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The Theory of the Individual in Economics

Introduction:

Economics is a social science—it is about people and about how we organize ourselves to meet our needs and enhance our well-being. Ultimately, all economic behavior is human behavior. Sometimes institutional forces appear to take over (witness the tendency of some bureaucracies to expand over time), but if you look closely at any economic outcomes, you will find that they are ultimately determined by human decisions or behavior. Thus, economists have traditionally used, as a starting point, some kind of statement about the motivations behind economic actions.¹

The concept of the individual is one of the most fundamental in contemporary society. It may even be the most fundamental of all our concepts. We cannot understand the historical evolution of political systems in terms of democracy, freedom, and human rights, the development of knowledge and science, and the quality and meaning of life without recognizing the centrality of the individual to our thinking. Human society could conceivably have developed differently in this regard. However, one thing we can know with certainty at this point in history is that individuality is a fundamental preoccupation of contemporary human society. In addition, the concept of the individual is central to the understanding of behavior in economics. Different approaches in economics implicitly rely on different theories of the individual. Yet in economics, with its tremendous influence on society, very little attention is given to the theory of the individual.^{2&3}

Classical, Neoclassical, Recent Theories of Individual

A) Classical Economic Views of Individuals

According to Adam Smith's concept of the invisible hand, people acting in their own self-interest would, through markets, promote the general welfare. The concept of the invisible hand has become very famous, but it is often taken out of context to mean that if people only behave with self-interest, they will do what is best for the entire society. This interpretation would have astonished Smith, who, before writing *An Inquiry into the Nature and Causes of the Wealth of Nations*, had written another long book, *The Theory of Moral Sentiments*, in which he examined with care how people are motivated. His emphasis there is on the desire of people to have self-respect and the respect of others. He assumes that such respect depends on people acting honorably, justly, and with concern and empathy for others in their community. Smith recognizes that selfish desires play a large role but believes that they will be held in check both by the "moral sentiments" (the universal desire for self-respect and the respect of others) and also by the fortunate accident by which "in many cases" (not all!) selfish acts can "promote the public interest." Thus Smith's vision of human nature and human motivation was one in which individual self-interest was mixed with more social motives. Rather than starting with Robinson Crusoe, who lived alone on an island, he perceived that the behavior of any one person always had to be understood within that person's social context.

¹ Goodwin, et al. (2004). *Economic Behavior and Rationality*. 3rd edition

² Note: this is true when it is compared with other social sciences.

³ John B. Davis (2003). *The Theory of the Individual in Economics: Identity and Value*. Routledge.



Smith was followed by other economists, such as the trade theorist David Ricardo and the philosopher/economist John Stuart Mill. They held similarly complex views of human nature and motivations. In 1890 Alfred Marshall tried to codify these ideas in a very influential text called *Principles of Economics*, which was published in eight editions, the last published in 1920. Marshall viewed the motives of human actors in an optimistic light—including those of economists, whom he assumed were motivated by a desire to improve the human condition. He specifically focused on the reduction of poverty so as to allow people to develop their higher moral and intellectual faculties, rather than being condemned to lives of desperate effort for simple survival.

B) The Neoclassical Model

In the twentieth century, the approach that came to dominate economics was known as the neoclassical model. This approach took a narrower view of human motivations. The basic neoclassical or traditional model builds a simplified story about economic life by assuming that there are only two main types of economic actors and by making simplifying assumptions about how these two types of actors behave and interact. The two basic sets of actors in this model are firms, which are assumed to maximize their profits from producing and selling goods and services, and households, which are assumed to maximize their utility (or satisfaction) from consuming goods and services. The two kinds of agents are assumed to interact in perfectly competitive markets.

Given some additional assumptions, the model can be elegantly expressed in figures, equations, and graphs. Some benefits can be gained from looking at economic behavior in this way. The assumptions reduce the actual (very complicated) economy to something that is much more limited but also easier to analyze. The traditional model is particularly well suited for analyzing the determination of prices, the volume of trade, and efficiency issues in certain cases. The neoclassical model was introduced to generations of students in 1948 with the publication of Paul Samuelson's textbook *Economics: An Introductory Analysis*. Samuelson's text promoted the idea that economics should be "value free" (i.e., it should be developed without reference to any human goals or values) and that it should be largely or purely deductive, meaning that it should derive conclusions from simple assumptions, about the motivations of market actors. In addition to the claim of being value free, through the second half of the twentieth century, many economists used another belief about the field to assert that their discipline was more scientific than other social sciences. They claimed that the entire system of economic theory is so purely deductive that everything in it can be deduced from one essential axiom⁴. This, the rationality axiom, states that "rational economic man maximizes his utility." (Some economists substitute for "utility" another term such as "self-interest," or "well-being.") This statement has often been interpreted to mean that pursuit of self-interest is the only thing that is done by rational economic actors—and that anything else is irrational. The statement that the subject of economics is "completely axiomatized" (i.e., everything in it can be deduced from this single basic axiom) has come under considerable criticism.

C) Recent Economic Theories

⁴ An axiom is a statement that is considered to be self-evident, without need of proof.



Recent economic theory has explored views of human nature and decision-making that go beyond the simple axioms of the basic neoclassical model. In this section, we examine other models of economic behavior that consider people's (1) choice of goals, (2) the actions they take to achieve these goals, and (3) the limitations and influences that affect their choices and actions.

In the past few decades, the neoclassical view of human behavior has been challenged by a strong alternative called behavioral economics, which studies how individuals and organizations make economic decisions. Studies in this area suggest that a more sophisticated model of human motivations is required to explain behaviors such as those that lead to stock market swings, the ways that people react to good and bad fortune, and why people often seem to act against their own self-interest.

Behavioral Economics: a subfield of microeconomics that studies how individuals and organizations make economic decisions.

Rather than making assumptions about human behavior, behavioral economics relies heavily on scientific experiments to determine how people behave in different situations.

Perhaps the most famous contemporary behavioral economist is not an economist by training. Despite being educated as a psychologist, Daniel Kahneman won the 2002 Nobel Memorial Prize in economic science. Kahneman's research has found that people tend to give undue weight to information that is easily available or vivid, something he called the availability heuristic (**Bias**). ("Heuristic" means a method for solving problems.). The availability Heuristic (**Bias**) happens when people often judge the likelihood of an event, or frequency of its occurrence by the ease with which examples and instances come easily to mind.

Availability Heuristic (Bias): placing undue importance on particular information because it is readily available or vivid.

Kahneman has also shown that the way a decision is presented to people can significantly influence their choices, an effect he referred to as framing.

Framing: changing the way a particular decision is presented to people in order to influence their behavior.

An effect similar to framing is known as anchoring, in which people rely on a piece of information that is not necessarily relevant as a reference point in making a decision.

Anchoring Effect: overreliance on a piece of information that may or may not be relevant as a reference point when making a decision.

The Role of Time in Economic Decisions

Recent economic theory has also explored the role of time in economic decisions. The retirement program example cited above suggests that in making their decisions people might not appropriately weigh the future. In other words, people seem to place undue emphasis on gains or benefits received today without considering the implications of their decisions for the future. Further evidence of this is the large number of people who have acquired significant high-interest credit card debt; indeed, about 6 percent of Americans are considered "compulsive shoppers," who seek instant gratification with little concern for often very troublesome consequences of running up a great deal of debt. But you do not need to be a compulsive shopper to fall short of the ideal "rational consumer" who knows and weighs all the relevant costs and benefits.



You may know someone who does not pay much attention to the future consequences of his or her actions. Economists would tend to say that this person has a very high time discount rate, meaning that in his or her mind, future events are very much discounted or diminished when weighed against the pleasures of today.

Time Discount Rate: an economic concept describing the relative weighting of present benefits or costs compared to future benefits or costs

On the other hand, you might also know people who seem to have the attitude “I’ve got to work hard and prepare now; enjoying myself will have to wait for later.” Economists would say that people like this have low time discount rates if by their current work they are gaining benefits for tomorrow. The later benefits loom large (that i.e., are not “discounted”) in their decisions. Time discount rates are important in all sorts of situations. Economists usually assume that people who invest in a college education has a relatively low time discount rate, because they are willing to forgo current income or relaxation to study for some expected future gain. (Of course, this is not true for individuals who enjoy college or regard it as more appealing than the prospects for post college experience.) Company leaders with high time discount rates may concentrate on making this quarter’s financial statement look good, whereas those with more concern about the future will look toward longer-term goals. In deciding on environmental regulations, people who work at government agencies are forced to make decisions about how much weight to give the wellbeing of future generations. The lower their discount rate, the more important safeguarding the well-being of future generations appears.

Economic Rationality

“Rationality” has become a loaded word in economics, bringing with it the baggage of earlier models that did not anticipate the findings of behavioral economics or take into account other everyday observations. In this section we formulate an alternative view of human behavior that is more realistic.

