Paper (1)
Introduction to Political Economics

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Introduction

Political economics studies situations that arise when there is interaction between politics and economics. Politics is exciting because people disagree. They disagree about the following questions:

- How should they live?
- Who should get what?
- How should power and other resources be distributed?
- Should society be based on cooperation or conflict?
- How social conflicts should be resolved?
- How should collective decisions be made?
- Who should have a say?
- How much influence should each individual/ institution/ organization have?

On the other hand, economics is exciting because resources are scarce. The basic questions of economics become:

- What to produce?
- When to produce?
- How to produce?
- For whom to produce?

Other significant economic questions involve:

- To what extent should the government intervene in the market?
- How to define economic welfare?
- To what extent can the government / Central Bank influence the macro-economy?

From the above, we can observe that the main questions of politics and economics are interrelated.

What Is Political Economy?

The phrase "political economy" has come to mean very different things in different places. In political science departments, it generally means the study of how economic forces affect politics. As such, the phrase often has a Marxist implication, because of the particular importance that Marxist theory places on economic forces for explaining political events. In economics departments, however, political economy is often taken to mean the study of political forces that affect economic activity.

In classical social philosophy, the study of markets was not so separate from the study of government. The phrase "political economy" was taken from Greek words meaning "housekeeping of city-states," and it was applied to describe the study of how civilized

societies are organized. So, the classical goal of political economy was to explain the functioning of all social institutions.

The successful development of price theory forced a separation between the study of markets and the study of government. Price theory describes market competition well, but it cannot be applied to political competition. So, a separation of political science from economics was necessary when price theory[1] was the only general analytical methodology in economics. Thus, economics has developed around a core analytical methodology, whereas descriptive methodologies have been more dominant in political science . Today, with game theory alongside price theory, it makes less sense to separate the study of politics from economics. Game theory is an analytical methodology that can be applied to political competition as well as to market competition. Game theory allows theorists to recognize the interconnections between economic and political institutions.

We must approach such a reunion between economic theory and political theory with careful respect for both academic traditions. Economists have much to teach political scientists about the analysis of incentives in competitive systems. But economists need to learn from political scientists about what are good questions to ask about political competition. It is good to pursue questions about how politics can affect economic variables, but our concern should not be limited only to economic variables.

For example, to be able to guide the writing of anti-trust laws, economists have invested generations of work in trying to understand the ways that different market structures may shape the conduct and performance of competing oligopolists. Political competition for control of governments is surely not less important to us than economic competition for profits. Furthermore, the range of explicit structural variables that need to be analyzed is greater in political competition, because rules of political competition are written in constitutions and electoral codes. [2]

Thus, the term "Political Economy" has been used for many years to express the interrelationship between the political and economic affairs of the state.

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[1] According to Thomas A. Weber (n.a), price theory is concerned with explaining economic activity in terms of the creation and transfer of value, which includes the trade of goods and services between different economic agents. A puzzling question addressed by price theory is, for example: why is water so cheap and diamonds are so expensive, even though water is critical for survival and diamonds are not? In a discussion of this well-known 'Diamond-Water Paradox,' Adam Smith (1776) observes that [t]he word value, it is to be observed, has two different meanings, and sometimes expresses the utility of some particular object, and sometimes the power of purchasing other goods which the possession of that object conveys. The one may be called "value in use;" the other, "value in exchange." (p. 31). For him, diamonds and other precious stones derive their value from their relative scarcity and the intensity of labor required to extract them. Labor therefore forms the basic unit of the exchange value of goods (or 'items'), which determines therefore their 'real prices.' The 'nominal price' of an item in Smith's view is connected to the value of the currency used to trade it and might therefore fluctuate. In this labor theory of value the Diamond-Water Paradox is resolved by noting that it is much more difficult, in terms of labor, to acquire one kilogram of diamonds than one kilogram of water.

[2] Roger B. Myerson (1996). Economic Analysis of Political Institutions: An Introduction. Tokyo.

