

Microeconomics

Web Chapter 3
Political
Economy

Acemoglu Laibson List

Modified by Joseph Tao-yi Wang

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Chapter Outline

W3.1. **Conflict of Interest** and **Political Economy**

- ▶ Do governments and politicians follow their citizens' and constituencies' wishes?

W3.2. Does **Democracy** Work?

W3.3. Controlling Politicians

W3.4. **Market Failure** vs. **Government Failure** from a Political Economy Perspective

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Key Ideas

1. Because the economic preferences and views of citizens are often opposed,
 - ▶ **conflicts of interest over government policies are inevitable.**
2. The Median Voter Theorem stresses the moderating influence of the median voter,
 - ▶ **who is the voter with the political bliss point (most preferred policy) in the middle of the distribution of political bliss points among voters.**

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Key Ideas

3. In the presence of perfect political competition, which allows political candidates representing different options to freely enter and compete in elections,
 - ▶ **there will be a tendency for parties to converge toward the median voter's political bliss point.**
4. In practice, politicians often do not follow the wishes of the median voter or the electorate.

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Key Ideas

5. Some elected officials are politically corrupt in that they use the advantages of their office to engage in illegal and unethical actions that benefit or enrich themselves.

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Conflict of Interest & Political Economy

- ▶ **Question:** What determines whether, in practice, governments work for the public good or toward different objectives?
- ▶ **Answer:** It is difficult to answer this question
- ▶ when some individuals and groups will **benefit** from a government policy and will thus **favor** it,
- ▶ while others will be **harmed** by that policy and thus will **oppose** it.
- ▶ **Ex:** Tax to fund national parks, universities, etc.

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Conflict of Interest & Political Economy

- ▶ As a result, we say that there is a
- ▶ **conflict of interest** when there are
 - ▶ opposing preferences concerning policies between individuals or groups.
- ▶ In most instances, there are
 - ▶ winners and losers from each feasible policy,
 - ▶ creating conflict of interest over policy choices.

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Conflict of Interest & Political Economy

- ▶ **Political economy** is the study of
 1. the conflict of interest between individuals and groups,
 2. how this conflict is resolved, and
 3. how citizens influence government policy and control politicians.
- ▶ Political economy also studies
 1. to what extent governments, politicians, and bureaucrats respond to these preferences and
 2. how they can be made more responsive.

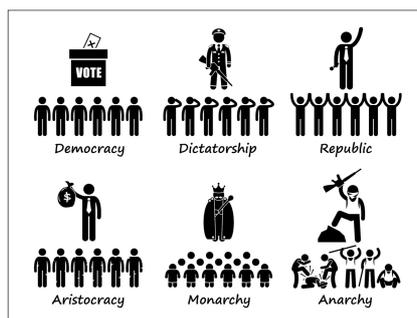
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There are many different types of governments.



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- ▶ **Representative democracy** is
 - ▶ a political system in which public officials are democratically elected and empowered to act on behalf of the citizens.
- ▶ A **dictatorship** is
 - ▶ a regime ruled by a single dictator or a small junta consisting of a small group of soldiers or rulers.

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Conflict of Interest & Political Economy

- ▶ In a dictatorship, there are no elections,
 - ▶ and thus dictators often pursue policies for their own interests and not those of their citizens.
- ▶ In a representative democracy, leaders can be voted out of office
 - ▶ if the citizens are not satisfied with their performance or if a better candidate emerges.

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- ▶ **Question:** Does voting deliver policies that citizens, or at least a large fraction of them, would agree with?
- ▶ **Caveat:** We first need to think about the preferences of citizens when there is a potential conflict of interest among them.

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Preferences are **transitive** if an individual prefers choice *a* to choice *b* and choice *b* to choice *c*; then she prefers choice *a* to choice *c*.

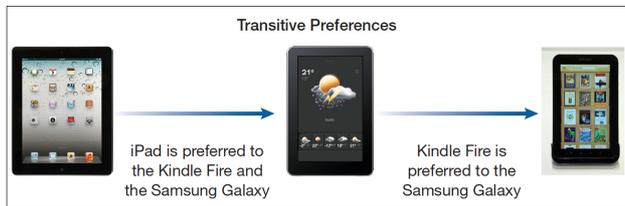


Exhibit W3.1 Transitive and Non-Transitive Preferences, Panel (a)

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Preferences are **non-transitive** if an individual prefers choice *a* to choice *b* and choice *b* to choice *c*; then she does **not** prefer choice *a* to choice *c*.

