

## Lecture V: Political Economy

- Decisions are made in the context of a complex political system
- Why governments do what they do?
- Unanimity
  - Direct Democracy
  - Representative Democracy
- Government Failure

### I. Unanimity

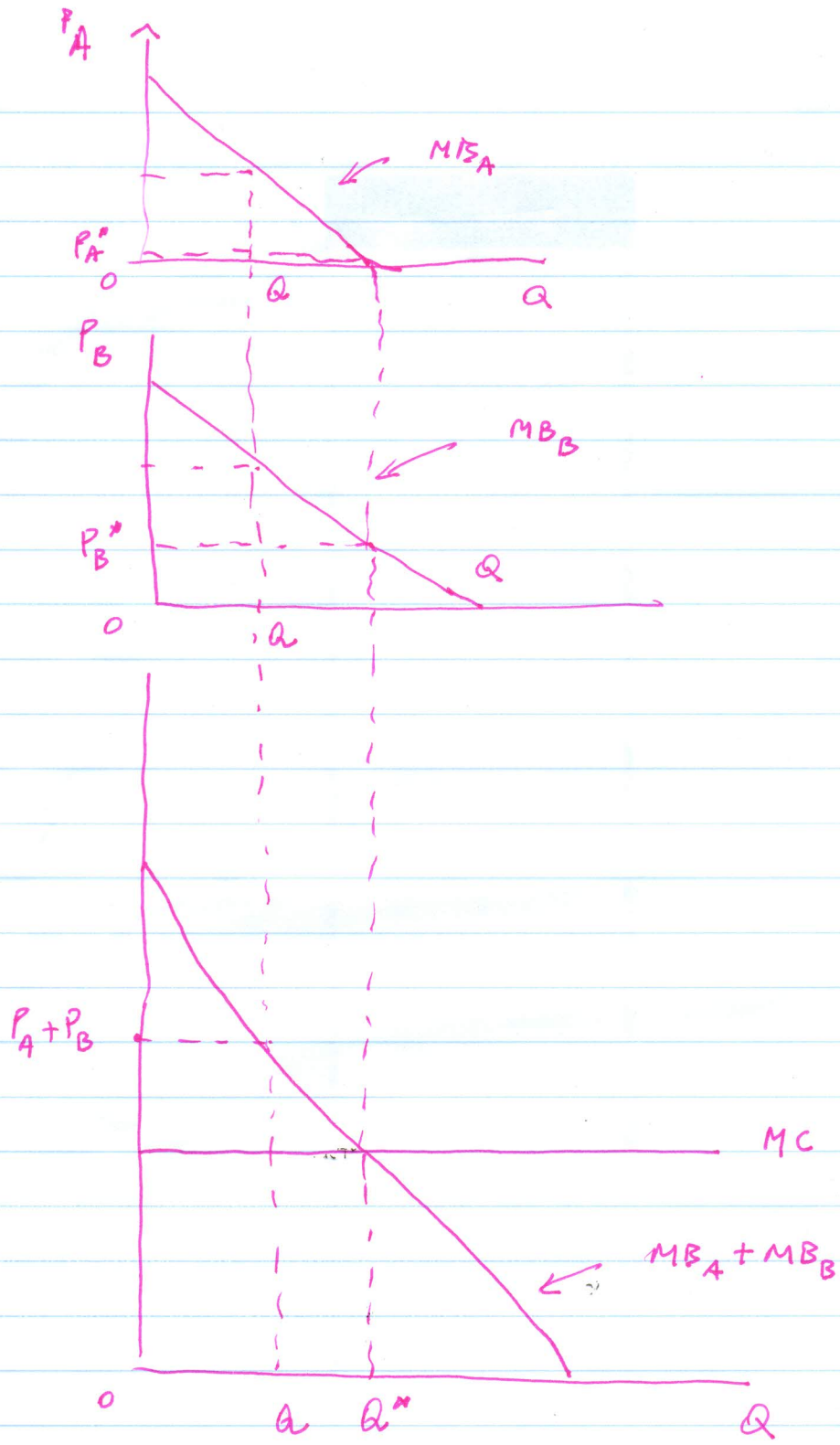
- Lindahl Pricing :  $P_i = MB_i$ 

↑  
marginal willingness to pay

Pricing

Lindahl Program:

  1. Government sets tax prices for each individual
  2. Individuals announce the quantity they want
  3. Steps 1 and 2 are repeated until a marginal willingness to pay schedule is constructed for each individual
  4. Government constructs a demand curve for the public good by adding up individual marginal willingness to pay for each quantity of the good
  5. Government decides the quantity following the Samuelson condition:
 
$$\sum P_i = \sum MB_i = MC$$
  6. Government finances project by charging each individual their marginal willingness to pay at the level of the public good obtained in step 5

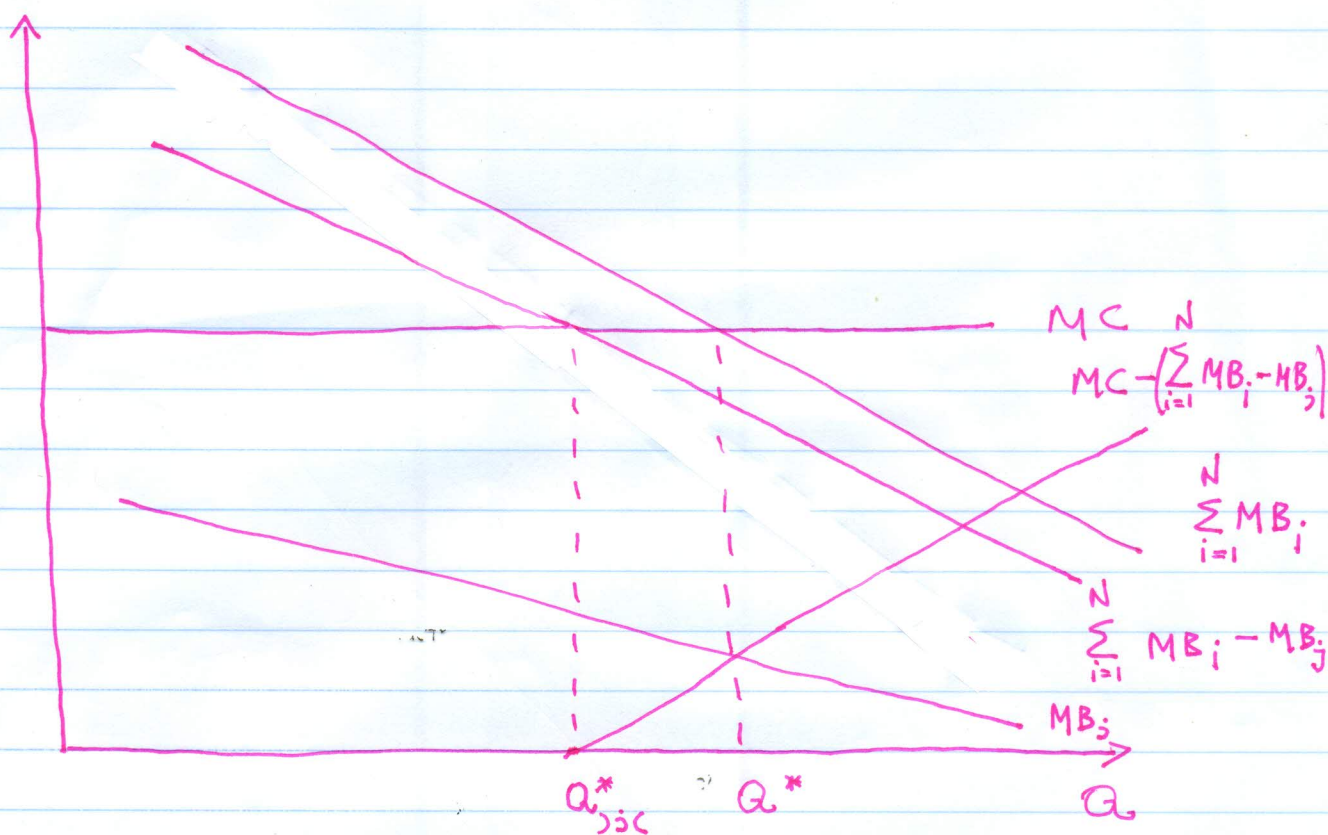


Lindahl Pricing

## Problems with Lindahl Pricing:

- 1) Preference revelation (Free rider problem)  
More of a problem in large groups.
- 2) Preference knowledge
- 3) Preference aggregation (Complexity)  
More of a problem in large groups

## Mechanism Design (Groves)



$$B_j = MC - \left( \sum_{i=1}^N MB_i - MB_j \right) = MB_j$$

$$T_j = A_j + B_j$$



fixed part of the tax paid by  $j$   
to balance the budget



## I. Direct Democracy

- Referendum (Vote on State laws)
  - Legislative Referenda } Laws already approved
  - Popular Referenda }
- Voter Initiatives (tax reform, environmental issues, euthanasia, animal rights, casino licenses, politicians term limits, ...)
- Majority Voting (Preference aggregation mechanism)
  - Consistency requirements:
    - a) Dominance (unanimity)
    - b) Transitivity
 
$$A \succ B, B \succ C \Rightarrow A \succ C$$

↑  
preferred to
    - c) Independence of Irrelevant Alternatives

$$A \succ B \succ C \not\Rightarrow$$

$$A \succ C \succ D \succ B$$

Example: Funding for schools

Case I:

	Parents	Elders	Young Couples
Preference ordering	H	L	M
	M	M	L
	L	H	H

$$P: H \succ M \succ L \quad E: L \succ M \succ H \quad YC: M \succ L \succ H$$

$$\left. \begin{array}{l} H \text{ vs } M: M \text{ wins} \\ M \text{ vs } L: M \text{ wins} \\ H \text{ vs } L: L \text{ wins} \end{array} \right\} \Rightarrow M \text{ wins}$$

Majority voting works

Case II:

Preference ordering	Parents for Public	Parents for Private	Young Couples
}	H	L	M
	M	H	L
	L	M	H

$H \text{ vs } L : L \succ H$   
 $H \text{ vs } M : H \succ M$   
 $L \text{ vs } M : L \succ M$

$\left. \begin{array}{l} L \succ H \\ H \succ M \end{array} \right\} \xRightarrow{\text{transitivity}} L \succ M$   
 $\otimes$  transitivity

cyclical outcome  $\uparrow$   
 Majority voting does not work  
 no matter what the order  
 of pairwise voting

Problem with setting the agenda  
 Agenda setter becomes a dictator

Arrow's Impossibility Theorem :

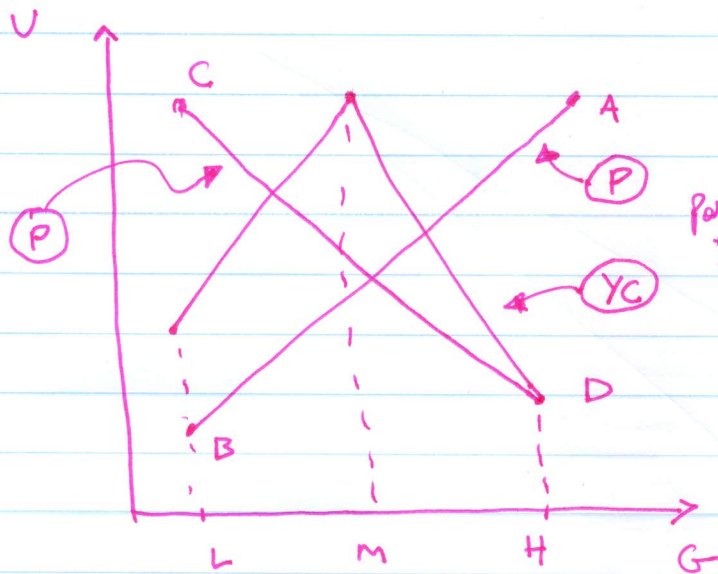
There is no social decision (voting) rule that converts individual preferences into a consistent aggregate decision without either (a) restricting preferences or (b) imposing dictatorship.



