold:*

(AM) *For all $n \in N$ and $x_n \in R$,*

$$\widehat{x}_n = \arg \max_{x_n} \sum_{m \in M} \widehat{C}_m^n(x_n; \widehat{x}_{-n})$$

(IC) *For every $m \in M$ and $x \in R^{|N|}$*

$$\widehat{x} = \arg\max_x u^m (x_n, x_{-n}) + \sum_{n \in N} \sum_{j \in M, j \neq m} \widehat{C}_j^n(x_n; x_{-n})$$

(CM) *For every $m \in M$ and $n \in N$*

$$\sum_{m \in M} \widehat{C}_m^n(\widehat{x}_n; \widehat{x}_{-n}) = \max_{x_n} \sum_{j \in M, j \neq m} \widehat{C}_j^n(x_n; \widehat{x}_{-n})$$

The first condition, agent maximization (AM), requires that each government selects the optimal policy action given the contribution schedules offered to it and given the equilibrium actions of the other governments. The second condition, incentive compatibility (IC), requires that a lobby group m cannot find contribution schedules that yield higher payoffs than its equilibrium schedules given the equilibrium contribution schedules of the other lobby groups. An implication of this is that the vector of equilibrium policy actions must maximize the joint surplus of each lobby group and the collective of all governments. This is what condition (IC) says. The third condition is a cost minimization condition (CM). It requires that the equilibrium contribution schedules are such that no lobby group can get the equilibrium policy vector implemented at lower cost.

Using this characterization, we can prove the main result of the paper.

Proposition 2 *(Foreign lobbying) The equilibrium policy vector with foreign lobbying, $(\widehat{x}_n)_{n \in N}$, internalizes all cross national externalities. Moreover,*

$(\widehat{x}_n)_{n \in N} = \{x_n^*\}_{n \in N}.$

Proof. Condition (IC) implies that $\widehat{x}$ must satisfy

$$\frac{\partial u^m(\widehat{x})}{\partial x_n} + \sum_{j \in M, j \neq m} \frac{\partial \widehat{C}_j^n(\widehat{x}_n; \widehat{x}_{-n})}{\partial x_n} + \sum_{k \in N, k \neq n} \sum_{j \in M, j \neq m} \frac{\partial \widehat{C}_j^k(\widehat{x}_n; \widehat{x}_{-n})}{\partial x_n} = 0 \quad (2)$$

for all $m \in M$ and $n \in N$. Adding these conditions up, we get

$$\sum_{m \in M} \frac{\partial u^m(\widehat{x})}{\partial x_n} + (|M| - 1) \sum_{j \in M} \frac{\partial \widehat{C}_j^n(\widehat{x}_n; \widehat{x}_{-n})}{\partial x_n} + (|M| - 1) \sum_{k \in N, k \neq n} \sum_{j \in M} \frac{\partial \widehat{C}_j^k(\widehat{x}_n; \widehat{x}_{-n})}{\partial x_n} = 0.$$

$$(3)$$

Since $\max_{x_n} \sum_{j \in M, j \neq m} \widehat{C}_j^n(x_n; \widehat{x}_{-n})$ is a constant, condition (CM) imposes

the following restrictions on the marginal contribution schedules, evaluated

at the equilibrium policy vector:

$$\sum_{m \in M} \frac{\partial \widehat{C}_m^k(x_n; \widehat{x}_{-n})}{\partial x_n} = 0 \text{ for all } k \in N. \tag{4}$$

This implies that equation (3) reduces to

$$\sum_{m \in M} \frac{\partial u^m(\widehat{x})}{\partial x_n} = 0 \text{ for all } n \in N, \tag{5}$$

which is the necessary condition for maximization of social welfare ∎

The proposition shows that foreign lobbying can serve a socially useful

purpose: it internalizes cross national externalities. Foreign lobbying allows

each government to accept contributions from foreign as well as national

lobby groups. Foreign lobby groups only have an incentive to offer these

10

contributions if they have a stake in the policy action. In effect, they reward the governments for taking into account the effect of their policy actions on the welfare of the foreign special interests represented by the foreign lobby groups. As a result, cross national externalities are internalized.

4 Discussion

We have formalized the case for legalizing all foreign lobbying based on a simple externality argument. In our specification, internalization is complete because all affected parties are organized in lobby groups and represent a national interest. In reality, this may not be case. Externalities are then only partly internalized and other social objectives may be compromised. In particular, when important segments of society remain unorganized, foreign lobbying as well as national lobbying may have undesirable side effects. For example, in the case of an environmental externality, lobbying against environmental protection by a well-organized foreign industry lobby group may have detrimental environmental effects, not only for unorganized citizens in the country concerned but also for citizens in the country that hosts the foreign lobby group. In other cases, the side effects are more benign. In fact, if foreign lobbying is targeted at reducing trade barriers (Husted, 1991; Gawande et al., 2006) or at gaining preferential market access (Kee et

11

al. 2007), this can increase the welfare of unorganized consumers. In some cases, however, foreign lobbying encourages political parties to replace tariffs with negotiated voluntary export restraints (Hillman and Ursprung, 1988). The resulting loss of revenue may place an additional burden on unorganized consumers. Keeping these caveats in mind, we nevertheless believe that the externality argument in favor of foreign lobbying is quite general, has a solid analytic foundation, and is of practical importance. It should, therefore, be part of an informed debate about the role of foreign lobbying and bans on foreign donations to domestic political campaigns. As pointed out by Gawande et al. (2007), in an interesting study of the link between foreign lobbying and Caribbean tourism, foreign lobbying may even in some cases be a vehicle for development. Ultimately, of course, these benefits must be quantified and weighted against any loss in democratic legitimacy, but it is important to consider the costs as well as the benefits to reach a balanced view on the consequences of banning foreign lobbying.

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