

Political Economics

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When the Political Process Works Well

Under what conditions are voting and representative government most likely to result in productive actions?

- People have a tendency to believe that support by a majority makes a political action productive.

However,

If a government **project** is truly **productive**, it will always be possible to find a way to allocate the cost so that all **voters gain**.

This would mean that, even if **voting rules** required **unanimity** or near-unanimity, all truly **productive** government **projects** would pass if the costs were allocated in the **right manner**.

The Benefits Derived by Voters from a Hypothetical Road Construction Project

Voter	Benefits Received-(1)	Tax Payment	
		Plan A- (2)	Plan B- (3)
Adams	\$ 20	\$ 5	\$ 12.50
Chan	\$ 12	\$ 5	\$ 7.50
Green	\$ 4	\$ 5	\$ 2.50
Lee	\$ 2	\$ 5	\$ 1.25
Diaz	\$ 2	\$ 5	\$ 1.25
Total	\$ 40	\$ 25	\$ 25.00

Note: When taxes are levied in proportion to benefits received (tax plan B), any efficient project can **pass unanimously** (and any inefficient project will fail unanimously). When taxes are not levied in accordance with benefits received (tax plan A), **efficient projects** can fail to win a **majority vote** (or inefficient projects can pass in a majority vote).

Thus,

✓ When voters pay in **proportion to benefits** received, all voters will gain if the **government action** is productive, and all will lose if it is **unproductive**

✓ When the benefits and costs derived by individual voters are closely related, the voting process will enact efficient projects while rejecting inefficient ones.

✓ When voters pay in proportion to the benefits they receive, there will tend to be harmony between good politics and sound economics.

■ How might the cost of government services be linked to the benefits received?

User charges for public services require people who use a service more to pay a larger share of the cost.

Sometimes the **intensity** of the use of a service and the **amount** paid for it can be linked by **specifying** that the **revenue** from a specific tax be used for a **designated purpose**.

For example,

Most states finance road construction and maintenance with the revenue collected from taxes on gasoline and other motor fuels. The more an individual drives, the more he or she benefits from the roads- and the more he or she pays.

Four possible combinations for the distribution of **benefits and costs** among voters

- ✓ **Widespread** among general public
- ✓ **concentrated** among a small sub-group

Type 2

Representative government is biased toward the adoption of inefficient projects.

Distribution of Benefits and Costs among Voters

		Distribution of benefits among voters	
		Widespread	Concentrated
Distribution of costs among voters	Widespread	Type 1	Type 2
	Concentrated	Type 4	Type 3

Type 1 & Type 3
Representative government will tend to undertake projects that are productive and reject those that are unproductive.

Type 4
The political process may reject projects that are productive

Thus,

■ **Type 1 and type 3 projects:**

They show that the political process yields reasonable results when there is a close relationship between the receipt of benefits and the payment of costs.

(a harmony between good politics and sound economics)

■ **Type 2 and type 4 projects:**

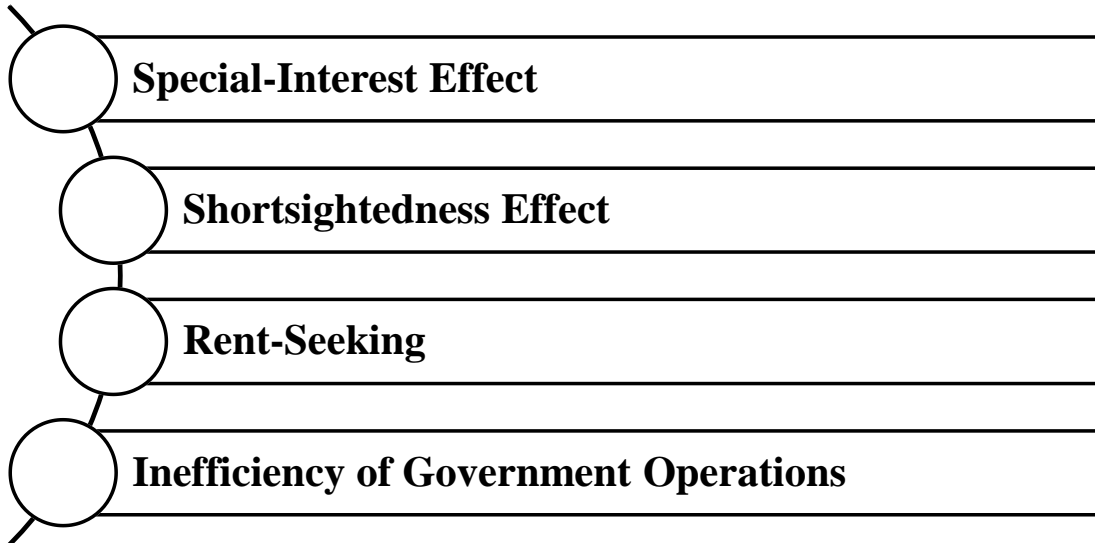
They show that the political allocation of resources will often result in inefficiency.

