

Political Economy

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Political Economy

Political Economy is the positive analysis of government: why do governments do what they do?

In democracies, citizens vote to elect politicians to run the government

In principle, government decisions should reflect the will of citizens

Even non-democratic rulers are in part subject to people's preferences (threat of revolts)

MAJORITY VOTING: WHEN IT WORKS

Majority voting: Mechanism used to aggregate individual votes into a social decision: individual policy options are put to a vote and the option that receives the majority of votes is chosen

Majority voting can produce a consistent aggregation of individual preferences only if preferences are restricted to take a certain form

Example: funding for local public schools using property taxes could be chosen as high (H), medium (M), or low (L)

9.2

Majority Voting: When It Works

- There are three types of voters in a town: *parents*, *elders*, and *young couples without children*.
- They have different preferences over the level of school spending (high, medium, or low).

	Parents (33.3%)	Elders (33.3%)	Young Couples (33.3%)
First choice	<i>H</i>	<i>L</i>	<i>M</i>
Second choice	<i>M</i>	<i>M</i>	<i>L</i>
Third choice	<i>L</i>	<i>H</i>	<i>H</i>

MAJORITY VOTING: WHEN IT WORKS

The town could proceed as follows:

- Vote on funding level H versus funding level L: L wins H
- Vote on funding level H versus funding level M: M wins H
- Vote on funding level L versus funding level M: M wins L

M has beaten both H and L so M is the overall winner.

Majority voting has aggregated individual preferences to produce a preferred social outcome: medium school spending and taxes.

9.2

Majority Voting: When It Doesn't Work

- **Cycling:** When majority voting does not deliver a consistent aggregation of individual preferences.

	Public school parents (33.3%)	Private school parents (33.3%)	Young Couples (33.3%)
First choice	<i>H</i>	<i>L</i>	<i>M</i>
Second choice	<i>M</i>	<i>H</i>	<i>L</i>
Third choice	<i>L</i>	<i>M</i>	<i>H</i>

MAJORITY VOTING: WHEN IT DOES NOT WORK

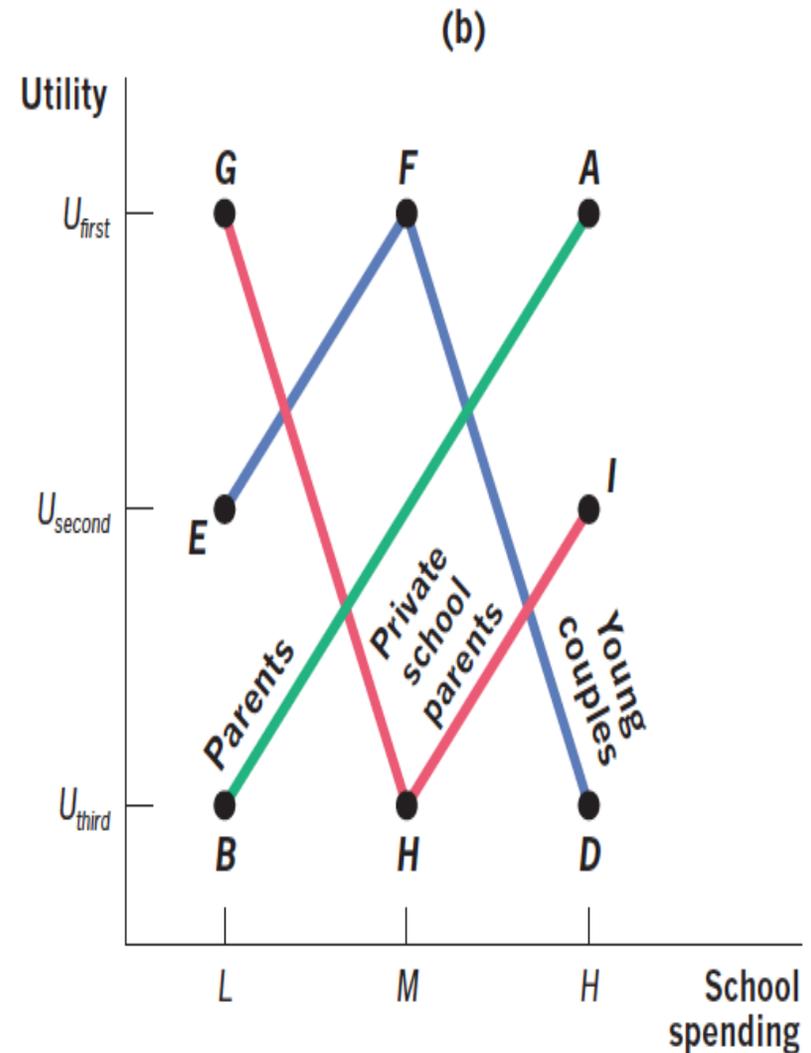
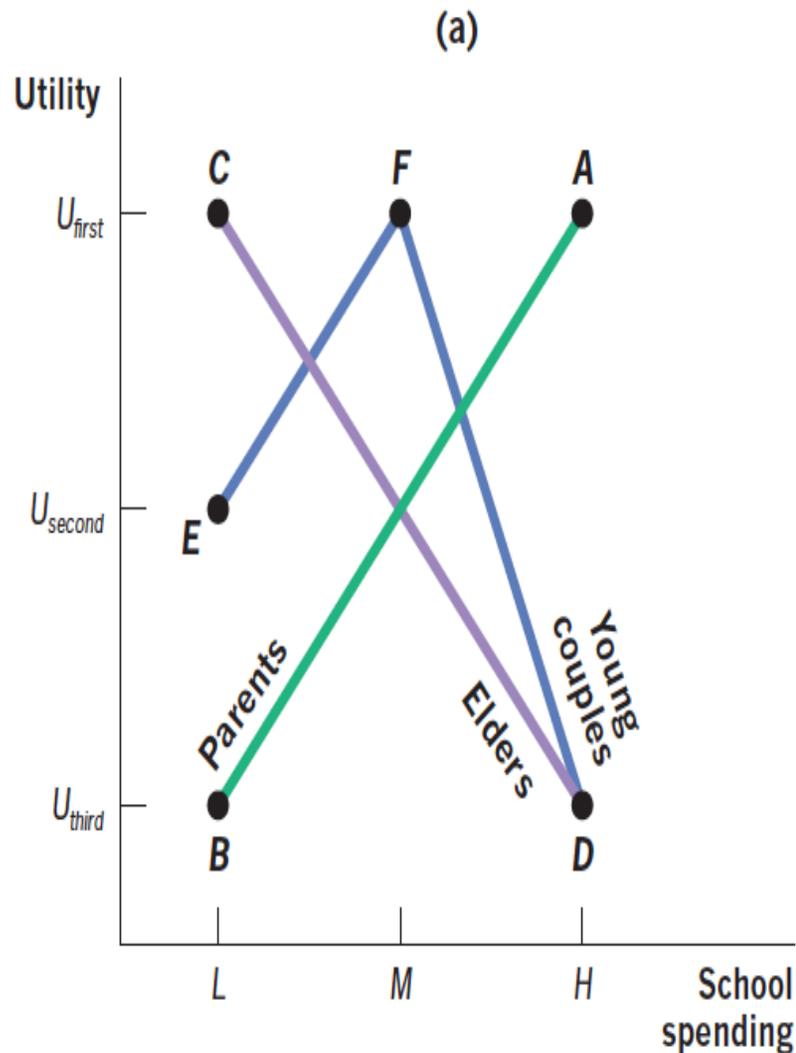
- Vote on funding level H versus funding level L: L wins H
- Vote on funding level H versus funding level M: H wins M
- Vote on funding level L versus funding level M: M wins L

