

EE441 Economics of Public Expenditure

5. Political Economy

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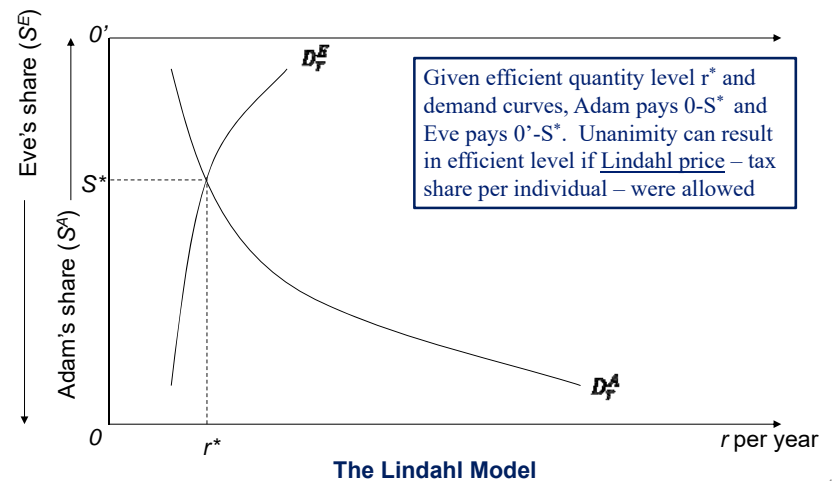
Outline of Topic 5

1. Direct democracy
 - a. Unanimity Rules
 - b. Majority Voting Rule
 - c. Logrolling
 - d. Arrow's Impossibility Theorem
2. Representative Democracy
 - a. Elected Politicians
 - b. Public Employees
 - c. Special Interests
 - d. Other Actors
3. Explaining Government Growth
 - a. Citizen Preferences
 - b. Marxist View
 - c. Chance Events
 - d. Changes in Social Attitudes
 - e. Income Distribution
4. Conclusion

Political Economy

- The field that applies economic principles to the analysis of *political decision-making*.
- How well do various decision-making procedures translate the preferences of their citizens into collective action?

Direct Democracy Unanimity Rules



Lindahl Prices

- An obvious similarity exists between the role of tax shares in the Lindahl model and market prices in the usual theory of demand.
- Important difference: Instead of each individual facing the same price, each faces a *personalized price per unit* of public good, which depends on his or her tax share.
- **Lindahl prices**- the tax share an individual must pay per unit of public good.

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Feasibility of Unanimity Rules in Reaching Equilibrium

- Practical problems
 - Strategic behavior: do people vote sincerely or under report value to escape tax liability?
 - Time to reach equilibrium given *many* citizens.
 - Eg., WTO case

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Direct Democracy Majority Voting Rules

- **Majority voting rule** – one more than half of the voters must favor a measure for it to be approved
- However, majority voting does not always yield clear-cut results
 - Given the voter preferences to the right, “**B**” always wins against opponents

Choice	Voter		
	Brad	Jen	Angelina
First	A	C	B
Second	B	B	C
Third	C	A	A

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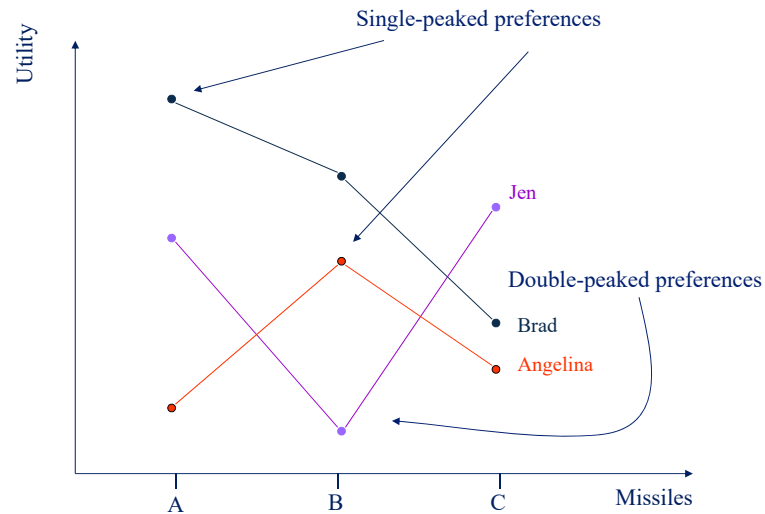
Majority Voting Does Not Always Yield Clear-Cut Results: Double- vs. Single-Peaked Preferences

- **Voting Paradox** – Community preferences can be inconsistent even though individual’s preferences are consistent
 - Given new preferences at the right:
 - A vs. B → A wins
 - B vs. C → B wins
 - A vs. C → C wins
- **Agenda Manipulation** – Process of organizing order of votes to ensure a favorable outcome
 - The ability to *control the order* of voting- the agenda- confers great power.
 - Eg., First round, A vs. B, then A vs C, C wins
 - Eg., First round, B vs C, then B vs A, A wins
- **Cycling** – when paired voting on more than two possibilities goes on indefinitely without a conclusion ever being reached

Choice	Voter		
	Brad	Jen	Angelina
First	A	C	B
Second	B	A	C
Third	C	B	A

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Graphing Preferences



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Peak

- Peak- a point on the graph of an individual's preferences at which all the neighboring points have lower utility.
- Single-peaked preferences- utility consistently falls as voter moves away from his or her most preferred outcome.
- Double-peaked preferences- If, as a voter moves away from his or her most preferred outcome, utility goes down, but then goes back up again.