Political Economy is about the effects of **political decisions** on social and economic development. Poor people don't get an opportunity to improve their lives, we should ask what **institutions** and **interests** are impeding them from being better off. Who takes the decisions on economic issues? Who are the winners and losers of the economy? Why are unequal distribution and poverty persisting? These questions get down to the fundamentals of development and social justice.

World attention is currently centered on the question of how to get economies growing again. While this is unquestionably an urgent issue, an equally important concern is inequality. Thinking of possible effects of reforms on the poor and disadvantaged is key to shaping sound programmes and policy reforms that encourage growth and make it pro-poor. A political economy perspective requires an operationally useful set of tools which links the economic context with institutions, power and actors. These elements can be seen as risks or blockages to effective policy reform and improved distributional equity.

What are the Main Economic Issues considered by the Political Economy?

Political economy focuses on the Welfare State.

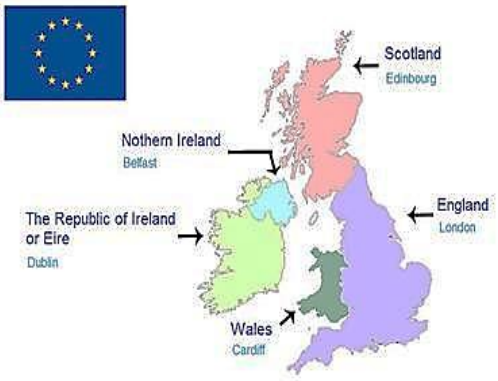
Welfare State: According to a narrow definition, the welfare state comprises two types of government spending arrangements: (i) cash benefits to households (transfers, including mandatory income insurance) and (ii) subsidies or direct government provision of human services (such as child care, pre-schooling, education, health care, and old-age care). By broader definitions, the welfare state may also include price regulation (such as rent control and agricultural price support), housing policies, regulation of the work environment, job-security legislation, and environmental policies.

Example, across developed OECD countries, total welfare-state spending ("public social spending"), including spending on education, varies today (2006) from about a fifth to about a third of GDP.

As we would expect, the share is tightly related to the degree of "universality" of public social spending, i.e., the extent to which benefits are received by individuals in all income classes, rather than largely targeted to particular groups of individuals, such as low-income groups.

Broadly speaking, the lowest figures are currently found in Anglo-Saxon countries, while the highest appear in the Nordic countries – with other countries in Western Europe somewhere in-between.

Anglo-Saxon Countries



Nordic Countries

Political economy analyzes how political institutions affect economic policies

A recent interest in political economy is about how political institutions, for example parliamentary or congressional systems (and different electoral rules), influence economic policy decisions and economic performance. For example, a number of studies have examined how a parliamentary system is more able to enhance public spending than a congressional/presidential system.

Political economy demonstrates how political ideology influences economic thought

Politics is about influencing of people through the exercise of power. It involves issues of the role of governments, elections and political parties. Economics can be non-political. But, this is true only in theory. However, in practice, economics is affected and influenced by political actions.

An ideal economist should ignore any political bias when recommending on how to improve the economic performance of a country. However, in practice there is a strong relationship between economics and politics because the performance of the economy is one of the key political battlegrounds.

In fact, many economic issues are seen through the eyes of political beliefs. For example, some people are instinctively more suspicious of government intervention. Therefore, they prefer economic policies which seek to reduce government interference in

the economy (i.e. Economic Liberalism[3]). On the other hand, others may prefer promoting greater equality in society and be more willing to encourage government intervention to pursue that end (i.e. Economic Interventionism).

If you set different economists to report on the desirability of income tax cuts for the rich, their policy proposals are likely to reflect their political preferences. You can always find some evidence to support the benefits of tax cuts, you can always find some evidence to support the benefits of higher tax. Some economists may be neutral and not have any political bias. Despite their preferences, they may find tax cuts do actually increase economic welfare.