Cycle with no clear winner.

Majority voting is unable to aggregate preferences in a meaningful way in that case

9.2

Single-Peaked versus Non-Single-Peaked Preferences



MEDIAN VOTER THEOREM

Consider choice along a single dimension (e.g., funding level)

Single peaked preferences: Each individual preferences for funding increase and then decrease (always increasing, or always decreasing also considered single peaked). Peak is preferred funding level for the individual.

Median voter is the voter whose peak is at the median (half have lower peaks, half have higher peaks)

Voting Equilibrium (or Condorcet winner) is an outcome that wins in majority voting against any other alternative

Median Voter Theorem: Peak of median voter is a voting equilibrium

⇒ Elected official should represent view of median voter

PROOF OF MEDIAN VOTER THEOREM

Let $a_1 < \dots < a_{median} < \dots < a_I$ be the peaks of individuals $1, \dots, I$

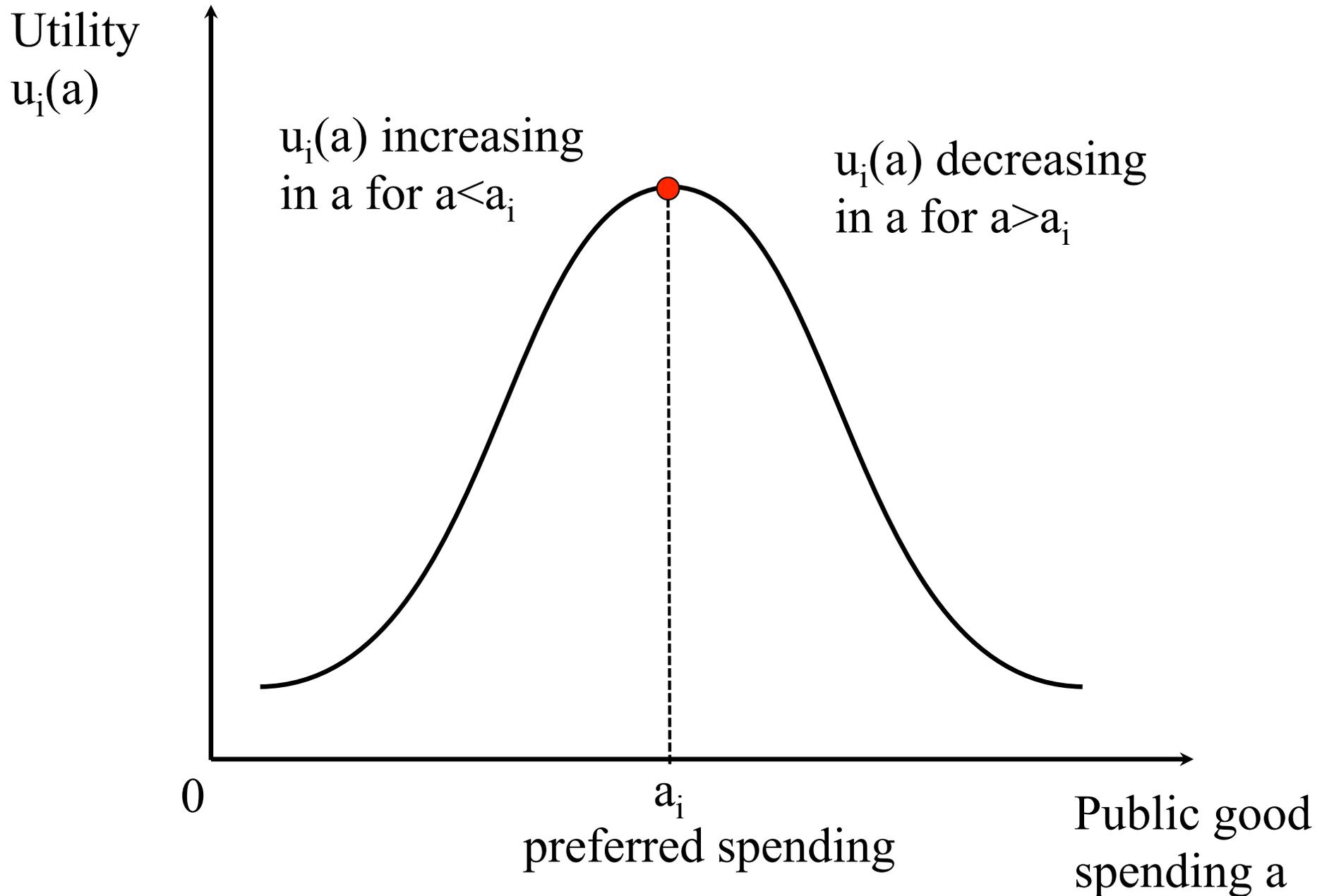
Suppose vote between a_{median} and a^* with $a_{median} < a^*$