(a harmony between good politics and sound economics breaks down).



**When the Political
Process Works Poorly**

we consider **four major reasons** why the political allocation of resources will often result in inefficiency. (type 2 and type 4 projects)



Special-Interest Effect

A number of economic policies, such as trade restrictions and subsidies for specific industries, may reflect the **attractiveness** of **special interests** to **vote-seeking** politicians.

Special-Interest Issue

- An issue that generates **substantial individual benefits** to a **small minority** while imposing a **small individual cost** on many other citizens (**type-2 projects**). In total, the net cost to the majority might either **exceed** or **fall short** of the net **benefits** to the special interest group.

- ✓ a few people gain a great deal, but many others lose a small amount.
- ✓ In aggregate, the losses may exceed the benefits.

How will a vote-seeking politician respond to special-interest issues?

- Since their **personal stake** is large, members of the **interest** group will **vote** for or **against** candidates strictly on the basis of **whether** they are **supportive** of their **positions**.
- Since their **personal stake** is large, members of the **interest** group will **vote** for or **against** candidates strictly on the basis of **whether** they are **supportive** of their **positions**.

In addition, **interest groups** are generally an attractive source of campaign resources (including financial contributions).

In general, **organized interest groups** provide politicians with vocal supporters, campaign workers, and, most important, financial contributions.

As a result,

- politicians have a strong incentive to support legislation giving concentrated benefits to special-interest groups at the expense of disorganized groups.
 - Even if such legislation is **counterproductive**

It should be noted that:

→ The power of special interests is further **strengthened** by **logrolling** and **pork-barrel** legislation

➔ **Logrolling:** The exchange between politicians of political support on one issue for political support on another.

➔ **Pork-barrel legislation:** A package of spending projects benefiting local areas financed through the federal government.

the net benefit or cost is shown (each is counterproductive)	All three projects are inefficient and would not pass majority vote individually	Representatives from districts A, B, and C could <u>trade votes</u> (logrolling) or put together <u>pork-barrel</u> legislation that would result in all three projects passing.		
Voters of District	Construction of Post Office in A	Dredging Harbor in B	Construction of Military Base in C	Total
A	+\$10	-\$3	-\$3	+\$4
B	-\$3	+\$10	-\$3	+\$4
C	-\$3	-\$3	+\$10	+\$4
D	-\$3	-\$3	-\$3	-\$9
E	-\$3	-\$3	-\$3	-\$9
Total	-\$2	-\$2	-\$2	-\$6

Trading Vote and Passing counterproductive Legislation

- ✓ The bottom line : **Public-choice** analysis indicates that **majority** and **representative democracy** work **poorly** when **concentrated interests** benefit at the expense of the **general public**.
- ✓ In the case of special interest issues, there is a conflict between good politics—getting elected—and the efficient use of resources.
- ✓ The special-interest effect helps explain the presence of numerous government programs that increase the size of government and reduce the overall size of the economic pie.

Shortsightedness Effect

Because **voters** have a **weak incentive** to acquire information, **current economic** conditions will have a major impact on their choices at election time.

Short-sightedness Effect

- The **misallocation** of resources that results because **public-sector** action is **biased (1)** in favor of proposals yielding **clearly defined** current **benefits** in exchange for difficult-to-identify future costs and **(2)** against proposals with **clearly identifiable** current **costs** that yield less concrete and less obvious future benefits.

✓ Complex issues, like reforming Social Security or restructuring health care programs that involve **future benefits and costs**, will be **difficult for voters to assess**.

➔ Thus, incumbent politicians will want to make sure economic conditions look good on election day.

The shortsightedness effect sheds light on:

- ✓ why legislators find debt financing so attractive → Debt financing makes it possible for **officeholders** to provide **visible benefits** to their constituents without having to **levy** an equivalent amount of **taxes**.