However, for a politician, they can use those economic researches which backs their political view. For example, Mrs. Thatcher and Ronald Reagan were belonging to neoliberalism. When they were attempting to 'roll back the frontiers of the state' – there was no shortage of economists who were suggesting this was not a good idea, but economists can be promoted by their political sponsors. Thus, they could find economists who were supporting their views. Another example is Republican and Democratic Approaches to Regulating the Economy. The Republican Party is considered business-friendly, as it favors limited government regulation of the economy. Republicans tend to support a much more laissez-faire style economy, which basically means that the government stays hands off. Given this more pro-business bias, Republicans tend to receive support from business owners and investment capitalists, as opposed to the labor component that constitutes workers and their interests. On the other hand, Democrats are said to rely more heavily on government intervention to influence the economy's path. They believe that economic health requires fiscal discipline, monitored by the federal government. So, the government has to intervene in the economy through social programs ranging from federal unemployment insurance to medical care provision. Doing this requires a lot of money, so Democrats tend to see raising taxes as a moral responsibility that gives the government the tools to guide the economy.

On the other hand, economists who stick to data may come up with conclusions and recommendations that don't necessarily fit with their political ideology.

It should be noted that economics needs political support. If you are an economist, you may be a supporter of a Pigovian tax – a tax which makes people pay the full social cost of the good, and not just the private cost. This principle of making the polluter pay provides a case for Carbon Tax, congestion charges, alcohol tax, and tobacco tax etc. However,

[3] Economic Liberalism encompasses the processes, including government policies, that promote free trade, deregulation, elimination of subsidies, price controls and rationing systems, and, often, the downsizing or privatization of public services (Woodward, 1992). Economic liberalization has been central to adjustment policies introduced in developing countries since the late 1970s, mostly in the context of the conditions for lending set by international financial institutions. Thus, government policies were redirected to follow a noninterventionist, or laissez-faire, approach to economic activity, relying on market forces for the allocation of resources. It was argued that market-oriented policy reforms would spur growth and accelerate poverty reduction. http://www.un.org.

whether these policies get implemented depends on whether there is political support for them.

Political economy considers Individuals as Economic and Political agents:

- Economic Agents take Labor, Savings, Consumption Decisions
- Political Agents (Voters) decide over Economic policies (Redistribution, Public Goods, etc.)

What are the Different Research Areas of Political Economy?

Collective Decision-Making: Social Choice and Political Economy [4]

When groups of people are merely extensions of more or less identical members, social choice would be simple. Any member or subset of members chosen at random would be able to articulate the interests of the whole. If there were apparent differences in expertise, everyone would agree that the most skilled in hunting, or witchery, or child care, etc. should decide, that is, should put his or her expertise to the service of everyone in the group. But groups are, in fact, not at all like that. The interests of the individual members differ and no one member has exactly the same interest as the group itself. Even for the family, the most general purpose of all groups, we speak of its interests as separate from the interests of parents and siblings. And when we speak of more specialized groups with limited purposes-the church, the nation, the city, the labor union, the commercial association, the club, etc.-we specify ever more precisely just what restricted purposes each group is intended to serve. The reason we do so is that we recognize wide variations in the interests of members. Given these variations, members seldom have identical preferences, even about the stated purposes of the group itself, let alone about how to accomplish these purposes.

Consequently, social decisions are not easily arrived at because they must accommodate the wide variations in members' values and tastes. At one extreme, groups accommodate by requiring unanimity: no social choice is made unless everyone agrees. At the other extreme, groups accommodate by establishing dictatorship: one person decides for everybody. The difficulty with unanimity is that agreement is difficult to reach. In the Society of Friends, where dissidents are expected to re-examine their consciences, facility in decision depends wholly on the dissidents' will and skill in re-examination. In the Polish Diet, where each person had a veto, facility in decision is said to have depended, occasionally, on defenestration of dissidents. On the other hand, the difficulty with a dictator is that, when he or she ignores the values of other members, they often infer that membership is itself no longer worthwhile. Schism, runaways, immigration, police

[4] William Riker (1991) in Collective Decision-Making: Social Choice and Political Economy. Edited by Norman Schofield. Springer Science+ Business Media, LLC.

terrorism and civil war are thus characteristic features of dictatorship in various kinds of groups.