Choosing Goals and Trying to Achieve Them

Economists generally proceed from a belief that people should be free to choose their own goals, even if their chosen goals differ from those of most others. However, what can be considered a rational goal has limits, especially considering that people usually have more than one final goal. Some goals that people pursue may be unachievable. People may also choose reasonable goals, but engage in irrational behavior that leads them away from their achievement rather than toward it. A reasonable definition of rational behavior includes (1) selecting goals that are consistent with present and future well-being, and (2) pursuing the goals in a manner that can reasonably be assumed to lead to their achievement.

The Role of Constraints and Information

It is important to note that economic decisions are always made subject to constraints, including limits on income and other resources and on physical or intellectual capacities. A universal constraint is time. Every day you face the choice of how to allocate 24 hours among competing activities such as sleeping, studying, going to class, eating, and entertainment. You cannot decide to allocate 10 hours each day to sleeping, 5 hours to studying, and 10 hours to hanging out with friends because you do not have 25 hours available. To put this in economic terms, your “production possibilities frontier” has only 24 hours per day.



Another important factor in an economic model of rationality is information. In assessing their options, economic actors make use of their existing knowledge but often need to collect additional information. Consider the decision to purchase a new automobile. Numerous factors go into such a decision. Should you buy a new car or a used one? What is the relative importance of fuel economy, safety, and luxury features? What about resale value and maintenance costs? Making a rational decision requires that you obtain information on these various factors.

The neoclassical approach tends to assume that rational behavior is optimizing behavior, based on the further assumption that rational economic actors have “perfect information.” A slightly more modest version says that people will collect information until the perceived costs of acquiring additional information exceed the perceived benefits. However, there is no way of guaranteeing either that people can know enough to make that “cost/benefit” calculation (i.e., to make an informed decision about when to stop gathering information) or that, when they do stop gathering information, they will know enough to make an optimal or even a good choice.

Optimizing Behavior: behavior that achieves an optimal (best possible) outcome.

One challenge to the traditional assumption of rationality comes from Herbert Simon, another psychologist who received a Nobel Memorial Prize in economic science (in 1978). Considering the matter of whether it is indeed possible for people to identify the optimal point at which one should cease gathering additional information, Simon logically showed that, in fact, one first needs to have complete knowledge of all choices in order to identify that optimal point! Moreover, determining what additional information might be out there and then gathering it can be very costly in time, effort, and money. Accordingly, Simon maintained, people rarely optimize. Instead they do what he called satisficing; they choose an outcome that would be satisfactory and then seek an option that at least reaches that standard.

Satisfice: to choose an outcome that would be satisfactory and then seek an option that at least reaches that standard

Given constraints of time and so forth, satisficing seems to be a reasonable behavior. If an individual finds that the “satisfactory” level was set too low, a search for options that meet that level will result in a solution more quickly than expected or perhaps even multiple solutions. In this case, the level may then be adjusted to a higher standard. Conversely, if the level is set too high, a long search will yield nothing, and the “satisficer” may lower his or her expectations for the outcome.

Another deviation from rational behavior as traditionally defined has been called ameliorating—defined as starting from the present level of well-being and then taking any opportunity to do better. A simple example is a line fisherman who has found a whole school of haddock but wants to keep only one for his supper. When he catches the second fish, he compares it to the first one, keeps the larger, and releases the other. Each subsequent catch is compared to the one held in the bottom of the boat. At the end of the day, the fish that he takes home will be the largest of all those caught.

Ameliorating: starting from the present level of well-being and continuously attempting to do better



One result of using amelioration as the real-world substitute for theoretical optimization is its implication that history matters: People view each successive choice in relation to their previous experience. It is commonly observed, for example, that people are reluctant to accept a situation that they perceive as inferior to previous situations. This psychological path dependence—the idea that where you are going depends on where you have been—is relevant to feelings about rising prices and even more so to attitudes about declining wages.

Satisficing and ameliorating may both be included under the term bounded rationality. The general idea is that, instead of considering all possible options, people limit their attention to some more-or-less arbitrarily defined subset of the universe of possibilities. With satisficing or meliorating behavior, people may not choose the “best” choices available to them, but they at least make decisions that move them toward their goals.

The Role of Influence

The discussion above cautions that in modeling⁵ human behavior, it is necessary to recognize that there is no known decision rule within human capabilities that guarantees an entirely satisfactory conclusion, let alone the “best of all possible” conclusions. A very important aspect of decision making relates to the outside influences on us.

In the discussion of behavioral economics, we saw examples of ways that others can affect our decisions by setting a “frame” or providing extra emphasis on one conclusion at the expense of others. Available information is, of course, a critical feature, and actors other than the decision maker may have a strong influence on which information is available. The literature in behavioral economics provides a wide array of other ways that decision making can be distorted by influences not related to the goals of the particular actor.

These realities have long been well known to politicians and advertisers, who, since the early part of the twentieth century, have often based their successes on assuming irrational consumers and voters.

And just as corporations gravitate toward behavior that fattens profits, even if their products do more harm than good, politicians also often find it hard to resist the easy appeal to emotions of greed, even fear, rather than offering sound information on which voters can make good decisions.

Self-Interest, Altruism, and the Common Good

We have referred to the neoclassical model of economic behavior that is deduced from the axiom: “Rational economic man acts so as to maximize his utility.” This could be—and often has been—interpreted by teachers, students, and practitioners of economics to mean: “Rational people try to get what they want.” That in turn was often understood as saying, “Rational people are only self-interested—any non-self-interested acts are irrational.” Many students found this approach so

Path Dependence: situations in which what is possible, or what is chosen, in the present depends on what has happened in the past.

Bounded Rationality: the hypothesis that people make choices among a somewhat arbitrary subset of all possible options due to limits on information, time, or cognitive abilities.

⁵ we employ the term “model” to mean a description of human behavior that emphasizes what is most important to understand how people act most of the time when engaging in economic activities. Such a model obviously cannot explain all human actions, but it should be sufficient to provide a general outline of what to expect.



unappealing that they dropped economics as their major, while others who stayed with these courses more or less bought in to the lesson that “Only self-interested behavior is rational.”

This probably explains a good deal of why economics students (and economics faculty) have frequently been shown, in tests, to be less altruistic than others (see the following topic, “Economics and Selfishness”). The opposite of pure self-interest is altruism, which means a concern for the well-being others, with no thought about oneself. Although it would be excessively idealistic to assume that altruism is the prime mover in human behavior, it is reasonable to assert that some elements of altruism enter into most people’s decision making—contrary to the simple neoclassical model of “rational” selfishness.

Altruistic Behavior:
actions focused on the well-being of others, with no thought about oneself.

Especially relevant to economics is the fact that much economic behavior may be motivated by a desire to advance the common good—the general good of society, of which one’s own interests are only a part. Striving to advance the common good means seeing your own well-being as connected to the larger well-being of society. That is, people are often willing to participate in the creation of social benefits as long as they feel that others are also contributing. Economists are increasingly realizing that a well-functioning economy cannot rely only on self-interest. Without such values as honesty, for example, even the simplest transaction would require elaborate safeguards or policing. Imagine if you were afraid to put down your money before having in your hands the merchandise that you wished to purchase—and the merchant was afraid that as soon as you had what you wanted, you would run out of the store without paying. Such a situation would require police in every store—but what if the police themselves operated with no ethic of honesty? Without ethical values that promote trust, inefficiencies would overwhelm any economic system. If all those in business cheated whenever they thought they could get away with it, business would grind to a halt. If everyone in the government worked only for bribes, meaningful governance would disappear. In addition, people have to work together to overcome problems from externalities. And it is hard to imagine how the human race could survive if altruism was not common enough that people would be willing to make sacrifices of time, convenience, and resources to meet the needs of those who cannot take care of themselves, such as children or sick people. Fortunately, recent experiments on human behavior demonstrate that people really do pay attention to social norms, and they are willing to reward those who follow these norms and to punish people who violate them, even when this has a cost in terms of their narrow self-interest.

The Model of Economic Behavior in Contextual Economics

Many real-world problems would be difficult, if not impossible, to solve in the absence of a reasonable number of people willing to work for the common good. These people are often especially concentrated in the public purpose sphere, while individual altruism is most often evident in the core sphere of the economy. Does that mean that business is the sphere that operates only on self-interest? From about 1970 to the end of the twentieth century, economists, especially from what was known as the “Chicago School,” pressed this case. Even early in this period concern arose that individuals who acted solely to achieve their personal goals could not be counted on to operate a business in ways that would be good for the business itself. This concern resulted in various efforts to reward business leaders for the success of their business.



These efforts had the unintended consequences of escalating compensation of top management in the United States to levels that were many times greater than anything that had previously been considered normal (or were normal in other countries). They also resulted in an increasingly short-term vision on the part of business leaders, whose compensation was set up to provide large rewards for quick profits. Large-scale frauds, Ponzi schemes, tax evasion, and environmental and human costs that businesses externalized during this period have made it increasingly evident that society cannot afford to encourage a definition of economic activity in which normal human motivations are stripped down to selfish pursuit of personal gain.