Thus, Vote-seeking politicians will find it attractive to promise future benefits without levying a sufficient amount of taxes to finance them.

The differences between the public and private sectors in terms of how future benefits and costs are considered?

➔ The private sector tends to place more weight on **future benefits and costs** and **less weight** on the current.

➔ The public sector tends to place more weight on **current benefits and costs** and **less weight** on the future.

Rent-Seeking

The **incentive** for individuals to spend **time** and **effort** in rent-seeking will be determined by how **rewarding** it is.

Rent-seeking

- **Actions** by individuals and groups designed to **restructure public policy** in a way that will either directly or indirectly **redistribute** more **income** to themselves or the projects they promote.

- ✓ Rent-seeking will be **unattractive** when **constitutional constraints** prevent politicians from taking the property of some and transferring it to others.
- ✓ (or from **forcing** some to pay for things desired by others).



Thus, incumbent politicians will want to make sure economic conditions look good on election day.

- **Resources** that would otherwise be used to create **wealth** and generate **income** are **wasted** as people fight over slices of the economic pie.

In such context: counterproductive activities will expand while productive activities will shrink.

As a result, the overall income level will fall short of its potential.

Rent-seeking is the **political "fuel"** for most of income transfers.

Government now taxes approximately one out of every seven dollars citizens earn and transfers it to someone else.

These **transfers** are generally directed toward **groups** that are either **well organized** (like businesses and labor union interests) or **easily identifiable** (like the elderly and farmers). The people receiving these transfers often have incomes well above the average person.

Transfers to the poor will be particularly less attractive to vote-seeking politicians.

- ✓ The poor are less likely to vote than middle- and upper-income recipients.
- ✓ The poor are also less likely to be well informed on political issues and candidates.
- ✓ The poor are not an attractive source of political contributions.

There are **three** major **reasons** why government **transfer** activity will reduce the **size** of the **economic pie**.

1- Income redistribution **weakens** the **link** between productive activity and reward

(When taxes take a larger share of a person's income, the **reward** from hard work and productive activity is **reduced**.)

2- As public policy redistributes a larger share of income, more resources will flow into **wasteful rent-seeking** activities.

Resources used for lobbying and other rent-seeking activities will **not** be **available** to increase the size of the economic pie.

3- Higher taxes to finance income redistribution and an expansion in rent-seeking will induce **taxpayers** to focus less on **income-producing** activities, and more on **actions** to protect their income.

Predictably, the incentives created by government redistribution policies will exert a negative impact on the level of economic activity.

Inefficiency of Government Operations

Will government goods and services be produced efficiently?

In the **private sector**, there is a strong incentive to produce efficiently

because lower costs mean higher profits, and high costs mean losses and going out of business.

But

There is no parallel mechanism (the absence of profitability criteria) to eliminate inefficiency in the public sector.

In fact, failure to achieve a **targeted objective** (for example, a lower crime rate) is often used as an argument for **increased public-sector** funding.

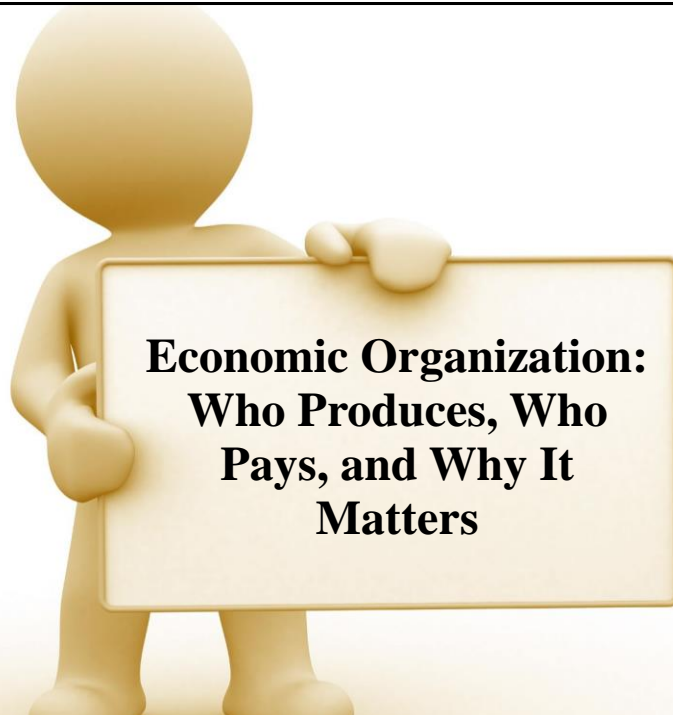
Public-sector managers are seldom in a position to gain personally from measures that reduce costs.