a_{median} wins because $i = 1, \dots, median$ all prefer a_{median} to a^*
(because they all have decreasing preferences for a beyond a_{median})

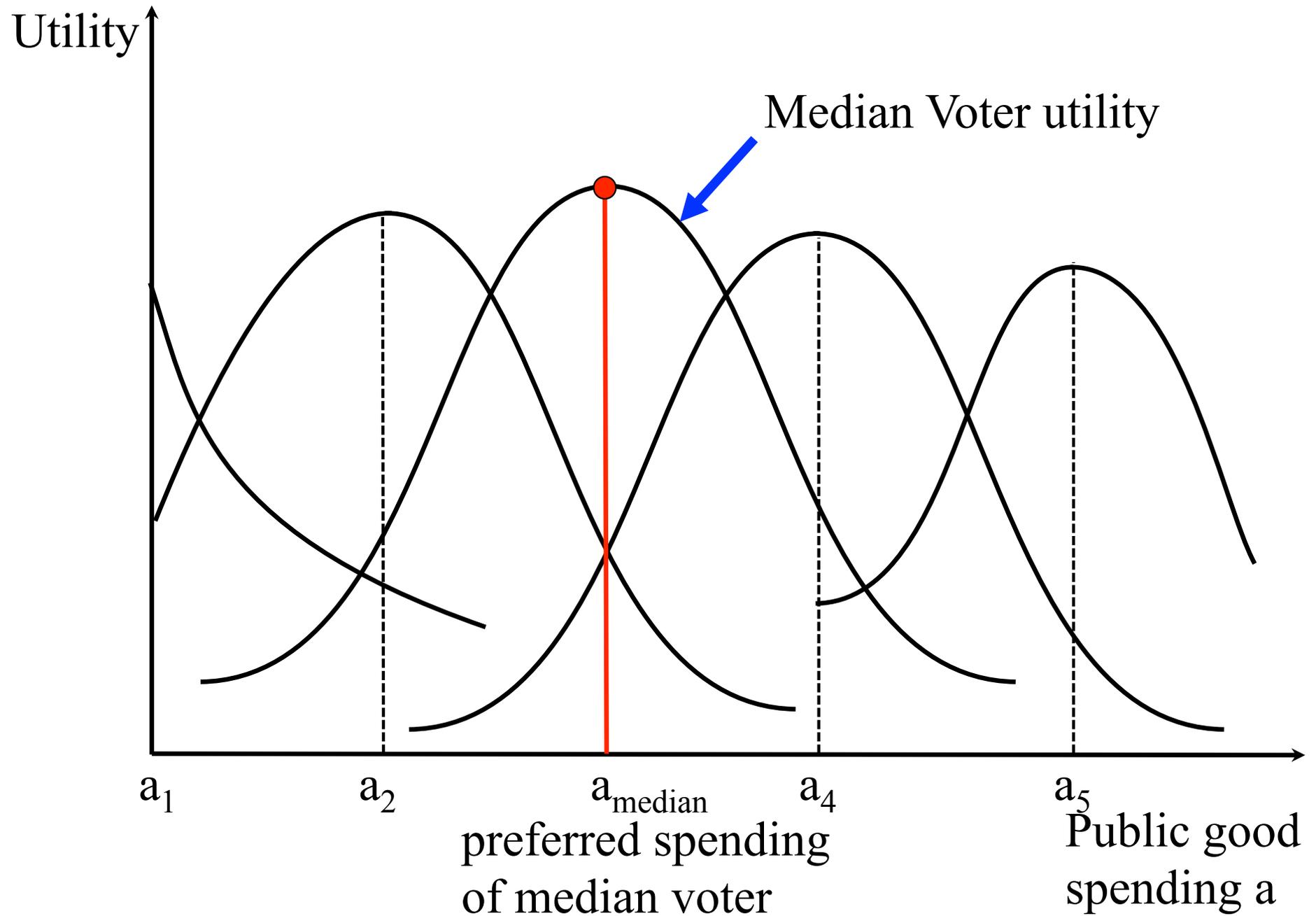
Symmetrically a_{median} wins against $a^* < a_{median}$ because $i = median, \dots, I$ prefer a_{median} to a^*

