Introduction to Political Economy

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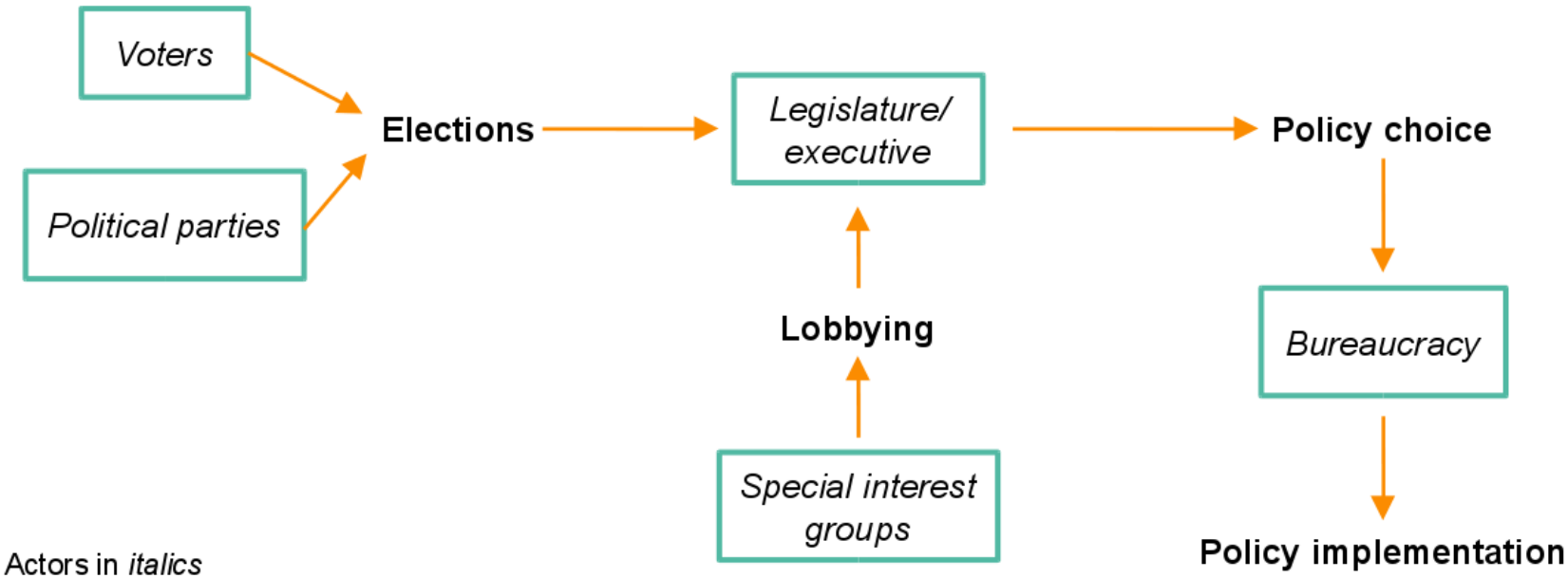
October 8, 2018

Outline

How is economy policy made?



Actors in *italics*
Processes in **bold**

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    - 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)

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  - 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.

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  - B wins against C (1 and 2)
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- 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)!

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  - 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

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  - 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

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  - Presidential (USA): powers are separated between President and legislature, as well as between legislative committees
  - Parliamentary (UK): powers concentrated in legislature

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- 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

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  - 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

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- 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 $u(q_A) = u(q_B)$, $p_A = .5$

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- 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?