The opposite is often true,

If an **agency** fails to **spend** its **entire budget** for a given year, not only does it have to return the extra money, but its **budget** for the **next year** is likely to be cut.

- ✓ It is important to note that the argument of **internal inefficiency** is not based on the assumption that employees of a bureaucratic government are lazy or less capable.
- ✓ Rather, the emphasis is on the **incentives** and **opportunities** that government managers and workers confront.

Government firms do not have **owners** that have **risked** their wealth on the **future success** of the firm.



The structure of production and consumption will influence economic outcomes.

Goods and services can either be produced by **private** enterprises or supplied by the **government**.

They can be **paid** for either by the **consumer** directly or by the **taxpayer** or some other **third party**.



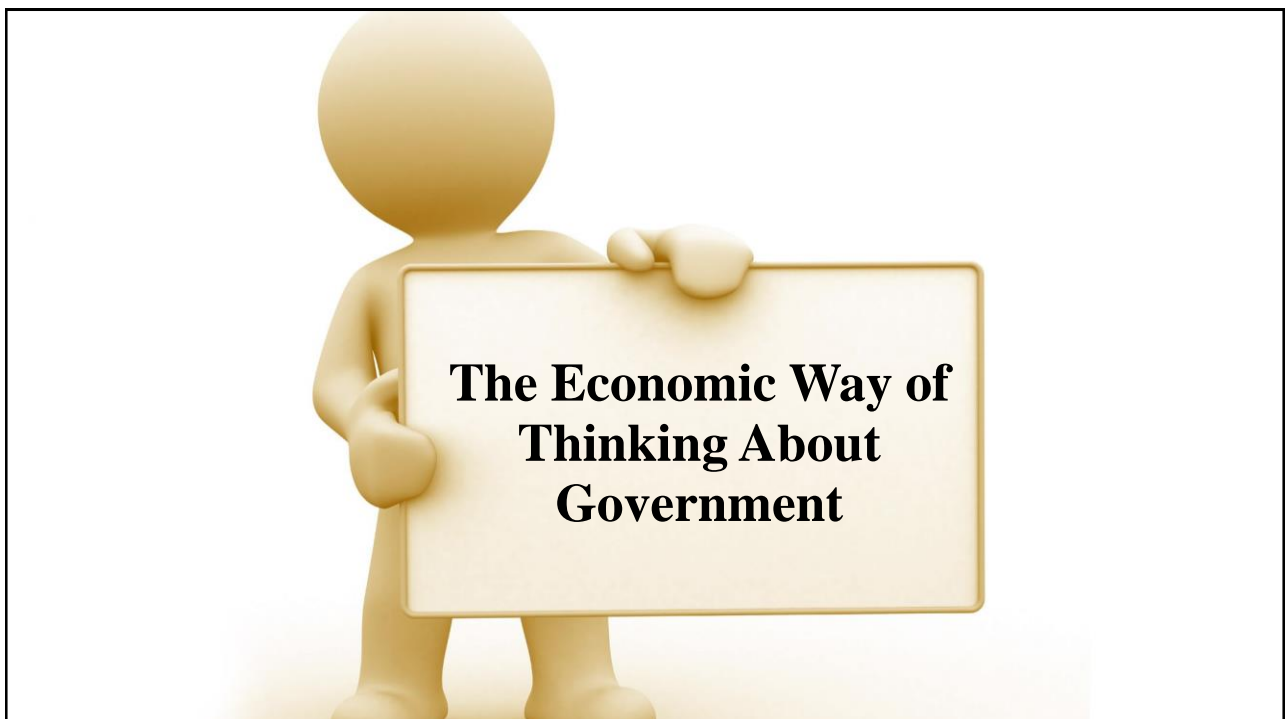
The Private and Government Sector Matrix of Production and Payment can explain the **payment-supply** link.