Median voter outcome from majority voting is very useful and a hugely influential result in the political economy literature

Single Peaked Preferences



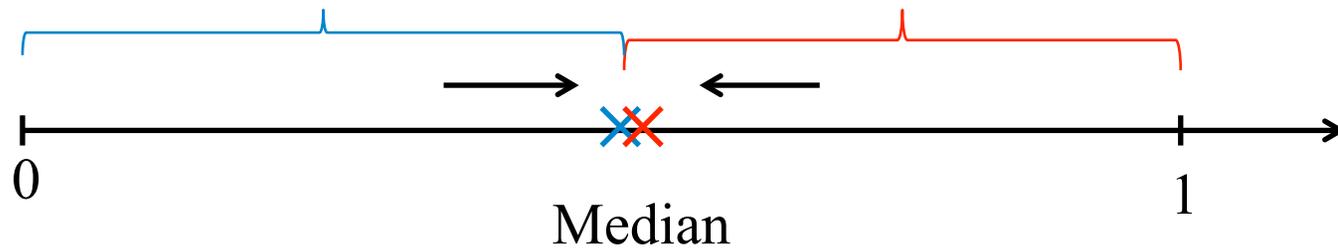
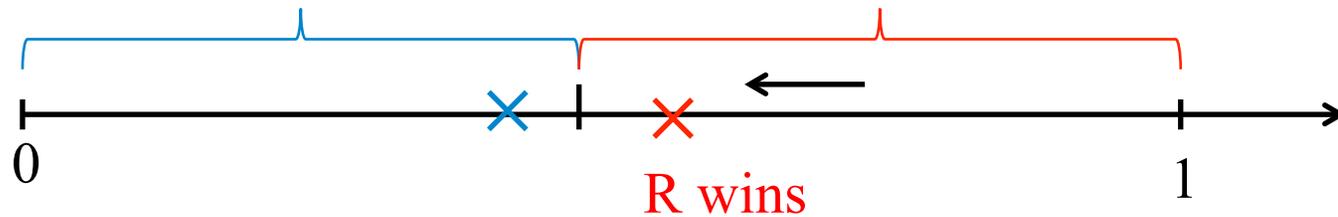
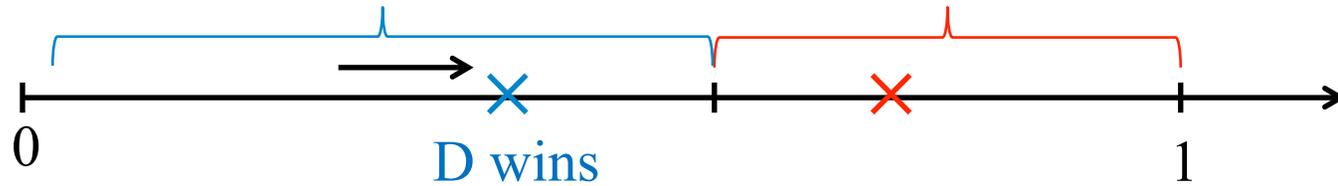
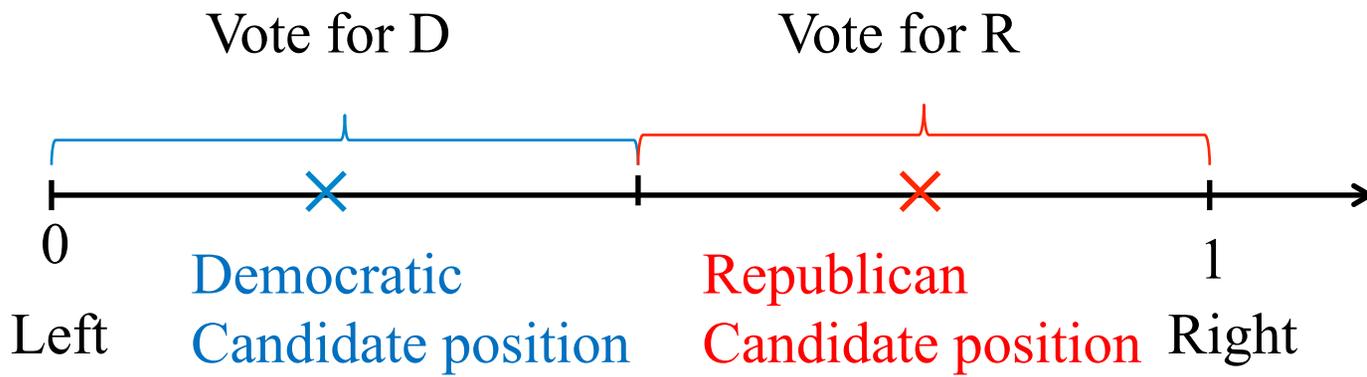
Median Voter Theorem



QUIZ ON MEDIAN VOTER THEOREM

Which one of these is true about the median voter theorem?

- A. Median voter peak represents the centrist view which is the most balanced
- B. Median voter peak represents the centrist view which averages diverse views in society
- C. Median voter peak is a vote winner
- D. All of the above
- E. None of the above



Both candidates positions converge to median

ABSTRACT SOCIAL CHOICE PROBLEM

$n = 1, \dots, N$ possible choices society can make

$i = 1, \dots, I$ individuals have preferences \prec_i over the N choices

Social decision rule: It aggregates individuals preferences $(\prec_i)_{i=1, \dots, I}$ into a social preference \prec_S over N choices that satisfies 3 key properties:

1) Pareto Dominance: if $a \prec_i b$ for all i then $a \prec_S b$

2) Transitivity: if $a \prec_S b$ and $b \prec_S c$ then $a \prec_S c$

3) Independence of irrelevant alternatives: whether $a \prec_S b$ or $a \succ_S b$ depends only on how individuals rank a vs. b (and not any other alternative).