Modern research in behavioral economics suggests that the neoclassical rationality axiom does not stand up to tests of logic, experience, or the needs of society. (And some feminist economists have pointed out that the reference to “rational economic man” may be related to this one-dimensional view of human nature.) With that said, the following statements concerning motivations and behavior may provide a better grounding for economic theory.

We start with a definition of rationality that includes: 1) choosing goals such that (a) when the actor achieves the goals, she or he will be glad to have done so; or (b) the pursuit of the goal itself contributes to well-being; and 2) pursuing those goals in a manner that the actor expects will lead toward their achievement.

This definition does not insist that the goals be either entirely self-interested or entirely altruistic. Rather, based on common experience and observation, it appears that most people operate with some mixture of these kinds of goals.

Our model then posits that most adults attempt to act rationally. However, sometimes lack of information, the influence of conflicting emotions, or influence from others who are pursuing different goals may cause rational actors to choose goals that are not consistent with well-being or to do things that lead away from their goals.

Although, compared to the rationality axiom, these statements are obviously much more inclusive, and closer to reality, they are also much looser and cannot be used in the same, deterministic manner. For example, because they do not claim that people optimize or maximize, they provide less opportunity for developing mathematical models based on simple axioms about behavior. Nor is there any claim that these statements are all that the economist needs to know about human behavior. Explanations or predictions of economic phenomena sometimes require individual judgment, experience, or inputs from other social sciences. Thus, they do not conform to the ideal of “scientific” social science pursued by neoclassical economists.

However, many people have come to believe that neoclassical economics, which achieved many fruitful insights in its early decades, has explored all the territory that it initially opened up and has contributed less and less value as time has gone on. Moreover, its narrow view of human nature and lack of contextual awareness are criticized for leading to some of today’s problems. Neoclassical economists almost uniformly failed to see the growth of the financial and real estate bubbles that led to the Great Recession, beginning in 2007. More broadly, some people believe the emphasis on selfishness has been used to justify a “culture of greed”, the dramatic increase in income and wealth inequality in recent decades, and ever greater concentration of economic and political power in ever larger corporations.



Once again, we face tradeoffs. If we are to develop economic theories equipped to deal with the critical issues of the twenty-first century, we probably need to give up a degree of tidiness, amenability to mathematical modeling techniques, and the appearance of completely value-free objectivity.

The Economics of Collective Decision Making⁶

Introduction

The important point of this part is to recognize that a government will not always implement policies that promote the general welfare. Public-choice analysis applies the principles of economics to the operation of the political process. It uses the same self-interest (everyone does what is best for himself/herself) principle that is used in understanding the market (the invisible hand theory).

As we already knew, the protection of property rights, evenhanded enforcement of contracts, and provision of a stable monetary environment are vital for the smooth and efficient operation of markets. Governments that perform these functions well will help their citizens prosper and achieve higher levels of income. Governments may also help allocate goods difficult for markets to handle. However, it is crucially important to recognize that government is simply an alternative form of economic organization. In most industrialized nations, the activities of governments are directed by the democratic political process. In this part, we will use the tools of economics to analyze how this process works.

The differences and similarities between governments and markets.

When political decisions are made democratically, the choices of individuals will influence outcomes in the government sector- just as they do in the market sector. Therefore, when we analyze the political process, we focus on individuals and how incentives influence their choices, just as we do when we analyze markets. There are both differences and similarities between political and market decision-making. Let's take a look at several of them.

1. Competitive behavior is present in both the market and public sectors.
The nature of the competition and the criteria for success differ between the two sectors, but people compete in both. Politicians compete for elective office. Bureau chiefs and agency heads compete for taxpayer dollars and the authority to regulate others to meet their bureau or agency goals. Public-sector employees compete for promotions, higher incomes, and additional power, just as they do in the private sector. Lobbyists compete for program funding, for favorable bureaucratic rulings, and for legislation favorable to the interest groups they present- including both private and government clients. The nature of the competition may differ between the two sectors, but it is present in both.
2. Public-sector organization can break the individual consumption-payment link.
In the market sector, goods are allocated to those who are willing to pay the price: there is a one- to- one relationship between a person's payment and receipt of a good. This is often not the case when decisions are made politically. Sometimes people receive very large benefits

⁶ James Gwartney, Richard Stroup, Russel Sobel, & David Macpherson (2010). Economics: Private and Public Choice. 13th ed.



from the government even though they do not pay much of the cost to cover them. In other cases, individuals are required to pay dearly for a government program even though they derive few, if any, benefits.

3. Scarcity imposes the aggregate consumption-payment link in both sectors.

Although the government can break the link between a person's payment for a good and the right to consume it, the reality of the aggregate consumption- aggregate payment link remains. Resources used by the government have alternative uses. Therefore, it is costly to provide goods and services through the government. This is true even if the good is provided "free of charge" to certain customers.

4. Private-sector action is based on mutual agreement; public-sector action is based on majority rule.

In the market sector, when two parties engage in trade, they do so voluntarily. Corporations like General Motors and Microsoft, no matter how large or powerful, cannot take income from you or force you to buy their products. On the other hand, when collective action occurs in a democratic setting, majority rule is the key, either through direct voting or through legislative procedures involving elected representatives. If a legislative majority decides on a particular policy, the minority must accept the policy and help pay for it, even if they strongly disagree. Similarly, if government regulators mandate that private parties must provide a wildlife habitat, wetlands, or housing at below-market prices, for example, both providers and potential buyers must comply. Although market action is based on mutual benefit, government action through the political process generates losers as well as winners.

5. When collective decisions are made legislatively, voters must choose among candidates who represent a bundle of positions on issues.

On election day, the voter cannot choose the views of one politician on poverty and business welfare and simultaneously choose the views of a different politician on national defense and tariffs. This greatly limits the voter's power to make his or her preferences count on specific issues. Since the average representative is asked to vote on roughly 2000 different issues during a two-year term, the size of the problem is obvious. The situation in markets, however, is quite different. A buyer can purchase some groceries or clothing from one store, while choosing related items from different suppliers. There is seldom a bundle-purchase problem in markets.

6. Income and power are distributed differently in the two sectors.

People who supply more highly valued resources in the marketplace have larger income. The number of these dollar "votes" earned by a person in the marketplace will reflect his or her abilities, ambitions, skills, past savings, inheritance, good fortune, and willingness to produce for others, among other things. Bill Gates is a good example. Many people have "voted" for his products. Consequently, Gates has become quite wealthy. This process results in an unequal distribution of income and power in the market sector.

On the other hand, in a democratic government, one citizen, one vote is the rule. But there are ways other than voting to influence political outcomes. People can donate both their money and their time to help a campaign. They can also try to influence friends and neighbors, write letters to legislators, and speak in public on behalf of a candidate or cause. The greatest rewards of the political process go to those best able and most willing to use their time, persuasive skills, organizational ability, and financial contributions to help politicians get votes. People who have more money and skills of this sort- and are willing to spend them in the political



arena- can expect to benefit more handsomely for themselves and their favorite causes. Thus, while the sources of success and influence differ, there is an unequal distribution of influence and power in both sectors.

Government's Role in Economy: Basic Concepts

Government

It is described as organizations of individuals or particular set of institutions and people authorized by formal documents and legally empowered in order to make binding decisions on behalf of a particular community. These decisions include:

- External Decisions: war, trade, border control, ...
- Internal Decision: tax, education, health, welfare, ...

Efficient decisions by government requires good governance. Good governance considers the following set of actions:

- Rule of law
 - o Government can take no action that has not been authorized by law
 - o Citizens can be punished only for actions that violate an existing law
- Property rights
- Regulatory regime
- Macroeconomic policies
- Absence of corruption

For the purpose of executing public decisions, governments need to use its executive arm. **Executive Government** broadly refers to the **arm of government** responsible for carrying out or administering laws enacted by the legislature. The term is also used in relation to Ministers from the governing party who make policy decisions and are responsible for the administration of **government**. This requires a government to have enough power. Government's Power can be defined as an ability to get people or groups to do what they otherwise would not do. Government's power is required for the following reasons:

- to develop institutions
- to carry out policies
- sometimes unpopular
- has to be sufficiently strong

Furthermore, government power not only is required but also it is required to be sufficient power (adequate power), which should be:

- **Constrained power** (Constitutionally Limited Government) : where governmental power is restricted by law, usually in a written constitution.
- **Checks and balances**: oblige the government to control itself.
- **Restraint** to check arbitrary and corrupt behavior by the government
- **Effective**: Key role of building effective political institutions

Political Institutions

Political Institutions are organizations which create, enforce and apply laws. They play important role in resolving redistribution conflict from economic policies. Characteristics of political institutions are extremely important in determining the prevalence of corruption

Political Institutions have the following key responsibilities:



- **Setting electoral rules**
 - Single-member district and first-past-the-post⁷
 - Proportional representation system
- **Defining constitutional rules**
 - division and limit of power
 - between branches of government (Executive, Legislative, Judicial).
 - between central and local governments
- **Constraining arbitrary exercise of power by politicians and bureaucrats**
 - Delineate property rights between state and private sector
 - Enforce property rights
 - Influence competition in political process
 - Hold public officials accountable for their actions

Political Institutions and Economic Policy Outcomes

One of the most interesting recent developments in the field of monetary and fiscal economics has been the recognition that institutional and political structures can matter for the conduct of monetary/fiscal policy and for macroeconomic outcomes. Political institutions play important role in resolving redistribution conflict from economic policies. Three examples of policy decisions (policies): budget deficit, financial market, and trade policy.