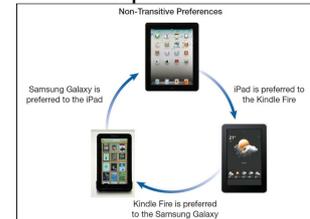


Exhibit W3.1 Transitive and Non-Transitive Preferences, Panel (b)

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- ▶ The French mathematician and philosopher **Marquis de Condorcet** found that
 - ▶ transitivity is not guaranteed when a society makes decisions by voting.
- ▶ The **Condorcet Paradox** refers to
 - ▶ the failure of transitivity in collective preferences implied by voting behavior.

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- ▶ Question: Who votes for what policy in each of the three choices:
 1. Low taxes versus intermediate taxes
 2. Intermediate taxes versus high taxes
 3. Low taxes versus high taxes

	Most preferred	In between	Least preferred
Adam	High taxes	Intermediate taxes	Low taxes
Bob	Low taxes	High taxes	Intermediate taxes
Charlie	Intermediate taxes	Low taxes	High taxes

Exhibit W3.2 Policy Preferences of Adam, Bob, and Charlie

Conflict of Interest & Political Economy

1. Adam and Charlie vote for **intermediate taxes**, and Bob votes for **low taxes**.
2. Adam and Bob vote for **high taxes**, and Charlie votes for **intermediate taxes**.
3. Bob and Charlie vote for **low taxes**, and Adam votes for **high taxes**.

	Most preferred	In between	Least preferred
Adam	High taxes	Intermediate taxes	Low taxes
Bob	Low taxes	High taxes	Intermediate taxes
Charlie	Intermediate taxes	Low taxes	High taxes

Exhibit W3.2 Policy Preferences of Adam, Bob, and Charlie

Conflict of Interest & Political Economy

- ▶ The Implications:
 - ▶ This result amounts to a lack of transitivity in the **collective** preferences implied by voting.
- ▶ Society preferred
 - ▶ high taxes over intermediate taxes and
 - ▶ intermediate taxes over low taxes,
 - ▶ but it preferred low taxes over high taxes.

Conflict of Interest & Political Economy

- ▶ **Question:** Should we expect non-transitivity in voting to occur?
- ▶ **Answer 1:**
- ▶ Nobel Laureate Kenneth Arrow shows that
 - ▶ if we do not put some more structure on individual preferences,
 - ▶ the Condorcet Paradox is far from unusual.

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- ▶ **Arrow Impossibility Theorem** argues that
 - ▶ any reasonable voting scheme should satisfy the following three conditions:
 1. **Unanimity:**
 - ▶ If all voters prefer A to B, then A is selected.
 2. **Transitivity** (see above)
 3. **Independence of Irrelevant Alternatives:**
 - ▶ preferences of voters concerning the comparison of A & B against third option C, should have no bearing on the outcome of the vote.

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- ▶ **The result of Arrow's Impossibility Theorem:**
- ▶ the only way of designing a voting scheme that always satisfies the three conditions is to **accept the existence of a dictator**.
 - ▶ Put differently,
- ▶ We cannot find a voting scheme that satisfies the three conditions
 - ▶ and the additional requirement that there should be no dictator.

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- ▶ **Question:** Should we expect non-transitivity in voting to occur?
- ▶ **Answer 2:** If preferences are **single-peaked**, then the Condorcet Paradox will not hold, and thus **transitivity will occur**.
 - ▶ An individual's policy preferences are **single-peaked** if he or she prefers policies closer to his or her **political bliss point** to those that are farther away.

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Conflict of Interest & Political Economy

- ▶ The **political bliss point** of an individual is his or her **most preferred policy option**:
 1. High taxes for Adam
 2. Low taxes for Bob
 3. Intermediate taxes for Charlie
- ▶ What about policies that are **close to** and **far from** the political bliss point?