In between these extremes of unanimity and dictatorship, groups accommodate to diversity by requiring only that some intermediate number, larger than one but less than everyone, be necessary for decision. Rules of this intermediate sort set the scene for coalitions, that is, subsets of members. Coalitions, defined as subsets, can, of course, be of any size, though usually we think of them as proper subsets with several members. {It is technically correct, but not particularly interesting, to speak of coalitions of one and of everyone.) Coalitions of the size required for decision are defined as winning (or decisive) and are the main focus of the essays printed here. Losing coalitions, or those that failed to develop into winners, are interesting for their impact on the future and their efforts to break up winning coalitions. but winning coalitions are themselves immediately interesting, for they are the ones that choose the alternatives to be pursued or enforced by the whole group.

From a practical viewpoint, the main feature of winning coalitions is that they are a means to enhance the force of their members. If a decision for a group is made by less than everyone, then a coalition of the appropriate size takes over the whole. There is both public and private advantage in this fact. The public advantage is that an intermediate rule avoids the immobilism of unanimity and the indifference of dictatorship. The private advantage is more delicate: When a winning coalition selects an alternative attractive only to its members, in effect these members utilize the name and resources of the whole group to enforce an only partially approved value. So long as the winning coalition selects an alternative within the (usually) ill-defined range of the goals of the whole group, then the non-members of the coalition are compelled, by their own continuing group membership and their own adherence to those goals, to recognize and accept the decision of the coalition. Thus, a winning coalition deciding for the whole enhances the significance of its choice by subsuming as joint authors those who in fact reject it. Thus, the private advantage of the method of decision by coalitions is that proper subsets of the whole group can enhance their influence or "power."

There is, it is true, one institution for decision making, namely the market, that does not utilize large coalitions and thus does not allow the winners to absorb the influence of the losers. In this idealized form of the economic world, coalitions are tiny, typically just two traders. A trader, it is said, "calls out" a wish to trade, and, if it reaches a receptive ear, a bargain is struck. The coalitions thus formed are not, of course, large enough to decide for the whole. So, conventionally, the decision for the whole is interpreted as the set of such bargains-at the equilibrium price-made by many coalitions. Since in this model every trader wins and, if everyone trades, everyone wins, winners cannot mulct the losers, as they do in institutions requiring decision-making by larger coalitions.

As we climb up from the agora, the marketplace, to the acropolis, the city center, where decisions are made on rules and rights and war and worship, we find that decisions require majorities and, often, supermajorities. No one has ever figured out how to operate a political system anarchically, that is, with numerous small decisive coalitions comparable

to market coalitions. Even in oligarchies, it usually turns out that a majority or supermajority of oligarchs is necessary to make a decision stick. And so it is that political decisions are almost invariably made by unique winning coalitions, which enhance themselves by absorbing and redirecting the force of the losers.

This is why political life is so intense. Unique winning coalitions are, by their very nature, devices to seize the usufruct of decision. Since the political method is decision by unique coalitions, it turns out that political life consists almost entirely of contests over the usufruct. Such contests involve force and intrigue, maneuver and manipulation. This is what gives politics its harsh persistent undertone of selfishness and exploitation.

This is also why we need to understand all the properties of coalitions and coalition-formation in order to appreciate and interpret politics.

Political Finance [5]

Students of government and social power recognize that wherever governmental systems embrace popular elections, the functions and mechanisms of political finance constitute inevitable links of influence between economic structures and political processes. The transmutation of economic power into political power has been of historic concern from ancient philosophers to modern political scientists.