1. Budget Deficit

It is the difference between revenue and expenditure. Government influence on budget through:

- Muster Political Support for Taxation
- Resist Demands for expansion of spending

Political institutions of budget procedures should consider balanced budget rules and the power of finance ministry. Balanced budget rules are more likely to be effective if:

- Voluntarily adopted
- Impose hard constraints (fiscal policy: the importance of seigniorage relative to other sources of government revenue)
- Difficult to reverse
- Effectively enforced by a credible third party or higher level government.

Political institutions in their decision about the budget are influenced by the prevailing “Electoral Rules”, as follows:

- **Minority** (coalition) **governments** tend to have higher budget deficit than majority government
- **States** with systems of **proportional representation** tend to have higher budget deficit than states with majoritarian voting systems.

Note that: Budget deficit tends to rise in election year

Institutions and taxation policies

Taxes provide the state with resources to build market-supporting institutions. Weak tax collection institutions lead to disproportionate reliance on tax revenue from more visible and easier sources: international trade and large firms. It should be noted that poor countries tend to have weaker tax administration & higher reliance on tariffs.

⁷ First-past-the-post is a type of electoral system. a voting system used by some countries to elect their governments or the members of their parliaments. In a first-past-the-post system, a country is divided into constituencies. In these constituencies people known as candidates, each of whom usually represents a different political party, will stand for election to the country's parliament. In the individual constituencies, the candidate who gets the most votes from people, wins the race to be elected to a seat in parliament. In the UK it is the system used for the election of MPs to the House of Commons and for some local government elections.



2. Financial Market Regulation

We need to consider the influence of political institutions on the financial market regulations. In this regard, it is necessary to consider how independent financial regulatory agencies are. In this regard, we need to note the similarities between central bank independence and Checks and balances⁸ in political process. Among developing countries, Central Bank independence doesn't seem to affect inflation outcomes, i.e., weak correlation. Among developed countries, a high degree of central bank independence appears to have the potential to yield low average inflation with no deleterious effects on real activity.

3. International Trade Liberalization

Trade policy refers to the regulations and agreements that control imports and exports to foreign countries. Government's trade policy is influenced by domestic political conflict between gainers and losers from trade liberalization. In any given economy, there exists a number of industries that tend to have tariff protection compared to others. Those industries include:

- a) Industries in decline
- b) Industries that are highly unionized (Industrial Unionism)
- c) Make substantial campaign contributions
- d) More geographically dispersed

Political Institutions and Corruption

What is Corruption?

Corruption is an exercise of public power for private gain. It involves the use of public resources for private gain. Corruption is an opportunist behavior aimed at producing benefits for individual or group at the expense of society. It usually has large costs for economic development. It undermines well-functioning markets by the possibility of the following occurrences:

- A tax that distorts competition & lower returns
- A barrier to new entries in market competition
- Subvert state's legitimacy
- Weakens state capacity for empowering institutions to support markets.

Once the constitution is adapted there is an incentive by individuals and groups to capture the state's redistributive or transfer power. The process through which individuals and or groups expend resources to affect distributional outcome is called Rent Seeking. Effective control of corruption must be based on institutional reforms including good constitutions to constrain the ability of the state to intervene in private transactions.

What are main causes of corruption?

- Distorted policy environment
- Weak judiciary
- Poor civil service management
- Low public sector pay
- Other factors that include: Openness to international trade; Complexity of regulatory environment; and High and variable inflation

Good Political Institutions and Corruption

It should be noted that promoting good governance that is accountable, transparent, honest, participatory, guarantees economic freedom, rights of individuals to freely exchange and contract,

⁸ Principle of government under which separate branches are empowered to prevent actions by other branches and are induced to share power.



based on well secured property rights by law. Political institutions can help reduce the opportunities and incentives for corruption by:

- Restraining politicians from arbitrary actions
 - ✓ Holding politicians accountable for their action through: Decentralization; Electoral rules; Press freedom; Civil society; Good governance
- There is a critical need to establish laws and institutions that place constraint on government to avoid opportunistic behavior of bureaucrats.
- Traditional ways of controlling corruption include: society, legal, market, and political
 - ✓ Society : civil society norms, media, education.
 - ✓ Legal: Control through laws, courts, police.
 - ✓ Market Strategies: reduce state control of markets- change incentives against corrupt behavior.
 - ✓ Political: Government decentralization, raise opportunities for citizen participation and liberalization.

Measuring Corruption

- Corruption can be measured by Corruption Perceptions Index(CPI), which ranks countries based on how investors, political and risk analysts, and the public perceive levels of corruption.
- The Index ranges from zero (high corruption), to 10 (highly clean-minimum corruption).

CPI in a number of developed and developing countries:

- Based on CPI data (1999), Denmark (CPI=10)and Finland (9.8) are the least corrupt or top two cleanest states.
- Nigeria (CPI=1.6) & Cameroon (CPI=1.5) are the most corrupt states.
- Of the 10 most corrupt economies 4 are in Africa (Cameroon, Nigeria, Tanzania, Kenya).
- Others- such as Botswana, Mauritius, Namibia, and South Africa are have relatively less corruption & making progress.

Corruption and Economic Outcomes

1. studies show corruption has negative effects on economic development by contributing to less effective governance and retarding wealth creation, reversing democratic gains, making economies less able to sustain viable and effective economic systems.
2. Cost of public service is high to provide more income to civil servants- contributes to high transaction costs
3. Increases the burden of the public sector on citizens.
4. It demoralizes, and leads to political opportunism such as ‘rent seeking’ that contribute to inefficiency.
5. Leads to inability of a government to sustain professionals and administrators,
6. Encourages the underutilization of skilled and educated labor cost or the ‘brain drain’.
7. Distorts international trade and investment,
8. Discourages investment and leads to capital flight (capital outflow).

Political Decision-Making: An Overview

Public-choice analysis is a branch of economics that applies the principles and methodology of economics to the operation of the political process. Public-choice analysis links the theory of individual behavior to political actions, analyze the implications of the theory, and tests them against events in the real world. Over the past 50 years, research in this area has greatly enhanced our understanding of political decision-making. Just as economists

Public-choice analysis: the study of decision-making as it affects the formation and operation of collective organizations, such as governments. In general, the principles and methodology of economics are applied to political science topics.



have used the idea of self-interest to analyze markets, public-choice economists use it to analyze political choices and the operation of government. After all, the same people make decisions in both sectors. If self-interest and the structure of incentives influence market choices, there is good reason to expect that they will also influence choices in a political setting.

The collective decision-making process can be thought of as a complex interaction among voters, legislators, and bureaucrats. Voters elect a legislature, which levies taxes and allocates budgets to various government agencies and bureaus. The bureaucrats in charge of these agencies utilize the funds to supply government services and income transfers. In a representative democracy, voter support determines who is elected to the legislature. A majority vote of the legislature is generally required for the passage of taxes, budget allocations, and regulatory activities. Let's take a closer look at the incentive structure confronting the three primary political players- voters, legislators, and bureaucrats- and consider how they affect the operation of the political process.

Voters, Politicians, and bureaucrats are the primary decision makers in the political arena.

Incentives confronted by the voter

How do voters decide whom to support? Self-interest dictates that voters, like market consumers, will ask, "what can you do for me and my goals, and how much will it cost me?" the greater the voter's perceived net personal gain from a particular candidate's election, the more likely it is that the voter will favor that candidate. In contrast, the greater the perceived net economic cost imposed on the voter by the positions of a candidate, the less inclined the voter will be to support the candidate. Other things equal, voters will tend to support those candidates whom they believe will provide them the most government services and transfer benefits, net of personal costs.

How well will voters be informed about political issues and candidates? When decisions are made collectively, the choice of a single person will not be decisive. The probability that an individual vote will decide a city, state, or national election is virtually zero. Realizing that their votes will not affect the outcome, individual voters have little incentive to spend much effort seeking the information needed to cast an informed ballot. Economists refer to this lack of incentives as the **rational ignorance effect**.

As the result of the rational ignorance effect, most voters simply rely on information supplied to them freely by candidates (via political advertising) and the mass media, as well as conversations with friends and coworkers. Surveys, in fact, indicates that huge numbers of voters are unable to even identify their own congressional representatives, much less know where they stand on issues like social security reform, tariffs, and agricultural price supports. Given that voters gain little from casting a more informed vote, their meager knowledge of political candidates and issues is not surprising.