3) rules out “ranking effects”. Focus is solely on which/how many individuals prefer a to b rather than whether some individuals prefer a to b slightly vs. a lot.

ABSTRACT SOCIAL CHOICE PROBLEM

ARROW'S IMPOSSIBILITY THEOREM: There is no social decision rule that converts individual preferences into a consistent aggregate decision without either

(a) restricting preferences or

(b) imposing dictatorship (i.e. $\langle_S = \langle_i$ for some "dictator" i)

Geanakoplos (2005) provides simple proofs

This result was very influential and shows that the abstract social choice problem cannot have a general solution

Most common solutions are to:

(1) restrict preferences to single peaked preferences (median voter thm)

(2) let intensity of preferences play a role (social welfare function and Samuelson rule for efficiency)

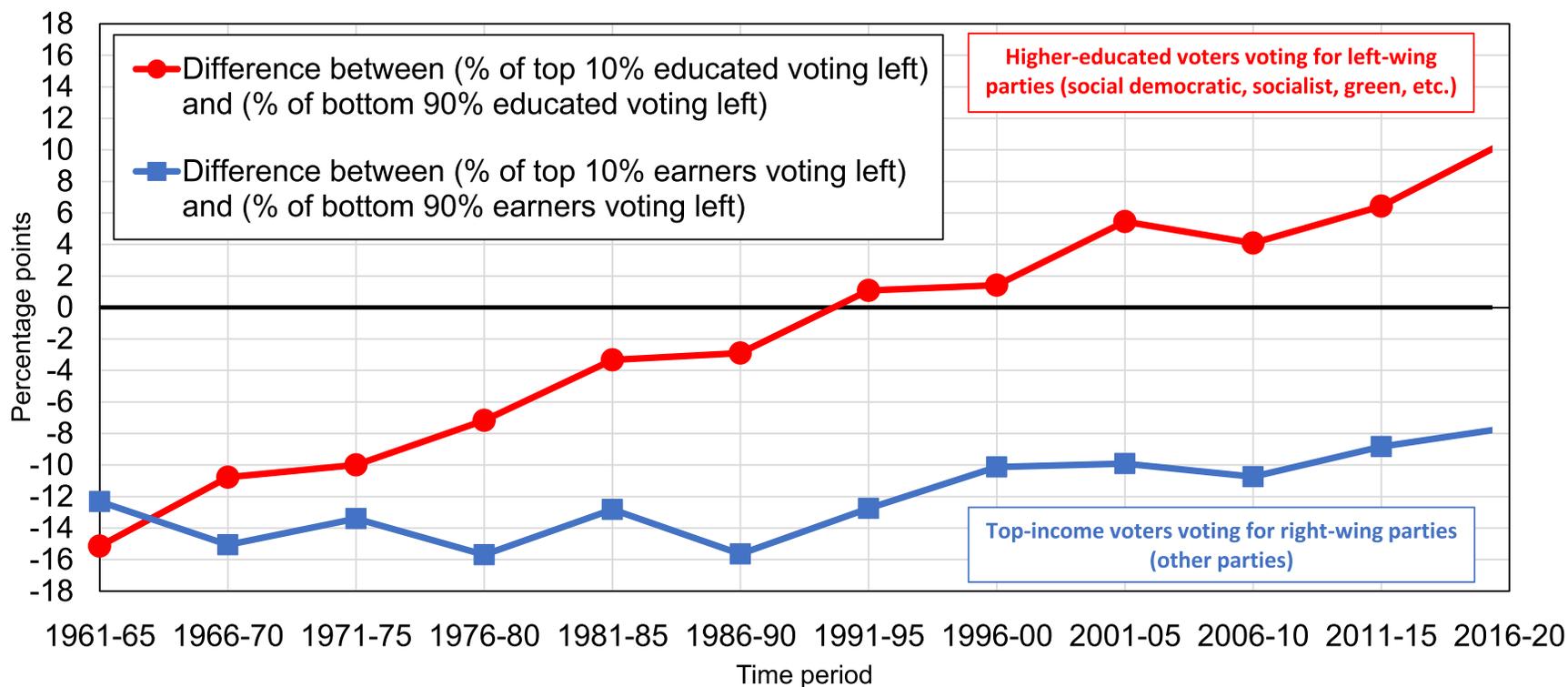
ASSUMPTIONS OF THE MEDIAN VOTER MODEL

Median voter theorem makes a number of assumptions:

1) Single-dimensional Voting: Median voter theorem breaks down with multiple dimensions. Western Democracies aligned along single socio-econ cleavage in the 1960s, but multiple cleavages today: income cleavage vs. education cleavage (right-wing populists, see Gethin, Piketty, Toledano 22)

2) Only Two Candidates: Median voter theorem breaks down with 3+ candidates. No stable equilibrium in the model with three or more candidates because there is always an incentive to move in response to your opponents' positions.

3) No Selective Voting: The median voter theory assumes that all people affected by public goods vote, but in fact, only a fraction of citizens vote in the United States. Appealing to the base (by moving away from median voter) is a way to increase turnout.