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1. Low taxes versus intermediate taxes
2. Intermediate taxes versus high taxes
3. Low taxes versus high taxes

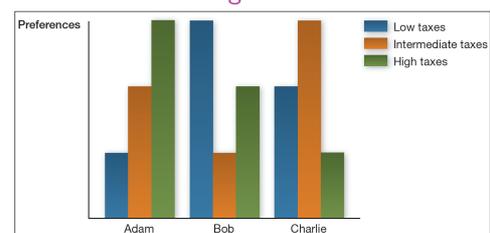


Exhibit W3.3 Policy Preferences of Adam, Bob, and Charlie

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- ▶ **Single-peaked:** prefers policies closer to his or her political bliss point to those farther away.
- ▶ **Question:** whose preferences are single-peaked?

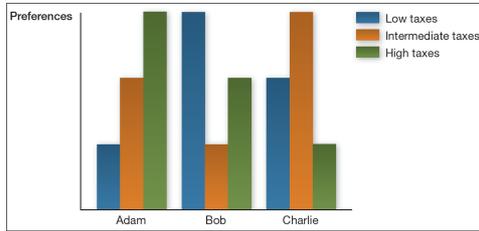


Exhibit W3.3 Policy Preferences of Adam, Bob, and Charlie

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- ▶ **Answer:** The preferences of Adam and Charlie are single-peaked, while those of Bob are not.

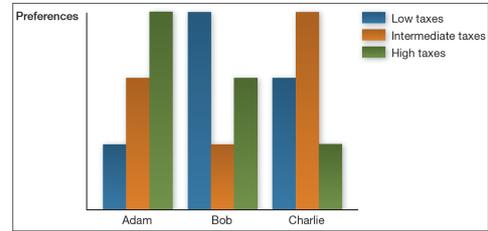


Exhibit W3.3 Policy Preferences of Adam, Bob, and Charlie

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- ▶ **Question:** Does voting deliver policies that citizens, or at least a large fraction of them, would agree with?
- ▶ **Definition:** The **median voter** is an individual whose political bliss point is
 - ▶ in the middle of the distribution of political bliss points (most preferred policy) among all voters.

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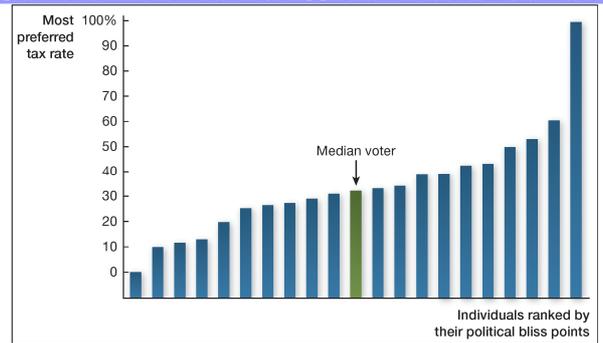


Exhibit W3.4 Political Bliss Points of Voters and the Median Voter

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- ▶ **Answer:** The Median Voter Theorem states that
 - ▶ when preferences are single-peaked,
 - ▶ the political bliss point of the median voter will receive a majority of votes
 - ▶ against any other alternative policy.



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- ▶ **Question:**
- ▶ Whose preferences are single-peaked?

	Most preferred	In between	Least preferred
Adam	High taxes	Intermediate taxes	Low taxes
Barbara	Low taxes	Intermediate taxes	High taxes
Charlie	Intermediate taxes	Low taxes	High taxes

Exhibit W3.5 Policy Preferences of Adam, Barbara, and Charlie

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▶ **Answer:** The preferences of all are single-peaked.

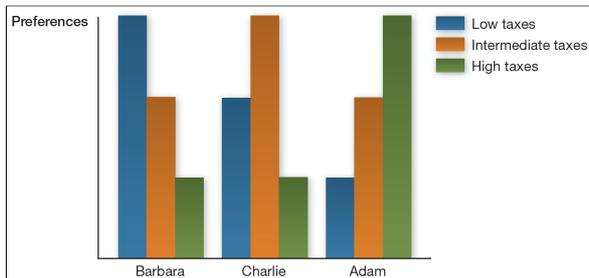


Exhibit W3.6 Political Bliss Points of Adam, Barbara, and Charlie

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▶ The **median voter** is Charlie, whose political bliss point is the intermediate tax rate.