Rational Ignorance Effect:
Because it is highly unlikely that an individual vote will decide the outcome of an election, a rational individual has little or no incentive to search for and acquire the information needed to cast an informed vote.

On the other hand, when people can put information to good use, they will put forth the effort to acquire it. Consider the incentive of an automobile purchaser to make a well-informed choice. If a bad choice is made, the individual consumer will bear the consequences. As a result, auto consumers have a strong incentive to make informed decisions. Thus, they often take different



models for test drives, review consumer publications, and consult with various car experts about them. On the other hand, the voter gains little or nothing in terms of a changed result from a more informed political choice. Because, the person is not in a position to decide the outcome of an election, if he or she makes a mistake by casting an uninformed ballot, it won't make much difference. Thus, it is actually reasonable to expect people to be far better informed when choosing a car than a senate, congressional, or other political candidate.

The fact that citizens realize their individual votes will not sway the outcome of an election also explains why so many of them don't vote. Even in a presidential election, only about half of all voting-age American take the time to register and vote. The turnout for state and local elections is generally still lower. Given the low probability that one's vote will be decisive, low voter turn-out is an expected result.

Incentives confronted by the politician

What motivates political candidates officeholders? Economics indicates that the pursuit of votes will primarily shape politicians' actions and political positions. No doubt, many of them genuinely care about the "public interest" and the quality of government, but they need to get elected to achieve their objectives, whatever they might be. To be successful, a candidate's positive attributes must be brought to the attention of rationally ignorant voters focused on their families, jobs, various civic activities, and local sports team (which are probably more entertaining)> the successful candidate needs an expert staff, sophisticated polling techniques to uncover popular issues and positions, and high-quality advertising to favorably shape his or her image. This, of course, will be costly. It is not unusual for an incumbent candidate to the U.S. Senate to spend more than \$15 million or more to get reelected. In other words, votes are the ultimate objectives of politicians, but money helps them get those votes. Predictably, the pursuit of campaign contributions therefore shapes the elections of politicians, too.

Are we implying that politicians are selfish, caring only for their pocketbook and reelection chances? The answer is "No". factors other than personal political gain, narrowly defined, may well influence their actions. Sometimes an elected official may feel so strongly about an issue that he or she will knowingly take a position that is politically unpopular and damaging to his or her future electoral prospects. None of this is inconsistent with the economic view of the political process we just described. Over time, however, the politicians most likely to remain in office are the ones who focus on how their actions will influence their reelection prospects. Just as profits are the lifeblood of the market entrepreneur, votes are the lifeblood of the politician.

Politicians face competition for elected office from other candidates. Just like market suppliers, political suppliers have an incentive to find ways to gain an advantage over their competitors. Catering to the views of voters and contributors is one way of doing that. Enacting rules that put potential challengers at a disadvantage is another. When geographic political districts are redrawn, for example, politicians frequently manipulate the process to increase their chances of reelection—a process known as "gerrymandering". Incumbents can also attempt to use government resources for their reelection campaigns, advantage challengers do not have. Campaign finance "reforms" that make it more difficult for a challenger to raise funds may also provide incumbents with an additional advantage.



Incentives Confronted by the Government Bureaucrat

Like other people, bureaucrats who staff government agencies have narrowly focused interests⁹. They usually want to see their own agency’s goals furthered. Many bureaucrats believe strongly in what they are trying to do. Furthering these goals, however, usually requires larger budget. In turn, larger budgets lead to more prestige and career opportunities for the bureaucrats. Economic analysis suggests there is a strong tendency for government bureaucrats and employees to want to expand their budget to sizes well beyond what is economically efficient.

Legislative bodies are in charge of overseeing these bureaus, but the individual legislators themselves are generally not very knowledgeable about the true costs of running these agencies. This makes it even more likely that bureaucrats will be able to get funding beyond what’s economically efficient.

The political process, which begins with voter-driven elections and proceeds to legislative decisions and bureaucratic actions, brings about results that please some voters and displease others. The goals of the three major categories of participants- voters, politicians, and bureaucrats- frequently conflict with one another. Each group wants more of the government’s limited supply of resources. Coalitions forms, and the members of each coalition, hope to enhance their ability to get the government to do what they want. Sometimes this results in productive activities on the part of the government, and sometimes it does not.

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.

Exhibit 4 helps illustrate this point. It presents hypothetical data on the distribution of benefits from a government road construction project.

Exhibit 4: 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).

⁹ The economic analysis of bureaucracy was pioneered by William Niskanen.



These benefits sum to \$40, which exceeds the \$25 cost of the road, so the project is productive. But if the project's \$25 cost were allocated equally among the voters (plan A), Adams and Chan gain substantially, but Green, Lee, and Diaz lose. If the fate of the project is decided by majority vote, the project will be defeated by the "no" votes of Green, Lee, and Diaz. The reason??? This productive government project fails to obtain a majority vote, however, is because of the way that the costs have been allocated.

Because the project is indeed productive, there is an alternate way to allocate its costs so that Adams, Chan, Green, Lee, and Diaz all benefit. This can be accomplished by allocating the cost of the project among voters in proportion to the benefits that they receive (plan B). Under this arrangement, Adams would pay half (\$12.50) of the \$25 cost, since he receives half (\$20) of the total benefits (\$40). The other voters would all pay in proportion to the benefits they receive. Under this plan, all voters would gain from the proposal. Even though the proposal could not secure a majority when the costs were allocated equally among voters, it will be favored by all five voters when they are taxed in proportion to the benefits they receive (plan B).

This simple illustration highlights an extremely important point about voting and the efficiency of government action. 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 unproductive¹⁰. 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, which require people who use a service more to pay a larger share of the cost, provide one way. User charges are most likely to be levied at the local level. Local services such as electricity, water, and garbage collection are generally financed with user charges. 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.

Exhibit 5 provides a useful way to look at the possible linkage between the benefits and costs of government programs. The benefits from a government action may be either widespread among the general public or concentrated among a small sub-group (for example, farmers, students, business interests, senior citizens, or members of a labor union). Similarly, the costs may be either widespread or highly concentrated among voters. Thus, as the exhibit shows, there are four possible patterns of voter benefits and costs: (1) widespread benefits and widespread costs, (2) concentrated benefits and widespread costs, (3) concentrated benefits and concentrated costs, and (4) widespread benefits and concentrated costs.

When both the benefits and costs are widespread among voters (type 1 issue), essentially everyone benefits and everyone pays. Although the costs of type 1 measures may not be precisely

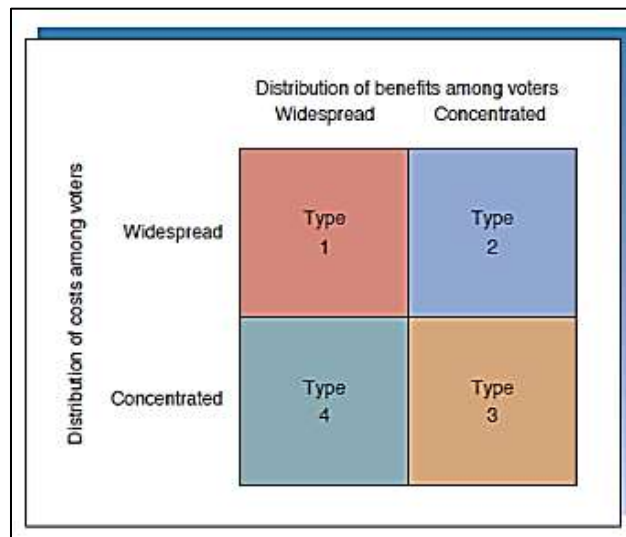
¹⁰ The principle that productive projects generate the potential for political unanimity was initially articulated by Swedish economist Knut Wicksell in 1896.



proportional to the benefits individuals receives, there will be a rough relationship. When type 1 measures are productive, almost everyone gains more than they pay. There will be little opposition, and political representatives have a strong incentive to support such proposals. In contrast, when type 1 proposals generate costs in excess of benefits, almost everyone lose, and representatives will face pressures to oppose such issues. Thus, for type 1 projects, the political process works pretty well. Productive projects will tend to be accepted and unproductive ones rejected.

Similarly, there is reason for which both benefits and costs are concentrated on one or more small subgroups. In some cases, the concentrated beneficiaries may be the same group of people paying for the government to provide them a service. In other cases, the subgroups of beneficiaries may differ from the subgroup footing the bill. Even in this cases, however, when the benefits exceed the costs, the concentrated group of beneficiaries will have an incentive to expand more resources lobbying for the measure than those harmed by it will expand opposing it. Thus, when the benefits and costs are both concentrated, there will be a tendency for productive projects to be adopted and unproductive ones to be rejected.