Source: Guethin, Piketty, Toledano 2022

FIGURE I

The Disconnection of Income and Education Cleavages in Western Democracies

In the 1960s, higher-educated and high-income voters were less likely to vote for left-wing (social democratic/socialist/communist/green/other left-wing) parties than were lower-educated and low-income voters by more than 10 percentage points. The left vote has gradually become associated with higher education voters, giving rising to a complete divergence of the effects of income and education on the vote. Figures correspond to five-year averages for Australia, Britain, Canada, Denmark, France, Germany, Italy, the Netherlands, Norway, Sweden, Switzerland, and the United States. Estimates control for income/education, age, gender, religion, church attendance, rural/urban, region, race/ethnicity, employment status, and marital status (in country-years for which these variables are available). Data from World Political Cleavages and Inequality Database.

ASSUMPTIONS OF THE MEDIAN VOTER MODEL

4) No Money

The median voter theory ignores the role of money as a tool of influence in elections.

If taking an extreme position on a given topic maximizes fundraising, even if it does not directly maximize votes on that topic, it may serve the long-run interests of overall vote maximization by allowing the candidate to advertise more strongly.

5) Full Information

The median voter model assumes perfect information of: (1) voter knowledge of the issues; (2) politician knowledge of the issues; (3) politician knowledge of voter preferences.

All these assumptions are unrealistic.

EVIDENCE ON THE MEDIAN VOTER MODEL FOR REPRESENTATIVE DEMOCRACY

While the median voter model is a potentially powerful tool of political economy, its premise rests on some strong assumptions that may not be valid in the real world.

A large political economy literature has tested the median voter model by assessing the role of voter preferences on legislative voting behavior relative to other factors such as party or personal ideology.

In principle, candidates should adjust their position toward the median voter to win the election (see graph above)

⇒ Elected officials should represent the view of the median voter in their district

TESTING THE MEDIAN VOTER MODEL

Evidence from US congress representatives:

1) Senate: 2 senators for each state in US senate: represent the same constituency and hence should vote in the same way in the senate if median voter model is right (Poole and Rosenthal, '96)

Yet, in the US, when a state has 1 republican senator and 1 democratic senator, those 2 senators vote very differently in the senate (contradicts the median voter model)

Recent example: Joe Manchin (D) and Shelley Capito (R) are senators from West Virginia and vote very differently

TESTING THE MEDIAN VOTER MODEL

2) House of Representatives: Using close elections for US representatives (Lee, Moretti, Butler QJE'04):

When a candidate crosses 50%, he/she gets elected. However, the constituency is virtually the same whether a candidate gets 49.9% or 50.1% of the vote.

Therefore, median voter implies that a Democratic representative elected with 50.1% should vote similarly in congress to a Republican representative elected with 50.1% of the votes.

Yet, in reality, closely elected representatives vote very differently (measured by Americans for Democratic Action ADA scores) if they are Democratic vs. Republican