▶ **Question:** Who votes for what policy in each of the two choices:

1. Low taxes versus intermediate taxes?
2. Intermediate taxes versus high taxes?

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▶ **Answer:**

- ▶ Low taxes versus intermediate taxes?
1. Charlie and Adam vote for intermediate taxes, and Barbara votes for low taxes.
- ▶ Intermediate taxes versus high taxes?
2. Adam votes for high taxes, and Barbara and Charlie vote for intermediate taxes.
- ▶ Therefore, an **intermediate tax rate** beats any alternative, and there is no Condorcet Paradox!

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▶ The Median Voter Theorem does not, by itself, tell us what policies will be chosen in a society.

1. We need to **translate** the insights of the Median Voter Theorem to a representative democracy.
2. We need to ensure that there is **perfect political competition**.

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- ▶ Perfect political competition refers to
- ▶ competition in the political sphere and,
 - ▶ in particular, to
- ▶ political institutions that allow different parties to enter elections and
 - ▶ offer any of the feasible options or policy choices.

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▶ **Question:** What happens when you combine the Median Voter Theorem and perfect political competition?

- ▶ **Answer:** You get
- ▶ Downsian **policy convergence**, in which
 - ▶ two parties competing for office both offer the same policy platform.

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- ▶ Suppose that two political parties—Red and Blue—both wish to come to power.
- ▶ Suppose also that the Median Voter Theorem holds and
 - ▶ a society consists of 21 voters, and the political bliss point of the median voter is a tax rate of 32%.

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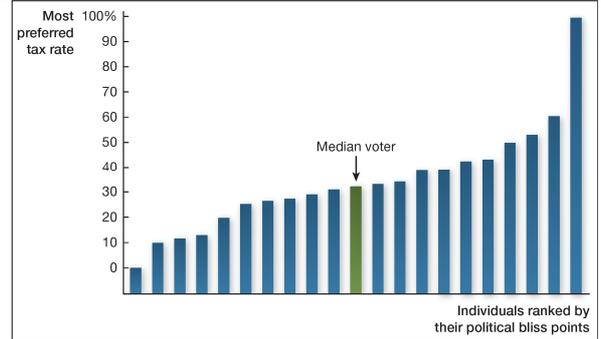


Exhibit W3.4 Political Bliss Points of Voters and the Median Voter

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- ▶ Suppose that the Red party offers a policy platform of a 25% tax rate, and
- ▶ the Blue party responds with a policy platform of a 32% tax rate
 - ▶ (= the political bliss point of the median voter).
- ▶ **Question:** Who wins the election?

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▶ **Answer:** The Blue party wins!

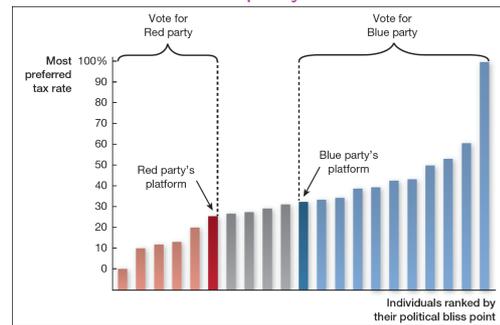


Exhibit W3.7 The Blue Party Wins a Majority

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- ▶ Suppose that the Red party offers a policy platform of a 34% tax rate, and
- ▶ the Blue party responds with a policy platform of a 32% tax rate
 - ▶ (= the political bliss point of the median voter).
- ▶ **Question:** Who wins the election?

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▶ **Answer:** The Blue party wins again!

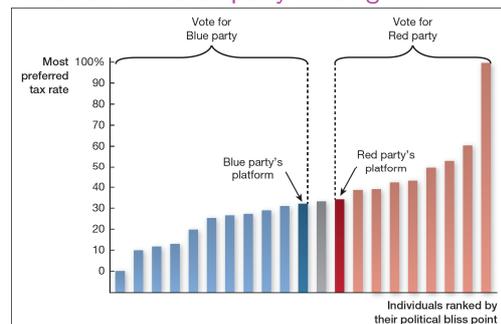


Exhibit W3.8 The Blue Party Again Wins a Majority

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- ▶ **Question:** So what can the Red party do if anything other than 32%
 - ▶ (= the political bliss point of the median voter)
- ▶ will lead to defeat at the polls?
- ▶ **Answer:** The Red party will also offer 32%.
- ▶ Why?