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Practical Importance of Double-Peaked Preferences: Examples

- Can occur with availability of private substitutes for a publicly provided good
 - Example: public park vs. private country club
- Can occur with issues that can't be ranked along single dimension
 - Example: abortion clinic vs. adult bookstore vs. Army recruitment office

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Direct Democracy The Median Voter Theorem

- As long as preferences are *single peaked*, the outcome of majority voting reflects the median voter preferences
- Huey's preference of \$150 spending would prevail in majority voting

Voter	Expenditure
Donald	\$5
Daisy	100
Huey	150
Dewey	160
Louie	700

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Median Voter

- The voter whose preferences lie in the middle of the set of all voters' preferences; half the voters want one of the items selected and half want less.
- Median voter theorem- As long as all preferences are single peaked and several other conditions are satisfied, the outcome of majority voting reflects the preferences of the median voter.

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Direct Democracy

Logrolling I: Welfare Improved

- The *trading of* votes to obtain passage of a package of legislative proposals
- If projects voted on 1 at a time, all lose
 - Hospital → only Melanie
 - Library → only Rhett
 - Pool → only Scarlet
- Solution is for Melanie to vote for library if Rhett votes for hospital, etc
- If the system includes "side payments," which are trades of dollars rather than votes, getting all three projects done would also be possible.

Voter				
Project	Melanie	Rhett	Scarlet	Total Net Benefits
Hospital	200	-50	-55	95
Library	-40	150	-30	80
Pool	-120	-60	400	220

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Direct Democracy

Logrolling II: Welfare Lowered

- Welfare lowered if vote trading leads to projects with *negative net benefits* being passed
- While logrolling can sometimes improve on the results from simple majority voting, it can also make things worse.

Voter				
Project	Melanie	Rhett	Scarlet	Total Net Benefits
Hospital	200	-110	-105	-15
Library	-40	150	-120	-10
Pool	-270	-140	400	-10

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Direct Democracy

Arrow's Impossibility Theorem

- "Reasonable" collective decision-making should be *logical* and *respect* individuals' preferences
- Criteria
 - It can produce a decision whatever the configuration of voters' preferences
 - It must be able to rank all possible outcomes
 - It must be responsive to individuals' preferences
 - If every individual prefers A to B, then society's ranking must prefer A to B.
 - It must be consistent
 - If A is preferred to B and B is preferred to C, then A is preferred to C.
 - Independence of irrelevant alternatives
 - Society's ranking of A and B must depend only on individuals' rankings of A and B.
 - Dictatorship ruled out
 - Social preferences must not reflect the preferences of only a single individual.

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Direct Democracy

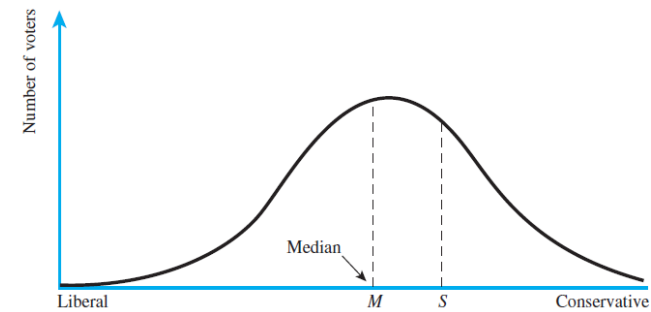
Arrow's Impossibility Theorem

- Unfortunately, all conceivable voting schemes have some potential for being *unfair* or producing a paradoxical result
- Meaning of theorem is that a fair, consistent rule is not necessarily impossible to find, but it is not guaranteed a society will find one
- **Buchanan's critique:** Despite being inconsistent, majority rule has other benefits
- Arrow's theorem implies social welfare functions are useless, but most economists believe they provide valuable insights

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Representative Democracy

Elected Politicians



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Implications of the Median Voter Model

- The candidate who adopts the median position (M) will defeat the candidate who adopts the position away from the median (S)
- Two-party systems tend to be stable because they stake out positions near center
- Replacement of direct referenda by representative system has no effect on outcomes

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Other Factors Influencing Voting

- *Non-single-dimensional rankings* cause median voter theorem to fall apart
- Ideology
- Personality
- Leadership
- Decision to vote