Exhibit 5: Distribution of Benefits and Costs among Voters



Notes: It is useful to visualize four possible combinations for the distribution of benefits and costs among voters to consider how the alternative distributions affect the operation of representative governments. When the distribution of benefits and costs is both widespread among voters (1) or both concentrated among voters (3), representative government will tend to undertake projects that are productive and reject those that are unproductive. In contrast, when the benefits are concentrated, and the costs are widespread (2), representative government is biased toward the adoption of inefficient projects. Finally, when benefits are widespread, but the costs concentrated (4), the political process may reject projects that are productive.

When the Political Process Works Poorly

Although the political process yields reasonable results when there is a close relationship between the receipt of benefits and the payment of costs (type 1 and type 3 projects), the harmony between good politics and sound economics breaks down when there is not (type 2 and type 4 projects). Inefficiency may also arise from other sources when governments undertake economic activities. In this section, we consider four major reasons why the political allocation of resources will often result in inefficiency.



Special-Interest Effect

Trade restrictions that limit the import of steel and lumber from abroad; subsidies for sports stadiums, the arts, and various agricultural products; federal spending on an indoor rain forest in Coralville, Iowa; a tattoo-removal program in San Luis Obispo County, California; the Rock and Roll Hall of Fame in Cleveland, Ohio; a golf awareness program in St. Augustine, Florida; and therapeutic horseback riding in Apple Valley, California. These seemingly diverse programs funded by the federal government have one thing in common: They reflect the attractiveness of special interests to vote-seeking politicians. A special interest issue is one that generates substantial personal benefits for a small number of constituents while spreading the costs widely across the bulk of citizens (type 2 projects). Individually, a few people gain a great deal, but many others lose a small amount. In aggregate, the losses may exceed the benefits.

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

How will a vote-seeking politician respond to special-interest issues? Since their personal stake is large, members of the interest group (and lobbyists representing their interests) will feel strongly about such issues. Many of the special-interest voters 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 contrast, most other rationally ignorant voters will either not know or will care little about special-interest issues. Even if voters know about some of these programs, it will be difficult for them to punish their legislators because each politician represents a bundle of positions on many different issues. While there is little to be gained from the support of the disorganized majority, 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 (like the bulk of taxpayers and consumers.). Even if supporting such legislation is counterproductive, politicians will often still be able to gain by supporting programs favored by special interests. For a real-world illustration of how the special-interest effect works, see Applications in Economics, "Sweet Subsidies to Sugar Growers: A Case Study of the Special Interest Effect."

The power of special interests is further strengthened by logrolling and pork-barrel legislation. Logrolling involves the practice of trading votes by a politician to get the necessary support to pass desired legislation. Pork-barrel legislation is the term used to describe the bundling of unrelated projects benefiting many interests into a single bill. Both logrolling and pork-barrel legislation will often make it possible for special-interest projects to gain legislative approval, even though these projects themselves are counterproductive and individually would be unable to muster legislative approval.

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 costs of the projects typically exceed the benefits in total, but the projects are intensely desired by the residents of a particular district who get the benefits without having to pay much of the costs.



Exhibit 6 provides a numeric illustration of the forces underlying logrolling and pork-barrel legislation. Here we consider the operation of a five-member legislature considering three projects: construction of a post office in district A, dredging of a harbor in district B, and spending on a military base in district C. For each district, the net benefit or cost is shown—that is the benefit to the district minus the tax cost imposed on it, the total cost of each of the three projects exceeds the benefits (as shown by the negative number in the total row at the bottom of the table), and therefore each is counterproductive. If the projects were voted on separately, each would lose by a 4-to-1 vote because only one district would gain, and the other four would lose. However, when the projects are bundled together through either logrolling (representatives A, B, and C could agree to trade votes) or pork-barrel legislation (all three programs put on the same bill), they can all pass, despite the fact that all are inefficient¹¹. When the number of districts (or projects) is large, the cost imposed on voters harmed by the legislation will be small. Given the weak incentive for voters to acquire information, those harmed by pork barrel and other special-interest policies are unlikely to even be aware of them. Thus, the incentive to support projects like these is even stronger than is implied by the simple numeric example in Exhibit 6.

Why don't representatives oppose measures that force their constituents to pay for projects that benefit others? There is some incentive to do so, but the constituents of any one elected representative can capture only a small portion of the benefits of tax savings from improved efficiency, since the savings would be spread nationwide among all taxpayers. We would not, for example, expect the president of a corporation to devote any of the firm's resources to projects not primarily benefiting its stockholders. Neither should we expect an elected representative to devote political resources to projects like defeating pork-barrel programs when the benefits of spending reductions and tax savings will be derived mostly by constituents in other districts. Instead, each representative has a strong incentive to work for programs that concentrate benefits among his or her own constituents—especially organized interest groups that can help the representative be re-elected. Heeding such incentives is a survival (reelection) tactic.

Exhibit 6 Trading Vote and Passing counterproductive Legislation

Voters of District (a)	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

(a): we assume the districts are of equal size.

Note: all three projects are inefficient and would not pass majority vote individually. However, representatives from districts A, B, and C could trade votes (logrolling) or put together pork-barrel legislation that would result in all three projects passing.

¹¹ Logrolling and pork-barrel policies can sometimes lead to the adoption of productive measures. However, if a project is productive, there would always be a pattern of finance that would lead to its adoption even if logrolling and pork-barrel policies were absent. Thus, the tendency for logrolling and pork-barrel policies to result in the adoption of inefficient projects is the more significant point.



On the other hand, when the benefits of a governmental action are widespread, and the costs are highly concentrated (type 4 of Exhibit 5), special-interest groups—those who stand to bear the cost—will strongly oppose and lobby against it. Most other voters will be largely uninformed and uninterested. Once again, politicians will have an incentive to respond to the views of the concentrated interests. A proposal to reduce or eliminate a tariff (tax) on an imported good would be an example of this type of legislation. Although many thousands of consumers would benefit from the lower prices that result, the domestic firms that compete with the imported good would devote substantial resources toward lobbying to keep the tariff in place. Projects of this type will tend to be rejected even when they are productive, that is, when they would generate larger benefits than costs.

The bottom line is clear: Public-choice analysis indicates that majority "Thing 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. As we discuss diverse topics throughout this text, counterproductive political action that has its foundation in the special-interest effect will arise again and again.

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. 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. To accomplish this, they will favor policies that provide current benefits voters can easily identify at the expense of future costs that are complicated and difficult to identify. Similarly, they will tend to oppose legislation that involves immediate and easily identifiable costs (and higher taxes) but yield future benefits that are complex and difficult to identify.

Economists refer to this bias inherent in the political process as **the shortsightedness effect**.

Shortsightedness 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.

As a result of the shortsightedness effect, politicians will tend to favor programs that generate highly visible current benefits, even when the true cost of these programs outweighs the benefits. In contrast, their incentive is weak to support efficient programs that generate future benefits but involve current costs.

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. During the last 45 years, the federal budget has been in deficit 40 times; there have been only five surpluses (1969 and 1998-2001). The bias toward budget deficits is a predictable result; it reflects the shortsighted nature of the political process. Similarly, the shortsightedness effect indicates that vote-seeking politicians will find it attractive to promise future benefits without levying a sufficient amount of taxes to finance them.



This has been the case with both the Social Security and Medicare programs. The unfunded liabilities of these two programs are nearly three times the size of the official outstanding federal debt. By the time the higher taxes (or benefit cuts) for these programs are confronted, the politicians who gained votes from the promised benefits will be long gone.

It is worth taking a moment to consider the differences between the public and private sectors in terms of how future benefits and costs are considered in current decisions. As we know, private property rights provide means by which the value of future benefits can be immediately captured (or costs borne) by a property owner. Owners who do not invest now to properly maintain their homes or cars, for example, will bear the consequences of the reduced value of those assets. Correspondingly, the value of a firm's stock will immediately rise (or fall), depending on the shareholders' perception of the expected future benefits and costs of an action taken by the company's executives today. In contrast, the public sector tends to place more weight on current benefits and costs and less weight on the future. In areas where the primary benefits are in the future, and property rights can be well defined and enforced, there is good reason to believe that the private sector will do a better job than the government sector.

Rent-Seeking

There are two ways individuals can acquire wealth: production and plunder. When individuals produce goods or services and exchange them for income, they not only enrich themselves, but they also enhance the wealth of the society. Sometimes the rules—or lack of rule enforcement—also allow people to get ahead by taking, or plundering, what others have produced.

This method not only fails to generate additional income—the gain of one is a loss to another—but it also consumes resources and thereby reduces the wealth of the society.

Rent-seeking is the term economists use when they refer to actions taken by individuals and groups seeking to use the political process to take the wealth of others. Perhaps "favor-seeking" would be a more descriptive term for this type of activity, which generally involves "investing" resources in lobbying and other activities designed to gain favors from the government. The incentive for individuals to spend time and effort in rent-seeking will be determined by how rewarding it is. Rent-seeking will be unattractive when constitutional constraints prevent politicians from taking the property of some and transferring it to others (or forcing some to pay for things desired by others).