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- ▶ If the Red party offers 32%, both parties would have the same platform, and
 - ▶ all voters would be indifferent between the two parties.
- ▶ We would therefore expect either party to
 - ▶ come to power with a probability of 50%, which is better than being defeated for sure.
- ▶ This is the **Downsian policy convergence result.**

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- ▶ In most democracies, political competition takes an imperfect form for at least three reasons:
 1. Perfect competition in politics needs free entry.
 2. Politicians and parties have ideological biases.
 3. Politicians are often highly self-interested and sometimes even untrustworthy.

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- ▶ These real-world situations restrict the applicability of the Median Voter Theorem and Downsian policy convergence.
 - ▶ For example,
 - ▶ an extremist left-wing position of 70% and
 - ▶ an extremist right-wing position of no tax along with non-binding political promises will
 - ▶ **not** generate Downsian policy convergence.

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Evidence-Based Economics Example

- ▶ **Question:** Do governments and politicians follow their citizens' and constituencies' wishes?
- ▶ **Data:**
 - ▶ Vote shares in House of Representatives elections in the United States and
 - ▶ votes of elected representatives in the House.
- ▶ Also vote shares in Swedish local elections and policies chosen by local governments.

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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?

- ▶ Economists David Lee, Enrico Moretti, and Matthew Butler
 - ▶ focused on narrow elections for the U.S. House of Representatives between 1946 and 1995 to
- ▶ see where politicians chose the policies that their voters preferred.
- ▶ If elected representatives do indeed represent the wishes of their constituencies,
 - ▶ these Democratic and Republican members of Congress would have **very similar** voting records.

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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?

- ▶ Lee, Moretti, and Butler found a large difference between the voting record of narrowly elected Republicans and Democrats.
- ▶ In fact, they found that a narrowly elected Republican votes in exactly the same way as an average Republican congressperson (with a right bias),
 - ▶ and the same applies to a narrowly elected Democrat (who votes with a left bias).

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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?

- ▶ One shortcoming of the study by Lee, Moretti, and Butler is that
 - ▶ we only observe the votes that the politicians cast in the House.
 - ▶ Some of these votes (for example, on the budget)
 - ▶ may be important for overall policy decisions.
 - ▶ However,
 - ▶ many other votes may not really matter
 - ▶ (for example, the naming of a federal park).

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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?

- ▶ Economist Per Petterson-Lidbom applied a similar methodology to
 - ▶ elections for Swedish municipalities,
 - ▶ where local officials decide local tax rates and influence unemployment rates.
- ▶ He found that the policy choices of narrowly elected politicians were very different:
 - ▶ a left-leaning politician chose a 2% to 3% higher tax rate and employed 4% more workers in local governments than a right-leaning politician.

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Evidence-Based Economics Example

- ▶ **Question:** Do governments and politicians follow their citizens' and constituencies' wishes?
- ▶ **Answer:** No. The evidence suggests that politicians of different parties representing
 - ▶ more or less the same preferences support
 - ▶ and choose very different policies.



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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?

- ▶ **Caveat:** The extent to which politicians from different parties vote and choose different policies varies across countries, issues, and time.
- ▶ Political scientists Nolan McCarthy, Keith Poole, and Howard Rosenthal developed a statistical procedure to
 - ▶ estimate the ideological positions of Congress from their votes and then
 - ▶ computed the average distance between Democratic and Republican members of Congress.

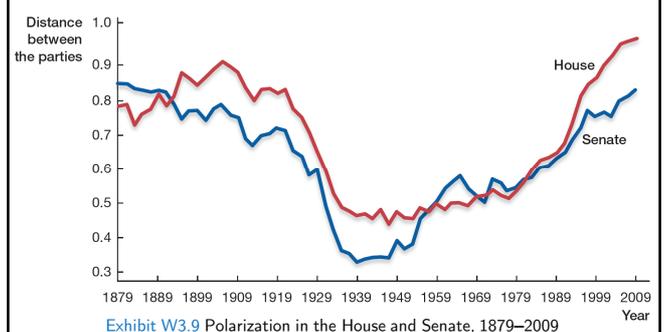


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Evidence-Based Econ: Do Politicians Follow Their Constituencies' Wishes?