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Representative Democracy

Public Employees

- Function of bureaucrats
 - Implement policy
 - Provide technical expertise in the design and execution of programs and policies
 - Provide “institutional memory”
 - Provide accurate documentation to ensure
 - *Equal treatment* for eligible citizens
 - *Prevent corruption*
- Goals of bureaucrats
 - Fulfill wishes of electorate and representatives
 - Perhaps increasing power and their own perks

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Representative Democracy

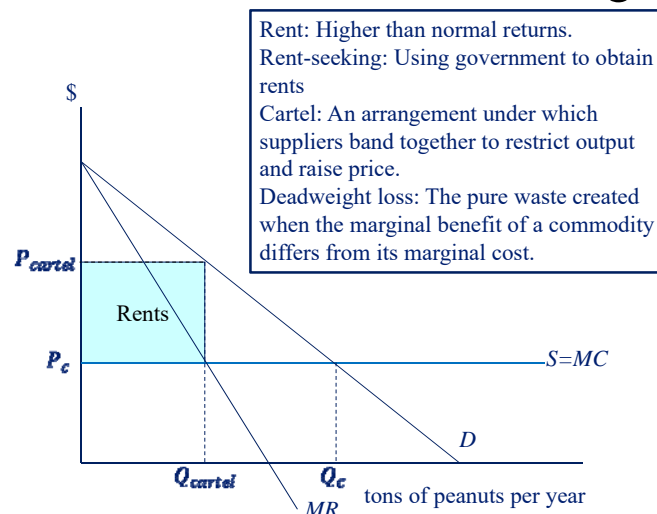
Special Interests

- Establishment of Special Interest Groups
 - Source of Income: Capital or Labor
 - Size of Income
 - Source of Income: Industry of Employment
 - Region
 - Demographic and Personal Characteristics

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Representative Democracy

Special Interests and Rent-Seeking



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Representative Democracy

Other Actors

- Judiciary
- Journalists
- Experts
- NGOs

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Explaining Government Growth

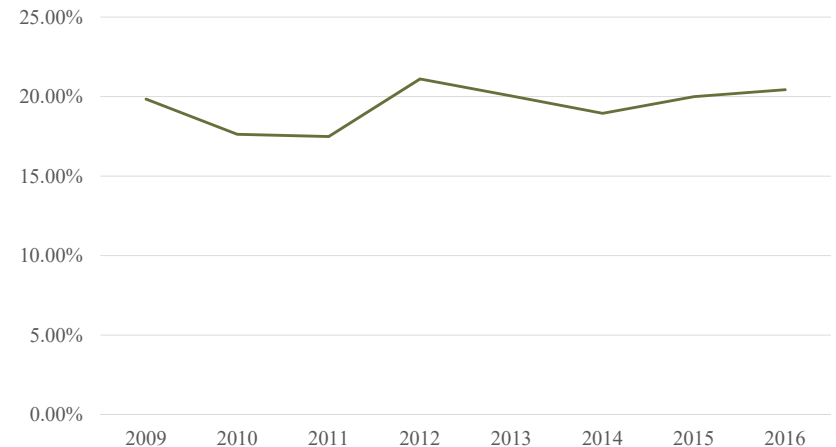
Ratio of government expenditures to Gross Domestic Product

Year	Canada	Switzerland	United Kingdom
1900	9.5	n.a.	14.4
1910	11.4	n.a.	12.7
1920	16.1	n.a.	26.2
1930	18.9	15.9	26.1
1940	23.1	19.2	30.0
1950	22.1	19.9	39.0
1960	29.7	17.7	31.9
1970	36.0	21.3	41.8
1980	41.6	29.3	45.2
1990	48.8	30.3	41.1
2000	41.1	35.1	36.8
2010	44.1	34.2	50.5

Sources: Pommerehne (1977); OECD (2012a)

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Expenditure as % GDP (Thailand)



Sources: Fiscal Policy Office

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Explaining Government Growth

• Citizen Preferences: $G = f(P, I)$

G=Median voter's demand of public sector goods & services

P=Price of public sector goods and services

I=Income

• Marxist View

– The public sector must expand to absorb private excess production.

• Chance Events

– Wars, recessions

• Changes in Social Attitudes

• Income Redistribution

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Topic 5 Summary

- Political Economy applies economic principles to analysis of political decision-making
- Majority voting in a direct democracy as a method for choosing levels of public goods includes consideration of single- vs. double-peaked preferences, log-rolling, and Lindahl pricing
- Arrow's Impossibility Theorem: a fair, consistent rule is not necessarily impossible to find, but is not guaranteed
- Understanding government behavior requires analysis of public employees, special interest groups and rent-seeking
- The growth of government in various countries can be explained by citizen choice, random events, government's need to absorb excess private production, ignorance of the opportunity costs of public programs, and efforts to use government to redistribute income

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Homework

Do discussion questions no. 3 and 9 on pp. 130-131 in the textbook.

Class Exercise

2. In Turkey, many shopping mall owners charge different rental rates on their tenants. The shops of local and relatively unknown brands pay higher rental rates per square meter than international and famous brand shops. Local shop owners protest this differential rental system. What motivates mall owners to use different rates?