Efforts to discern and interpret the political roles of those engaged in funding candidates and political parties have intensified in recent years. Attention given the subject has deepened substantially in the United States since World War II and, while there have been differences in range and quality, serious analytical interests have also developed in numerous other nations around the world. These trends have been accompanied by increasingly more energetic and sophisticated attempts at comparative analysis. Problems in transnational studies of political processes have always been formidable.

The comparative study of political finance has been retarded by difficulties in defining units of analysis that make it possible to identify in some measurable way the effects of political finance in precise phases of the governing process, e.g., in the persuasion of voters, in party nominating processes, in executive decision making. Cash transactions, even when known with confidence, constitute only a partial aspect of political finance. Other shades of economic power may be equally relevant, involving services or goods directly provided, credits and other economic benefits extended or withheld, and the exercise of less tangible but equally potent influence. The significance of even cash transactions themselves may differ substantially, moreover, in accordance with the institutional, social, and cultural context.

[5] Arnold j. Heidenheimer and Frank c. Langdon (1968). Business Associations and the Financing of political parties: A Comparative Study of the Evolution of Practices in Germany, Norway and Japan. Martinus nijholl. The hague. Netherlands.

Private Development Financing[6]

Demographics shape global capital flows through the global savings rate and, since the population shares of the working young and the retired old vary across countries, the pattern of cross-border capital flows. Financing the pension and health costs of ageing societies, notably Europe and Japan but also increasingly China, is having powerful effects on international capital markets. Today, large volumes of global savings move through an increasingly integrated global capital market in search of investment opportunities. Since the capital is abundant, the developing world is receiving an increasing share of these flows, to the benefit of private investment – in production, trade and infrastructure – as well as to the balance of payments. **Foreign Direct Investment** (FDI) is considered the most stable form of capital flow. It is mainly concentrated on a narrow range of countries, where China is Dominating. while FDI into the smaller economies (in Sub-Saharan Africa) is rising, it remains confined mainly to its traditional destination – the mining sector. This benefits growth but leaves economies undiversified.

Private portfolio[7] flows into equities and bonds are still concentrated on a narrow range of emerging markets. While flows into the 'frontier markets[8]' is still small. There usually exists a mutual benefit from private portfolio for both recipient countries and global investors.

The recipients of increased private capital flows need effectively to turn these into investments that generate higher economic growth, and therefore deliver the higher returns global investors expect. Otherwise, they will go elsewhere in their search for yield. recipients must also improve corporate governance substantially to protect shareholder rights (otherwise equity investment will not be sustained), build better sovereign-debt management (a tough challenge for the poorer countries), and improve their macroeconomic management to cope with the real-economy effects of the capital inflows (thereby ensuring that they facilitate rather than undermine economic development).

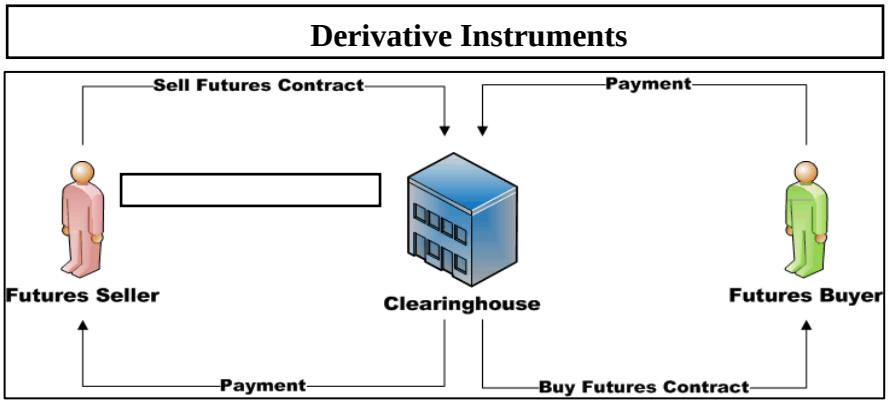
Global investors must be sufficiently risk-taking to allocate a large enough share of their portfolio to the relevant asset categories to benefit significantly from any superior