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Does Democracy Work?

"Democracy is the worst form of government, except for all those other forms that have been tried from time to time."

- ▶ Former British Prime Minister Winston Churchill

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Does Democracy Work?

- ▶ There are several reasons democratic governments may be advantageous:
 1. A democracy represents the wishes of the citizens, at least under perfect competition.
 2. A group of uninformed voters can collectively have much more knowledge
 - ▶ than any single informed voter and therefore can actually elect the "correct" candidate.

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Does Democracy Work?

- ▶ Why does a democracy represent the wishes of the citizens, at least under perfect competition?
- ▶ Even under imperfect competition, as in the U.S. House of Representatives, the deviation is rather limited since
 - ▶ an elected member of Congress must ultimately represent the wishes of his or her median voter
 - ▶ (rather than his or her political party) in order to win reelection.

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Does Democracy Work?

- ▶ Francis Galton thought that a group of relatively uninformed individuals would
 - ▶ collectively have much more knowledge than any single one of them and
 - ▶ could actually make highly accurate predictions.
 - ▶ To test his idea, Galton went to an agricultural fair in 1906 and asked 800 people to
 - ▶ guess the weight of a slaughtered and dressed ox.

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Does Democracy Work?

- ▶ Galton found that the middle estimate—the equivalent of the median voter—was 1,197 pounds,
- ▶ while the actual weight was 1,198 pounds!



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Does Democracy Work?

- ▶ Galton's result has been proved further in prediction markets.
 - ▶ In prediction markets, people, often non-experts, make predictions or bets over things ranging from outcomes of sports contests to elections.
 - ▶ The prediction markets for elections consistently outperform public opinion polls and pre-election surveys performed by knowledgeable experts.

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Controlling Politicians

- ▶ In a representative democracy, we the voters elect politicians to public office to act as agents on our behalf.
 - ▶ The misuse of public office for private gain—corruption—is a failure of representation.
- ▶ Two forms:
 1. Political Corruption
 2. Bureaucratic Corruption

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Controlling Politicians

- ▶ **Political corruption** refers to
- ▶ illegal and illegitimate actions,
 - ▶ such as bribery and misuse of public funds,
 - ▶ for private benefit by elected public officials.



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Controlling Politicians

- ▶ Political corruption can take the form of:
 1. Appropriation of public funds for personal use
 2. Bribes taken from companies in return for special treatment, including the awarding of public contracts
 3. Support for policies and legislation against citizens' interests in return for bribes and campaign contributions

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Controlling Politicians

- ▶ Political corruption is costly to society because:
 1. It leads to wasteful use of tax dollars
 - ▶ since some goes into the pockets of corrupt politicians.
 2. It induces a misallocation of resources
 - ▶ since contracts are awarded to firms paying bribes.
 3. It potentially discourages investment
 - ▶ since companies have to pay bribes in order to be successful.

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Controlling Politicians

- ▶ Political corruption is costly to society because:
 4. It may have highly distortionary indirect effects
 - ▶ since politicians may erect entry barriers to protect incumbent firms that pay bribes.
 5. It may create a political system that
 - ▶ attracts politicians who are not public spirited but rather are looking to enrich themselves through bribes.

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Controlling Politicians

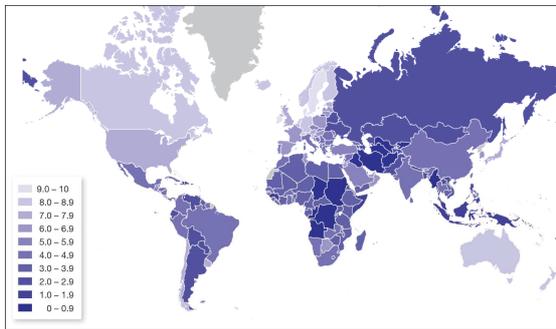
- ▶ **Question:** Which countries exhibit a lot of corruption, and which exhibit little?
- ▶ **Data:** A public sector corruption index on a scale of 0 to 10, where
 - ▶ 0 means that a country is perceived as highly corrupt and
 - ▶ 10 means that a country is perceived as very clean.