When a government fails to allocate the costs of public-sector projects to the primary beneficiaries (through user fees, for example), or when it becomes heavily involved in transfer activities, people will spend more time organizing and lobbying politicians and less time producing goods and services. Resources that would otherwise be used to create wealth and generate income are wasted as people fight over slices of the economic pie—a pie that is smaller than it could be if they were engaged in productive activities instead. When the government grants favor to some people at the expense of others (instead of simply acting as a neutral force protecting property rights and enforcing contracts), counterproductive activities will expand while productive activities will shrink. As a result, the overall income level will fall short of its potential.

When buying and selling are controlled by legislation, the first things bought and sold are legislators.

P. J. O'Rourke'

Rent-seeking: actions by individuals and groups designed to restructure public policy in a manner that will either directly or indirectly redistribute more income to themselves or the projects they promote.



There is ample evidence that rent-seeking consumes a substantial amount of resources. Washington D.C. is full of organizations seeking subsidies and other favors from the federal government. More than 3M00 trade associations have offices in Washington, and they employ nearly 100.000 people seeking to alter the actions of Congress. Of course, business and labor organizations are well represented, but so, too, are agricultural interests, health-care providers, trial lawyers, senior citizens, export industries, and many others.

To get elected (or reelected), politicians have a strong incentive to provide transfers to important interest groups to secure their support.

As we noted earlier, income transfers have grown substantially during the last several decades. The government now taxes approximately one out of every seven dollars citizens earn and transfers it to someone else. Rent-seeking is the political "fuel" for most of these transfer activities. Interestingly, means-tested transfers, those directed toward the poor, constitute only about one-sixths of all transfers. No income test is applied to the other five-sixths of income transfers. 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.

Within the framework of public-choice analysis, the relatively small portion of income transfers directed toward the poor is not surprising. There is little reason to believe that transfers to the poor will be particularly attractive to vote-seeking politicians. After all, in the United States, the poor are less likely to vote than middle- and upper-income recipients. They are also less likely to be well informed on political issues and candidates. They are not an attractive source of political contributions. Politicians often argue that their proposed policies will help the poor, but there is little reason to believe that this will be a high priority for most of them.

There are three major reasons why government transfer activity will reduce the size of the economic pie. First, 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. Second, 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. Third, 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. More accountants, lawyers, and tax-shelter experts will be retained as people seek to limit the amount of their income redistributed to others. Like the resources allocated to rent-seeking, resources allocated to protecting one's wealth from the reach of government will also be unavailable for productive activity. 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? The pride of a job well done is likely to motivate both public- and private-sector suppliers. However, the incentive to reduce costs and operate efficiently differs substantially between the two. 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. This index of performance (profit) is unavailable in the public



sector. Missing also are signals from the capital market. When a corporation announces a strategy or a plan that vigilant personally committed investors believe to be faulty, the price of the corporation's stock will drop. There is no mechanism similar to the stock market in the public sector. Furthermore, direct competition in the form of other firms trying to woo the customers of a government agency or enterprise is largely absent in the public sector. As a result, bureaucrats have more freedom to pursue their narrow goals and interests without a strong regard for the control of costs relative to the benefits the public derives.

Bankruptcy weeds out inefficiency in the private sector, but there is no parallel mechanism to eliminate inefficiency in the public sector. In fact, failure to achieve a targeted objective (for example, a lower crime rate or improvement in student achievement scores) is often used as an argument for increased public-sector funding. Furthermore, public-sector managers are seldom in a position to gain personally from measures that reduce costs. The opposite is often true, in fact. 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. Because of this, government agencies typically go on a spending spree near the end of a budget period, if they discover they have failed to spend all the current year's funds appropriated to them.

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. There is no entity that will be able to reap substantial economic gain if the firm produces more efficiently or incorporates a new product or service highly valued relative to its costs. The operation of the firm and the appointment of high-level managers might be influenced by political rather than economic considerations.

Because the profitability criteria are absent, performance is difficult to evaluate. There are no tests to define economic inefficiency or measure it accurately—much less eliminate it. These perverse incentives are bound to affect efficiency.

The empirical evidence is consistent with this view. Economies dominated by government control, like those of the former Soviet bloc, India, Syria, and Nigeria (and many other African countries) have performed poorly. The level of output per unit of resource input in countries with numerous government enterprises is low. Similarly, when private firms are compared with government agencies providing the same goods or services (like garbage collection, hospitals, electric and water utilities, weather forecasting, and public transportation), studies indicate that private firms generally provide the services more economically.

Economic Organization: Who Produces, Who Pays, and Why it Matters

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. As Exhibit 7 shows, there are four possible combinations of production and consumption. Let's take a closer look at each and consider its impact on the allocation of resources and the incentive to economize.



In **quadrant 1**, goods are produced by private firms and purchased by consumers with their own money. Clearly, consumers will have a strong incentive to economize in this case. They will compare value with cost and will make purchases only when they value items more than their purchase price. Correspondingly, the owners of private enterprises have a strong incentive to both cater to the views of consumers and supply goods efficiently. Net revenues can be increased if the output can be produced at a lower cost. Producers will continue supplying goods only if consumers are willing to pay an amount sufficient to cover their production costs. Essentially, the supply and demand analysis focused on quadrant 1 cases.

Quadrant 2 represents the case in which goods are produced privately but are paid for by the taxpayer or some other third party. Providing health care to citizens financed primarily by government (Medicare and Medicaid) or insurance is an example. If someone else is paying the bill, 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. The behavior of producers will also be affected. If consumers are largely insensitive to prices, producers have little reason to control costs and offer services at attractive prices. This can dramatically affect economic efficiency.

Quadrant 3 represents the situation in which consumers pay for a good or service, but production is handled by the government. First-class mail delivery via the U.S. Postal Service, water and electricity by municipal governments, and the operation of toll roads are examples that fall into this category. When consumers pay for a good or service directly, they will economize and seek the most value per dollar they spend. This will be true whether their purchases are from private or government enterprises. As we just discussed, however, there is reason to believe that government-operated firms will generally be less efficient than private enterprises. Cost consciousness is also likely to be reduced if the government firm is a monopolist—if it is protected from competition with potential private rivals. Competition, however, is difficult to maintain in some markets. When this is the case, government enterprises may offer a reasonable alternative.

Quadrant 4 represents the case in which the government both provides the service and covers its costs through taxation. In this case, the political process determines what will be produced, how it will be produced, and how it will be allocated among the general public. Under these circumstances, 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. As we know, the nature of public goods—items such as national defense—makes it difficult, if not impossible, to supply them through markets. In these cases, there may be little alternative to having the government provide them. In other instances, however, there are feasible alternatives. This is true for education.

Most goods and services in the United States are allocated under conditions approximating those of quadrant 1. Thus, most of our analysis focuses on this case. However, a sizable portion of economic activity takes place under conditions present in quadrants 2, 3, and 4, where the incentive structure often creates problems. As a result, our analysis also considers modifications that might improve the efficiency of activities currently undertaken in these quadrants.



Exhibit 7: The Private and Government Sector Matrix of Production and Payment

		Good is paid for by:	
		Consumer- Purchaser	Taxpayer or other Third party
Good is produced by:	Private Enterprises	(1) Examples: apples, oranges, television sets, food, housing, most other goods	(2) Examples: health- care, food pur- chased 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

Note: The incentive to economize is influenced by who produces a good and who pays for it. Economizing behavior will be strongest when consumers purchase goods produced by private firms (quadrant 1). The incentive to economize is reduced 'when payment is made by a third party and when production is handled by the government.

The Economic Way of Thinking About Government

Given its monopoly power over the legitimate use of force, people have a tendency to believe that the government, particularly a democratic representative government, can solve all types of problems. Further, 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 more fundamental: there is sometimes a conflict between winning elections and following sound policies. For some types of activities, there is reason to believe that the political action that will help get one elected will, at the same time, reduce income levels and living standards.

Both the market and the political process have shortcomings. Understanding the strengths and weaknesses of both sectors is important if we are going to improve our current economic institutions. 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. The basic problem, however, is how a society can obtain the benefits of the protective functions of government and at the same time constrain it to those activities where it is a productive force. However, this is not an easy task.

Could Constitutional Changes Help Promote Prosperity?

When we think about how to get the most out of our government, it is important to distinguish between ordinary politics and constitutional rules. Constitutions establish the procedures utilized to make political decisions. Constitutions can also limit the activities of government.

The framers of the U.S. Constitution were aware that even a democratic government might undertake counterproductive actions. Thus, they incorporated restraints on the economic role of government. They enumerated the permissible tax and spending powers of the central government (Article I, Section 8) and allocated all other powers to the states and the people (Tenth Amendment). They also prohibited states from adopting legislation "impairing the obligation of



contracts" (Article I, Section 10). Furthermore, the Fifth Amendment specifies that private property shall not be "taken for public use without just compensation." Over time, however, these restraints have been significantly eroded, due in part to Supreme Court decisions that have effectively reinterpreted the Constitution. Today, it is difficult to think of an economic activity that is beyond the reach of majority rule or normal legislative procedure.