The Private and Government Sector Matrix of Production and Payment		Good is paid for by:	
		Consumer- Purchaser	Taxpayer or other Third party
<p>Quadrant 1:</p> <ul style="list-style-type: none"> ✓ Consumers will have a strong incentive to economize. <i>value > cost</i> ✓ The owners of private enterprises have a strong incentive to supply goods efficiently. 	Private Enterprises	(1) Examples: apples, oranges, television sets, food, housing, most other goods	(2) Examples: health care, food purchased with food stamps
	Government Enterprises or contracting	(3) Examples: Post Office, water and electricity in many cities, toll roads, many hospitals	(4) Examples: public schools, streets and roads, national defense, law enforcement

The Private and Government Sector Matrix of Production and Payment		Good is paid for by:		
<p>Quadrant 2:</p> <ul style="list-style-type: none"> ✓ Consumers have little incentive to care much about the price of their health-care services. ✓ Instead of economizing, many consumers will simply purchase from suppliers they believe offer the highest quality, regardless of the price. ✓ producers have little reason to control costs and offer services at attractive prices. ✓ This can dramatically affect economic efficiency. 		Consumer- <input type="checkbox"/> Purchaser	Taxpayer or other <input type="checkbox"/> Third party	
		Private <input type="checkbox"/> Enterprises	(1) Examples: apples, <input type="checkbox"/> oranges, television <input type="checkbox"/> sets, food, housing, <input type="checkbox"/> most other goods	(2) Examples: health- <input type="checkbox"/> care, food pur- <input type="checkbox"/> chased with food <input type="checkbox"/> stamps
		Government <input type="checkbox"/> Enterprises <input type="checkbox"/> or contracting	(3) Examples: Post <input type="checkbox"/> Office, water and <input type="checkbox"/> electricity in many <input type="checkbox"/> cities, toll roads, <input type="checkbox"/> many hospitals	(4) Examples: public <input type="checkbox"/> schools, streets <input type="checkbox"/> and roads, <input type="checkbox"/> national defense, <input type="checkbox"/> law enforcement

The Private and Government Sector Matrix of Production and Payment		Good is paid for by:		
<p>Quadrant 3:</p> <ul style="list-style-type: none"> ✓ Consumers will economize and seek the most value per dollar they spend. ✓ government-operated firms will generally be less efficient than private enterprises. ✓ Cost is also likely to be reduced if the government firm is a monopolist. 		Consumer- <input type="checkbox"/> Purchaser	Taxpayer or other <input type="checkbox"/> Third party	
		Private <input type="checkbox"/> Enterprises	(1) Examples: apples, <input type="checkbox"/> oranges, television <input type="checkbox"/> sets, food, housing, <input type="checkbox"/> most other goods	(2) Examples: health- <input type="checkbox"/> care, food pur- <input type="checkbox"/> chased with food <input type="checkbox"/> stamps
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The Private and Government Sector Matrix of Production and Payment		Good is paid for by:	
<p>Quadrant 4:</p> <ul style="list-style-type: none"> ✓ The political process determines what will be produced, how it will be produced, and how it will be allocated among the general public. ✓ consumers are in a very weak position to either discipline the suppliers or alter their production. ✓ The incentive to produce efficiently is weak, and there is likely to be a disconnect between the goods produced and the preferences of consumers. 		Consumer- Purchaser	Taxpayer or other Third party
		Private Enterprises	(1) Examples: apples, oranges, television sets, food, housing, most other goods
Government Enterprises or contracting	(3) Examples: Post Office, water and electricity in many cities, toll roads, many hospitals	(4) Examples: public schools, streets and roads, national defense, law enforcement	



- People have a **tendency** to believe that the **government**, particularly a **democratic representative** government, can **solve** all types of problems.
- if things do **not** go well, people tend to think that it is because the "**wrong**" people won the last election.
- **Public-choice** analysis suggests that the **problem** is that there is sometimes a **conflict** between **winning elections** and following **sound policies**.
- As we can see, when the **government** protects **property rights**, enforces **contracts**, and provides a **stable monetary environment**, economic **prosperity** is more likely to ensue.



**Could Constitutional
Changes Help
Promote Prosperity?**

Constitutions

- ✓ They incorporated **restraints** on the **economic role** of government.
- ✓ They **enumerated** the permissible tax and spending **powers** of the central government and allocated all other powers to the states and the people.
- ✓ They ensure that **private property** shall not be "taken for public use without just compensation"

Public-choice analysis highlights the importance of constitutional rules and procedures capable of **restraining** government **activities** to those areas in which it will **promote prosperity**.

- ✓ If we can **figure out** how to **constrain** the activities of government to those **areas** in which it is most likely to be **productive**, higher income levels can be **achieved**.

- ✓ The **challenge** is to develop **constitutional rules** and **political institutions** more consistent with economic efficiency and prosperity.



Thank you