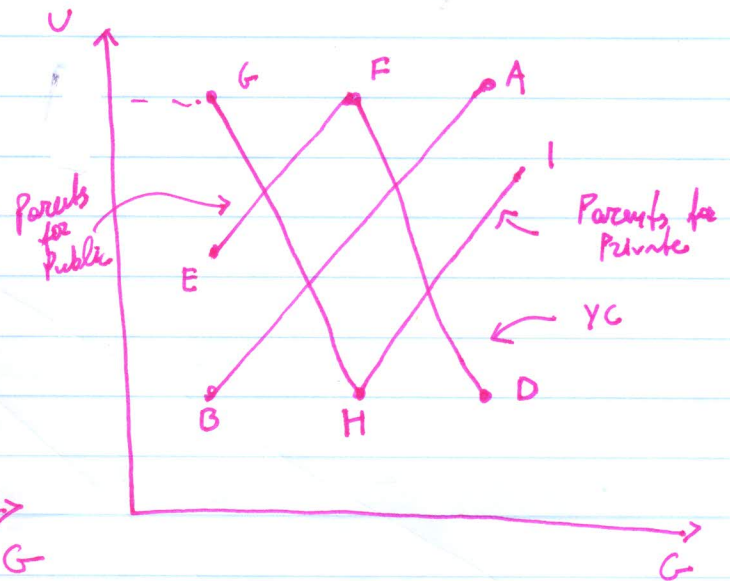
Welfare functions have problems

## Restricting Preferences (Singled-Peaked Preferences)

Singled-peaked preferences with only a single local maximum, or peak, so that utility falls as choices move away in any direction from that peak.



Singled-peaked



Case II: Not Singled-Peaked  
(Multi-peaked)