[6] Tony Addison and George Mavrotas in Tony Addison and George Mavrotas (Eds) (2008). Development Finance in the Global Economy: The Road Ahead. Palgrave Macmillan

[7] Foreign direct investment (FDI) and foreign portfolio investment (FPI) have been long considered as distinct and independent forms of international capital flows, but in the globalized world there are reasons to treat them as interconnected phenomena. Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) are the two ways through which foreign investors can invest in an economy. FDI connotes a cross-border investment, by a resident or a company domiciled in a country, to a company based in another country, with an objective of establishing a lasting interest in the economy. On the contrary, FPI connotes a route to funds into a nation, where foreign residents can buy securities from the country's stock or bond market. Both FDI and FPI involve the acquisition of a stake in an enterprise which is domiciled in another country. But, these two differ, in nature of holdings, term, the degree of control, etc.

[8] Frontier markets are less advanced capital markets in the developing world. Frontier markets are countries that are more established than the least developed countries (LDCs) but still less established than the emerging markets. Frontier markets are also known as "pre-emerging markets."

returns. In addition, we can expect more use of derivative instruments (i.e. Forwards, Futures, Options, Swaps) by global investors, in order to hedge currency and political risks.



Furthermore, we can expect more use of innovation by global investors to reduce the costs of such hedging, which could help in stimulating flows to riskier countries. But not all risks can be hedged (or are indeed observable, since many are asymmetric – as between lender and borrower). The political risks of investing in poor countries[9] remain high (giving rise to insecure property rights) and to a degree unpredictable – including those associated with adverse global climate changes. So, the world's capital markets are unlikely ever to achieve textbook perfection in which every investment need of poor countries[10] is matched by willing global investors.

Consequently, there will remain considerable space for official flows. And the need for ODA[11] could actually rise much further (even beyond that projected to meet MDG requirements) as the effects of global warming take their toll on the South (in particular, a greater variance of rainfall in Africa's agricultural margins, and increased flooding in the many densely populated and low-lying lands of Asia).

Official Development Assistance[12]

Running alongside the private capital flow is one of increased official flows, official development assistance (ODA) having rebounded since its mid-1990s slump. And the flows of private and official capital run together at times, as with the international finance

[9] The poorer and smaller countries are becoming better known to international investors since declining yields on emerging market debt – the consequence of large inflows in recent years and a reduction in the supply of such debt – have encouraged investors into 'frontier markets'.

[10] Information asymmetries and high transactions costs have made it difficult for small, poor countries to tap into global capital markets, but this is starting to change.

[11] The borrowed funds are used to fund infrastructure to diversify economies away from their traditional dependence on commodity exports.

[12] Tony Addison and George Mavrotas in Tony Addison and George Mavrotas (Eds) (2008). Development Finance in the Global Economy: The Road Ahead. Palgrave Macmillan

facility[13] (IFF) which aims to leverage and frontload ODA by borrowing from international capital markets.

A significant part of the recent growth of ODA consists of debt relief. Reducing the debt overhang of the heavily indebted poor countries (HIPCs) has been important to restoring their attractiveness to investors.

The new international financial architecture raises many political and foreign-policy issues: (1) finding the finance to tackle global environmental and health problems is recognized increasingly as being in everyone's interest; (2) foreign aid is now viewed as an important part of the post-9/11 international security framework; and (3) the balance of power in setting the international finance agenda is shifting, not only within the group of rich countries (as between the United States, Europe and Japan) but also between rich and poor countries, as China and India become increasingly important global actors.