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Controlling Politicians



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Controlling Politicians

Least Corrupt vs. Most Corrupt

1	Denmark	9.1	167	Yemen	1.8
1	New Zealand	9.1	168	Syria	1.7
3	Finland	8.9	168	Turkmenistan	1.7
3	Sweden	8.9	168	Uzbekistan	1.7
5	Norway	8.6	171	Iraq	1.6
5	Singapore	8.6	172	Libya	1.5
7	Switzerland	8.5	173	South Sudan	1.4
8	Netherlands	8.3	174	Sudan	1.1
9	Australia	8.1	175	Afghanistan	0.8
10	Canada	8.1	175	North Korea	0.8
11	Luxembourg	8.0	175	Somalia	0.8

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Controlling Politicians

- ▶ **Bureaucratic corruption** refers to illegal and illegitimate actions,
 - ▶ such as bribery and misuse of public funds,
 - ▶ for private benefit by bureaucrats, judges, or law enforcement officers.
- ▶ Bureaucratic corruption imposes an **even greater social cost** to society than political corruption because
 - ▶ it is more widespread and pervasive.

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Controlling Politicians

- ▶ Economist Raymond Fisman found that
 - ▶ firms highly connected to the former Indonesian dictator Suharto lost about 23% of their stock market value as a result of his death.
- ▶ Economists Benjamin Olken and Patrick Barron found that
 - ▶ truck drivers in Indonesia had to pay bribes at checkpoints accounting for 13% of the total cost of the trip and that
 - ▶ bribes were higher near the end of the trip.

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Controlling Politicians

- ▶ There are two ways to think about this evidence of political corruption:
 1. Why are politicians often corrupt and unscrupulous?
 2. Why are politicians not **even more** corrupt, given their control over millions of dollars?

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Controlling Politicians

- ▶ While social norms of honesty might go some ways toward explaining the relatively limited amounts of political corruption,
- ▶ a large part of the answer lies in the fact that elections are a good way of disciplining politicians.
- ▶ Voters can reward good behavior with reelection and punish bad behavior by casting their votes for other candidates.

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- ▶ Economists Claudio Ferraz and Frederico Finan used a large audit study of Brazilian municipal elections.
- ▶ They showed that mayors who were found out to be corrupt in the audit report were significantly less likely to be reelected.

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Controlling Politicians

- ▶ One of the many roles of free media is to act as a conduit for this type of information.
- ▶ If this is true, we should indeed observe news affecting voting behavior,
 - ▶ and we should even observe in some cases corrupt politicians attempting to control news and media outlets.

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Market Failure vs. Government Failure from a Political Economy Perspective

- ▶ The distortions caused by political economy conflicts and politicians and bureaucrats
 - ▶ acting in their own interests rather than as representatives of the electorate and society
- ▶ are referred to as **government failure**.

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Market Failure vs. Government Failure from a Political Economy Perspective

- ▶ **Government failure** imply that
- ▶ an increase in the set of activities that are delegated to the government
 - ▶ will lead to more conflict of interest among voters about exactly what action should be taken.
- ▶ There will then be more areas in which politicians can pursue their own agendas or will have more money to use for their own benefit.

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Market Failure vs. Government Failure from a Political Economy Perspective

- ▶ However, turning those activities over to the private market may **not** deliver a socially efficient outcome due to **market failure**.
- ▶ We saw earlier that a market failure is likely
 - ▶ in the provision of a public good or
 - ▶ the protection of a common pool resource.

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Market Failure vs. Government Failure from a Political Economy Perspective

- ▶ The costs of market failures should be stacked up against the costs of government failure.
- ▶ We should try to quantify both
 - ▶ the costs of market failures and
 - ▶ the costs of government failures.
- ▶ For example, what will society lose if
 - ▶ a factory continues to pollute the air with no enforced abatement policies, *vs.*
 - ▶ what will society lose if elected officials pursue mainly their own agendas?

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Homework

- ▶ ALL Web Chap. 3, Problem 3, 5, 6, 8, 9, 12
- ▶ Challenge Questions (from Past Finals)
 - ▶ 2007 - Essay Q5
 - ▶ 2008 - Essay D
 - ▶ 2009 - Multiple Choice Q15
 - ▶ 2010 - Essay B, D
 - ▶ 2012 - Essay I, II-A
 - ▶ 2013 - Essay I
 - ▶ 2015 - Essay D

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