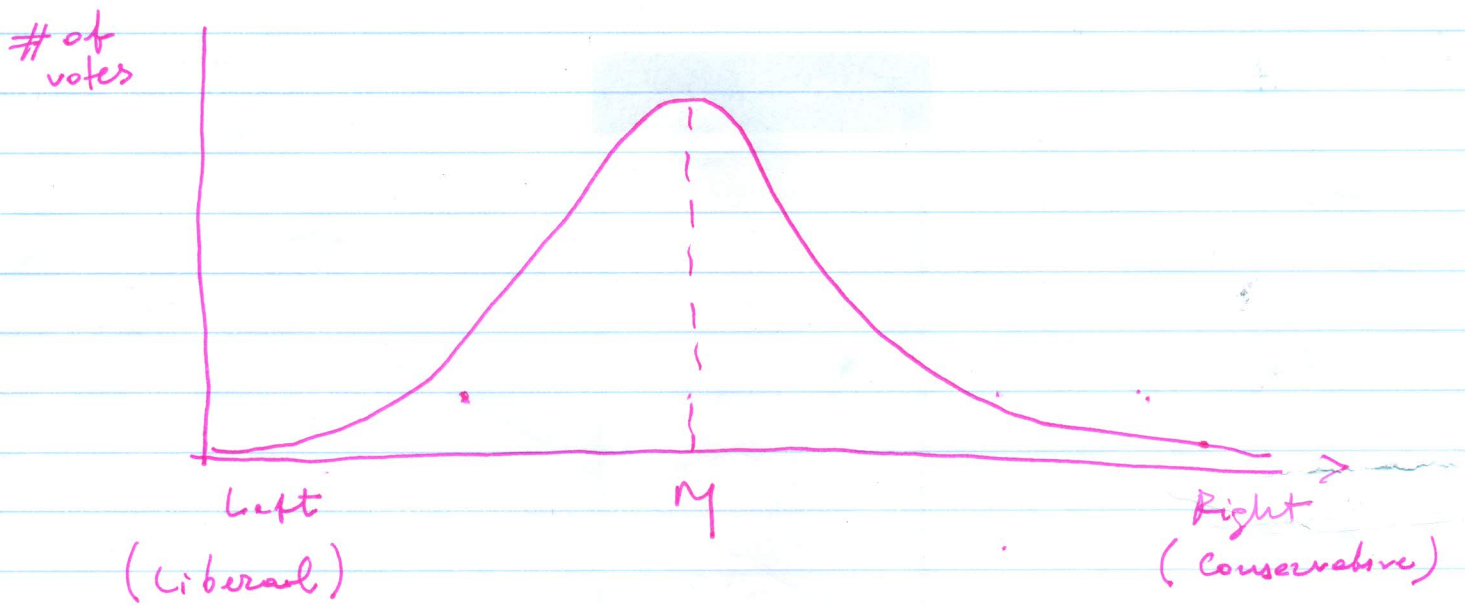
### Case I: Median-Voter Theorem

Majority voting will yield the outcome preferred by the median voter if preferences are singled-peaked.

Example: Minimum spending in Case I, above YC are the median voter  
(Actually, YC is the median voter in both examples, but Case II yields an inconsistent outcome).



## Median Voters Theorem for Elections (Downs)



ignores intensity of preferences ( $\Rightarrow$  ignores  $\sum MB_i$ )

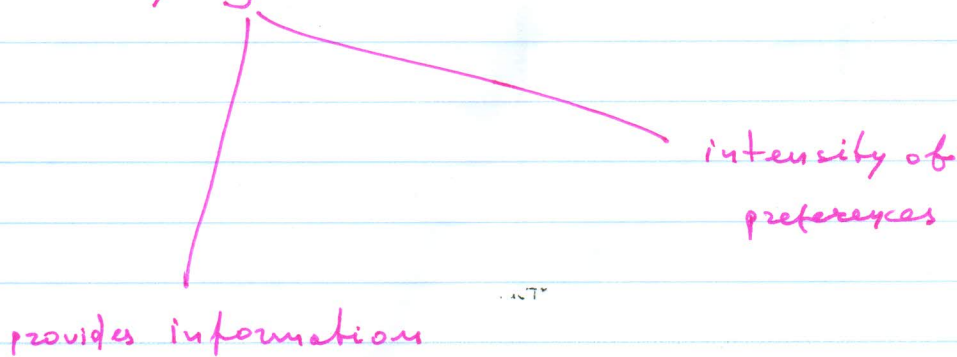
### III Representative Democracy

- Vote-maximizing politicians represent the median voter

Assumptions needed:

- 1) Single-dimensional voting (single issue is that matters)
- 2) Only two candidates
- 3) No ideology or influence (influence voters preferences)
- 4) No selective voting (extreme positions to mobilize groups of voters)
- 5) No money (influence voters preferences)
- 6) Full information

Lobbying:



But the free rider problem is greater in the large groups  $\Rightarrow$  Small groups may capture government (Mover Olson).

Example: farm subsidies

**Logrolling**: Systems that allow people to trade votes and hence may register their intensity of preferences. It can lead to efficient or inefficient outcomes