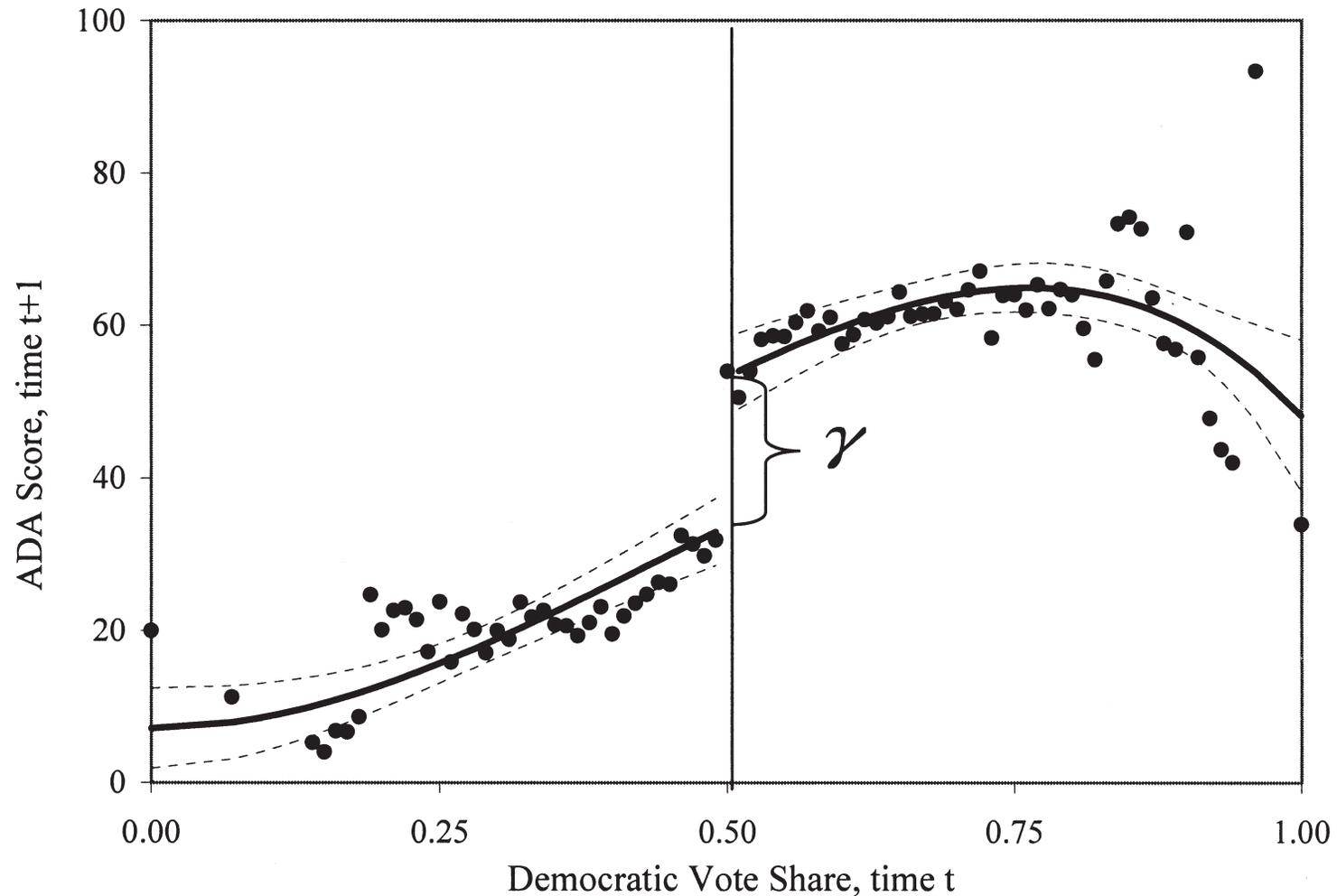


FIGURE I

Total Effect of Initial Win on Future ADA Scores: γ

This figure plots ADA scores after the election at time $t + 1$ against the Democrat vote share, time t . Each circle is the average ADA score within 0.01 intervals of the Democrat vote share. Solid lines are fitted values from fourth-order polynomial regressions on either side of the discontinuity. Dotted lines are pointwise 95 percent confidence intervals. The discontinuity gap estimates

$$\gamma = \underbrace{\pi_0(P_{t+1}^{*D} - P_{t+1}^{*R})}_{\text{"Affect"}} + \underbrace{\pi_1(P_{t+1}^{*D} - P_{t+1}^{*R})}_{\text{"Elect"}}.$$

Source: Lee, Moretti, Butler

MEDIAN VOTER AND EFFICIENCY

Efficiency for public goods requires the Samuelson rule

\sum social marginal benefits = social marginal costs

\Rightarrow Public good is worth providing if \sum benefits $>$ costs

What matters for efficiency is the **average** marginal benefit across individuals and not the **median** marginal benefit

\Rightarrow Median outcome is not efficient unless Median = Average (not true in general)

Example: bridge project would serve 10 people. 6 people value bridge at \$50, 4 people value bridge at \$100. Total social value of bridge is \$700 = $6 \cdot 50 + 4 \cdot 100$

Suppose cost is \$60 per person so total cost = \$600 = $\$60 \cdot 10$.

Mean net benefit is $70 - 60 = \$10$, median net benefit is $50 - 60 = -\$10$

Project is socially desirable but is opposed by 6 people to 4 in majority voting \Rightarrow Median voter leads to an inefficient outcome

LOBBYING

Lobbying: The expending of resources by certain individuals or groups in an attempt to influence a politician

In principle, lobbying could correct inefficiencies due to median voter theorem: those who really want the bridge pay politicians who can provide transfers to those who don't want the bridge as much and get it built

However, lobbying can also lead to inefficiencies if public does not have perfect information and hence does not care to pay attention

Example: 5 people value bridge net of cost at \$100, 100 people value bridge net of cost at -\$6. Median voter does not produce the bridge (the socially desirable outcome)

However, 5 people have strong incentives to lobby and may get the project approved (if the 100 do not pay attention)

Quiz on vote

Which system do you find best for elections of government officials?

- A. 1 person = 1 vote as voting rights should be equalized
- B. 1 person gets 1 vote but can sell his/her vote to another voter if both find it beneficial
- C. \$1 paid in tax = 1 vote because government is about raising taxes and to fund government program so larger taxpayers should have more say

1 person = 1 vote vs. \$1 = 1 vote

Voting rights: Democracy gives each person one vote regardless of how much they care and value alternatives

