Introduction to Political Economy

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How is economy policy made?

Voters

Political parties

Elections

Legislature/ executive

Policy choice

Lobbying

Special interest groups

Bureaucracy

Policy implementation

Actors in *italics*
Processes in **bold**
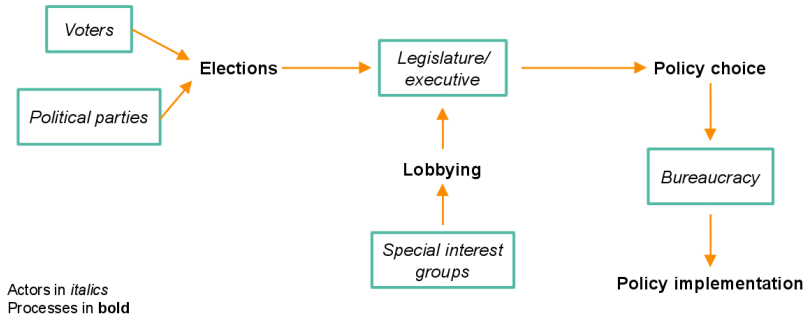
Political Economy

- *Economic* analysis of *non-market or social* decision making
  - application of economics to political science
- Distinctive features:
  - Assumes (mostly) rational behaviour by voters and policymakers
    - i.e. maximisation of some utility function
  - These people ("players") are assumed to interact ("play games") with well-defined rules:
    - the "rules of the game" are simplified versions of real-world constitutional rules
    - Relies on deductive reasoning, often using mathematical modelling
  - Intended to be universally applicable (i.e. to all democracies)

Dictatorship or Democracy?

- What is optimal, an enlightened monarch or a messy democracy?
  - a lot of value judgments in this type of question.
  - Political economists try to abstract away from value judgments with formal math.
- Acemoglu and Robinson (2004) provide a model in which a ruling oligarchy voluntarily implements democracy to avoid violent revolution.

The Peculiar Problem with Majority Voting

- 3 choices (A, B and C), 3 voters (1, 2 and 3):
  - Voter 1 prefers A to B and B to C (and therefore A to C)
  - Voter 2 prefers B to C and C to A (and therefore B to A)
  - Voter 3 prefers C to A and A to B (and therefore C to B)

- In pair-wise contests:
  - A wins agains B (1 and 3)
  - B wins against C (1 and 2)

- If A preferred to B, and B preferred to C, then is A preferred to C?
  - No: in a pairwise content, C wins against A (2 and 3)!

Moral Hazard Among Politicians

- Moral hazard:
  - when a politician takes a personally beneficial action that imposes undue costs or risks on the public.
- When voters cannot effectively monitor politician activities, politicians might divert resources to friends, or use more resources than is optimal.
  - Good politics is about avoiding moral hazard. Politicians can be constrained by institutions and electoral competition

Selecting Good Politicians

- Adverse selection:
  - when voters have imperfect information about candidate quality, they might choose the wrong candidate.
- Politician quality (competence and/or motivation) is heterogenous across politicians. Voters observe signals but not the truth.
  - Voters try to figure out who is good, and re-elect the good types
  - important role for transparency, and news media.

Electoral Rules

- How vote shares are translated into seat shares, typically, plurality rule/majoritarian or proportional representation:
  - Plurality, highest vote share gets the seat in a given district (USA or UK)
  - PR, seats in a given district are awarded in proportion to vote share obtained (Switzerland or Germany)

Forms of government

- ▶ Separation of powers: defines the allocation of powers between different offices over legislation and policy
    - ▶ Presidential (USA): powers are separated between President and legislature, as well as between legislative committees
    - ▶ Parliamentary (UK): powers concentrated in legislature

A basic model of elections

- ▶ Electoral competition between two opportunistic candidates
- ▶ Candidates make binding promises on taxes τ and government spending g
- ▶ Candidate platform options:
    - ▶ Please most voters ($\searrow \tau$ and broad-based g)
    - ▶ Please some voters (narrowly targeted g)
    - ▶ Please themselves ($\nearrow \tau$ and diverted g)

Voters

- Three equal-sized groups of voters, denoted $j = 1, 2, 3$.
- Preferences identical for all members, given by utility function

$$u_j = 1 - \tau + g(\tau - r)$$

  - $\tau \in [0, 1]$ is a fixed tax rate
  - $g(\cdot)$ is a concave function determining supply of a universal public good
  - $r \in [0, 1]$ is the politician rent siphoned off of taxes

Parties

- Two parties $p \in \{A, B\}$.
  - Parties are rent-motivated, not policy-motivated
- Before the elections, parties simultaneously commit to policy platforms
$$q_p = \{\tau_p, r_p\}$$

  - voters choose policy/party that gives highest utility.
    - Assume that when voter is indifferent, they choose randomly.

Party payoff from office

- Party receives $R + r$ from getting into office, where R is the benefit from holding office, and r is the siphoned-off rent. Party gets zero from losing, so always prefers to win.

- Party A maximises expected payoff:

$$\mathbb{E}[v_A] = p_A(q_A, q_B)(R + r_A)$$

  where $p_A(\cdot)$ is the probability that A wins
  - problem is symmetric for party B.

- if $u(q_A) > u(q_B)$ (party A gives more utility than party B), $p_A = 1$
- if $u(q_A) < u(q_B)$, $p_A = 0$
- if $u(q_A) = u(q_B)$, $p_A = .5$

Party Optimization

- If other party provides more utility, I will change to replicate their policy.

- If other party provides same utility, and a policy with higher utility exists, I will change to that policy.

- If other party provides same utility, but no policy with higher utility exists, I will keep my current policy.

Equilibrium

▶ In equilibrium, both parties supply same utility, and voter utility is maximized:

    ▶ $r = 0$, because if other party has $r > 0$, setting $r = 0$ increases voter utility.

    ▶ the winning τ^* maximizes voter utility (i.e., $g'(\tau^*) = 1$)

► What are some limitations of this basic model?