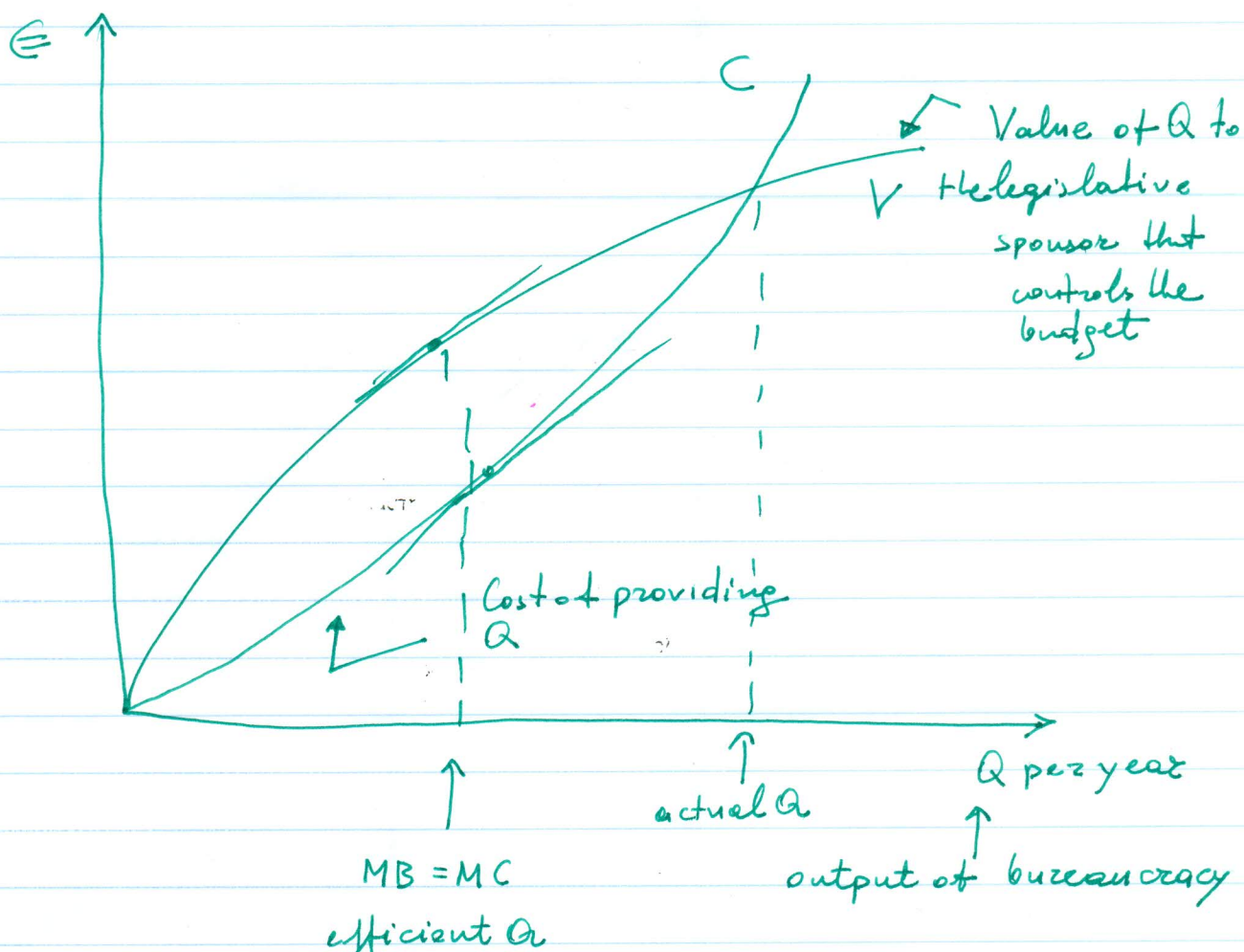


Public Choice Theory : School of Thought emphasizing that the government may not act to maximize the well-being of its citizens (government failure)

James Buchanan + Gordon Tullock in the 1950's

Sources of government failure :

- 1) Bureaucracy (William Niskanen, 1971) :  
Budget maximizing bureaucrat



Bureaucrats have incentives to spend resources to manipulate perceptions of the value of Q (i.e., to shift the V curve up)

Question raised:  
Private vs Public Provision?