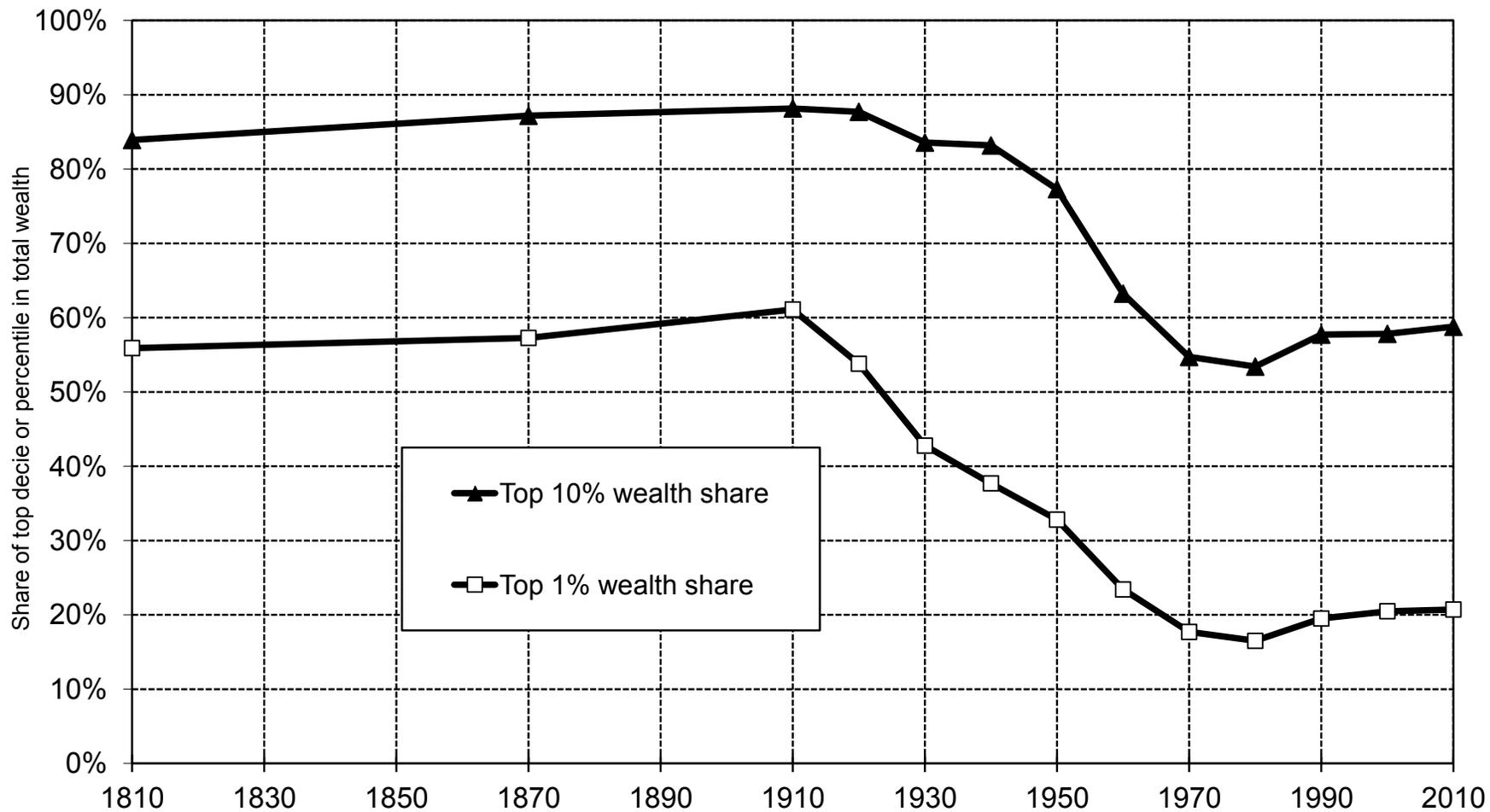
Narrow economic view: this can be inefficient (bridge example) \Rightarrow We should allow people to trade votes \Rightarrow Creating this missing market can make everybody better off

Vote trading would allow the rich to buy elections (much more cheaply/effectively than campaign donations) \Rightarrow Democracy (1 person = 1 vote) becomes a Plutocracy (\$1 = 1 vote)

Early democracies tied voting rights to taxes paid (often called poll taxes). Sweden had votes proportional to taxes paid before 1900 \Rightarrow Govt policies favorable to the rich (Piketty 2020)

Protecting voting rights and regulating political contributions are important aspects of democracy

Figure 3.4. Wealth inequality in Sweden, 1810-2010



The top 10% holds 80-90% of total wealth in 1810-1910, and 55-60% today.

PUBLIC CHOICE THEORY: THE FOUNDATIONS OF GOVERNMENT FAILURE

Public choice theory: Government may not act to maximize the well-being of its citizens.

Government failure: The inability or unwillingness of the government to act primarily in the interest of its citizens.

Two examples:

1) Dictatorship: Dictator runs country for his own benefit (personalist dictatorship), family (absolute monarchy), or his party (one-party/military dictatorship), not all citizens

2) Bureaucracies: Organizations of civil servants that are in charge of carrying out the services of government but may follow their self-interest

LEVIATHAN THEORY

Under this theory, voters cannot trust the government to spend their tax dollars efficiently and must design ways to combat government overreach.

This view of government can explain the many rules in place in the United States and elsewhere that explicitly tie the government's hands in terms of taxes and spending.

Famous example: Proposition 13 passed by voters in California in 1978 sharply limits ability of CA legislature to increase taxes (needs a 2/3 super majority of both senate and assembly) and sets a 1% cap on the real estate property tax rate.

Historically in democracies: limiting government power was a conservative cause. With the rise of authoritarian regimes, it may become again a progressive cause.

PUBLIC VS. PRIVATE PROVISION

Are goods and services provided more efficiently by the public or the private sector? (Cohen-Mikaelian 2021)

1) With competition, private production is more innovative and efficient but govt provision or regulation make sense for natural monopolies (e.g. utilities: water, energy, broadband)

2) For goods that consumers do not understand well (pensions, health insurance, education), private competition can lead to wasteful advertising or scamming

Private firms compete using enticing and costly advertising rather than underlying product quality \Rightarrow higher costs than public provision

3) In emergency situations (covid), govt command and control beats market to allocate resources (e.g. vaccine distribution)

4) Not-for-profit is an intermediate solution (e.g. education) more innovative than govt and not as predatory as for-profit

Do Government Failures Affect Economic Growth?

Studies that suggest that poor government structure can have long-lasting negative impacts on economic growth

1) Effect of current institutions (Acemoglu and Robinson 2012):

North and South Korea had similar economies when they split in 1948 but South Korea is now more than 10 times richer per capita than North ⇒ Government policies/failures can have a huge impact

Conclusion of Acemoglu-Robinson: countries with “inclusive governments” (extending political and property rights broadly) grow faster than countries with “extractive governments” (power held by small self-serving elite)

2) Long-term consequences of institutions:

Acemoglu, Johnson, Robinson (2001) showed that places where European colonists settled instead of just extracting (settlers' mortality instrument) have experienced better economic development. Hugely influential study.

Dell (2010) shows long-run negative impacts of mita (forced labor mining in 16-17th century in a region of Peru) on stunting and consumption **today** using comparisons across old mita borders

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