Political scientists and international relations specialists are now busy debating the implications of these trends both for the international financial architecture and for the global economy more widely. From the above introduction about ODA, it is important to define its concept:

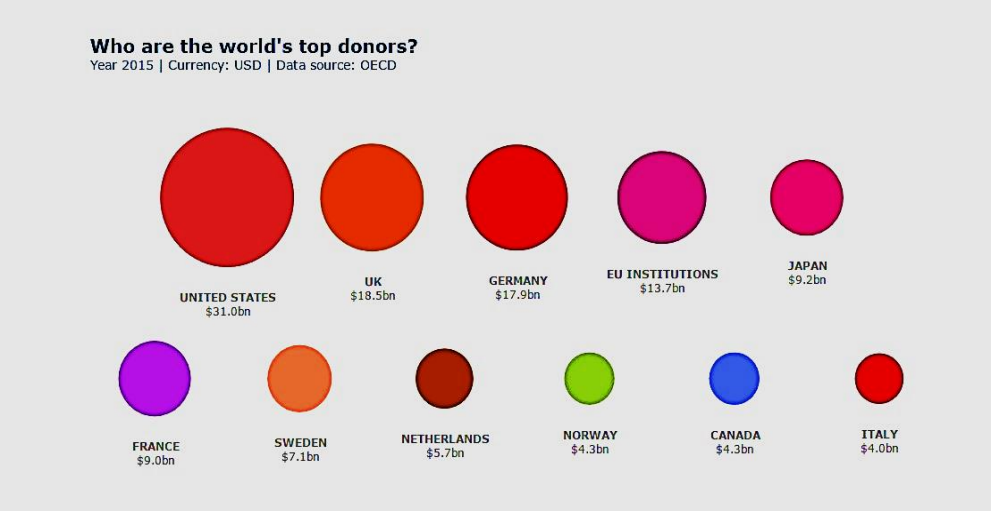
What is ODA?

ODAs indicates loans to developing countries to promote economic development and welfare. The DAC defines ODA as "those flows to countries and territories on the DAC List of ODA Recipients and to multilateral institutions. These flows are:

1. provided by official agencies, including state and local governments, or by their executive agencies; and
2. Each transaction of which:
   - Is administered with the promotion of the economic development and welfare of developing countries as its main objective; and
   - Is concessional in character.

According to OECD (2015), the world's top donors are United States, UK, and Germany, Eu institutions, and Japan, as shown in the following figure.

[13] IFF is designed to frontload aid to help meet the Millennium Development Goals. Bonds are issued on global capital markets, against the security of government guarantees to maintain future aid flows, which would be used to buy back the bonds over a longer period. This allows a large amount of aid to flow soon, at the expense of less aid in the future.



ODA from EU - Sectoral Distribution:

The main sectors that the aid from EU institutions and members is spent on are:

- Government and civil society $7,716m
- Humanitarian Aid $6,101m
- Banking and financial services $4,691m
- Transport and Storage $2,962m
- Education $5,670m
- Agriculture $2,630m

What has EU aid achieved?

In the last ten years EU aid:

- Gave more than 31 million people access to safe drinking water
- Stopped 24 million from going hungry
- Gave more than 9 million children a primary education
- Equipped 2.1 million rural people with modern energy services
- Helped protect more than 1.5 million hectares of forest
- Vaccinated more than 5 million children against measles
- Supported 58 election observation missions

The Politics of Austerity

After a credit crunch, there was a strong economic case for expansionary fiscal policy to fill in the gap of aggregate demand. Politically, it can be hard to push a policy which results in more government debt. There may be an economic logic to Keynesian demand management in a recession – but a politician appealing to the need to 'tighten belts' and 'get on top of debt' can be easier slogans to sell the general public, rather than slightly more obtuse 'multiplier theories of Keynes'.

International Trade War

A trade war is when a nation imposes tariffs or quotas on imports and foreign countries retaliate with similar forms of trade protectionism. As it escalates, a trade war reduces international trade. A trade war starts when a nation attempts to protect a domestic industry and create jobs. In the short run, it may work. But in the long run, a trade war costs jobs and depresses economic growth for all countries involved. It also triggers inflation when tariffs increase the prices of imported goods.