Problems with Privatization (Scale economies)

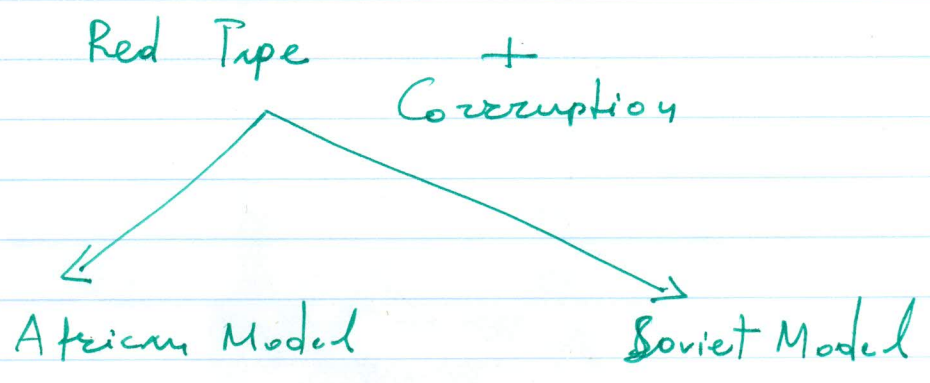
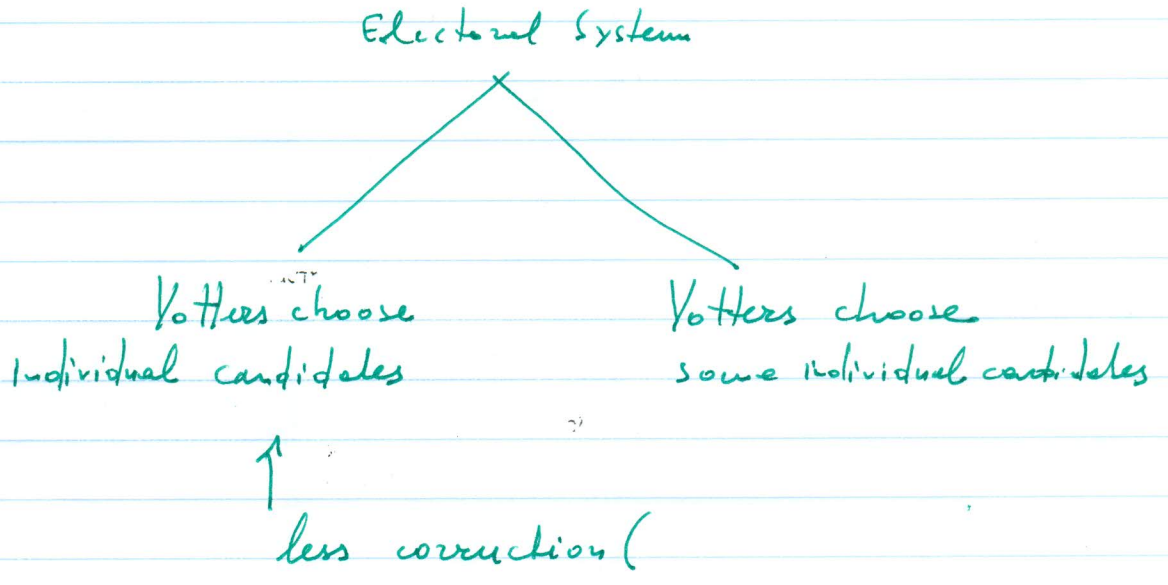
Contracting Out (Auctions)

Leviathan Theory (Government as One monopoly)

2) Corruption

George Ryan (Governor of Illinois) ~ 2003  
Carlos Menem (President of Argentina) 1989

Electoral accountability  
(Persson + Tabellini (2000))



# Government failure + Economic Growth

Daron Acemoglu + Robinson :

Institutions matter

	Income per capita	
	North Korea	South Korea
1950	\$ 770	\$ 770
2000	\$ 1200	\$ 12,200

K :

## Insiders - Outsiders Society