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 left alone, even democratic governments will tend to cater to special-interest groups and draw significant resources into rent-seeking. 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. The theory of public choice and its applications can help us do that. Needless to say, this topic is one of the most exciting and potentially fruitful areas of research in economics.

Additional notes:

What Weakens the Case for Market-Sector Allocation versus Public-Sector Intervention, and Vice Versa?

These factors weaken the case for market-sector allocation:

1. Lack of competition
2. Externalities
3. Public goods
4. Poor information

These factors weaken the case for public-sector intervention:

1. The special-interest effect
2. The shortsightedness effects
3. Rent-seeking
4. Weak incentives for operational efficiency

Political Finance

Introduction: Money is Ubiquitous in Politics.

Democratic regimes and **representative institutions** are based on **free** and **fair** elections. **Political parties** play a key role in **representative government** by **nominating candidates** for office, running governments when they are the ruling party, or holding governments accountable when they are not. **Trust** in the political system depends on the extent to which officeholders and political parties are responsive to the citizenry between elections. The media, interest groups and nonprofit organizations all find ways of rallying the citizenry to hold **politicians** and **parties** accountable between elections. Election campaigns, political parties, interest groups, nonprofit organizations and the media depend heavily on money, or more broadly speaking on **material resources**. **Thus, organizing collective action** depends on funding to reach out to **citizens**.

Money Raised and Spent by Parties

Money raised and spent by parties to fund political competition. Since the early times of **representative democracy**, **politicians** have struggled to develop ways of **financing political**



competition that enhance democratic process without putting at risk key **values** of **democracy**. The **negative** effect of **money** on politics has been **denounced** by **reformers** and in the **literature**. Accordingly, money has been looked at as a necessary **evil**.

How does Money Affects Political Competition?

The Three Ways in which Money Affects Political Competition

1- Money is a Channel of Political Participation

- Donating money is one form to participate in the political process.
- When members pay membership fees to political parties, activists make donations to election campaigns and interest groups fund lobbying activities they participate in the political process

2- Money Both Reflects and Shapes Political Competition

- Money enables political parties to **recruit** and **train** new political leaders from different social backgrounds and make politics more **inclusive**.
- Money allows candidates with new ideas to **communicate** with **voters** and challenge traditional political elites and makes **politics** more **competitive**.
- Candidates that are **well funded** are likely to defeat opponents who have less money.
- Within certain limits, the regulation of money in politics can influence the process of political competition, fostering party organizations, setting incentives for new competitors or consolidating existing parties.
- When **donations** are viewed as an **external factor** influencing politics, **funding** tends to be viewed as a source of **unleveling** the playing field of elections (i.e. unfair elections).

3- Money Influences Politics

- **Parties** and **candidates** are answerable to their **donors**.
- Citizens or organized interests will **abstain** from donating when **disagreements** with candidates or political parties arise. (Donors' expectations)
- Benefitting **political donors** will often include breaking laws by civil servants, thus undermining the integrity of public administration.

The Difficult Task of Defining Political Financing

Political financing includes **financial resources** raised and spent by parties in the process of **political competition**. Where strong party organizations exist, the demand for resources will come from the need to cover annual **expenses** for headquarters, for public **outreach**, **recruitment** of members, and for **selecting** and **grooming** candidates.

In other political systems **party organizations** are **weak**, but the **mobilization** of **voters** reaches its peak during **election campaigns**, with spending on communication with voters, including professional campaign management along modern standards of marketing.

Defining political financing depends on the development of the political system:

- In some political systems → Political financing is a synonym of **campaign funding**
- In other political systems → Political financing is a synonym of **party funding**

Both in **party centered** and **campaign centered systems** the core definition of resources raised and spent for political competition become fuzzy when it comes to identifying **relevant players** involved.

1) Party Centered Political Systems

Apart from political parties themselves, other organizations have to be included.:

- party foundations
- political **think tanks**



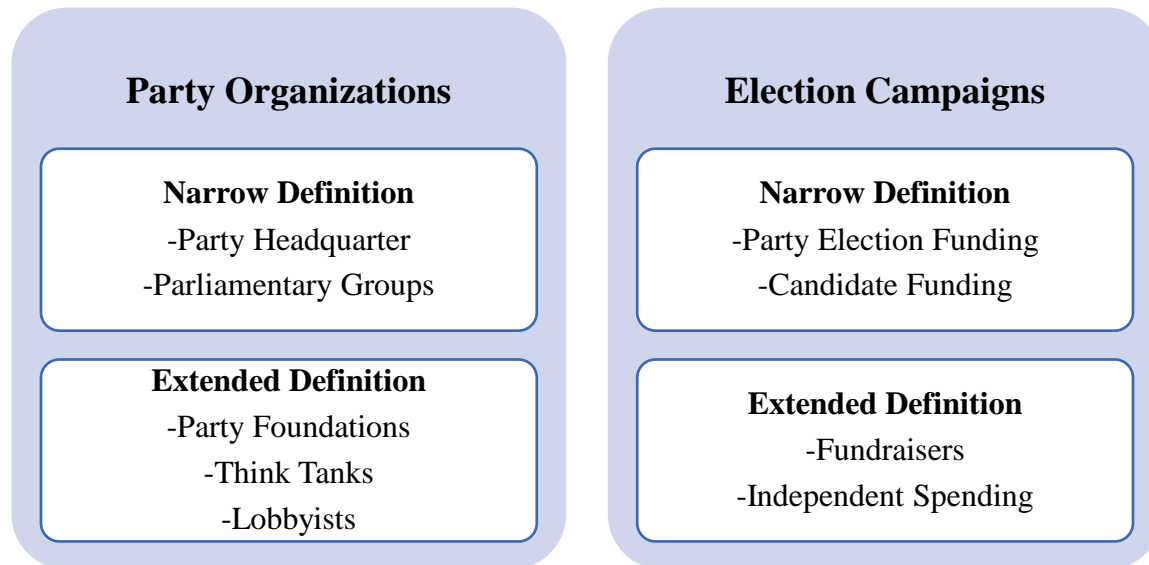
- Lobbyists

Such **sources of funding** have to be **included** for a **complete picture** on relevant resources for political competition.

2) Election (Candidates) Centered Political Systems

A considerable amount of money is raised, spend and accounted for by individual candidates. **Organizations** raising and spending funds other than political parties may play an important role in **fundraising**. In addition, independent spending are included, which involves:

- Political advertisement by citizens
- Companies or organized interest groups during election campaigns
- Personal wealth (e.g., **wealthy businesspeople**) is an important factor of political campaigns



It should be noted that; in practice, limiting resources to financial assets and transfers is not satisfying.

It is important to add in kind donations and discounts. In kind donations and discounts are substantially not so different from donating money.

It should be noted that; the **system of election administration** has also a huge impact on the **costs of election**. The **system of election administration includes:**

- Where voters have to register for each election,
- Where parties have to print the ballot and
- Where voting is not compulsory.
- The number of voting stations does equally impact the cost of voting, which candidates have to co-finance if they want to convince voters.

To sum up, it is hard to define clear boundaries. It depends on the local context which activities to include, which players to cover and which kind of resources to account for.

Political Instability and Economic Growth

Political Instability: Introduction

Political instability, uncertainty, and political regime (i.e., level of democracy) together have a distinct effect on the economic growth of any country and especially developing countries. Political instability affects the long-run economic growth of the country, while uncertainty level is expected to mainly affect medium- and short-run economic growth. Middle East and North



Africa (MENA) countries, like Tunisia, Egypt, Libya, Yemen and Syria, suffered from low levels of democracy, which resulted in a high level of political instability (the Arab Wakening or Arab Spring, which occurred at the end of 2010 and the beginning of 2011). The Egyptian experience is very rich and interesting due to many periods and events of political instability between the period after the 6th of October War and until the period after the 25th of January Revolution.

Additionally, fluctuations in measures of economic activity, which reflect the uncertainty level, can be explained, at least partially, according to the business cycle. However, political instability can affect the uncertainty level, which refers to the overlapping effect. Economic growth depends on many determinants, but some factors will have a high impact on the economy, such as political instability, uncertainty, and level of democracy. No investor will be interested in investing in a country where political instability and economic uncertainty are at a high level, especially since many countries that are stable politically and economically are trying to attract investment.

Political Instability: Definition

According to the World Bank, Political Instability can be defined as the propensity of a government collapse either because of conflicts or rampant competition between various political parties. Also, the occurrence of a government change increases the likelihood of subsequent changes. In such cases, political instability tends to be persistent. In other words, it measures the propensity of a change in the executive, either by “constitutional” or “unconstitutional” means.

Political Instability and Economic Growth: Bidirectional

As we mentioned, political instability” is defined as the propensity of a change in the executive, either by “constitutional” or “unconstitutional” means. Thus, we study whether a high propensity of an executive collapse leads to a reduction of growth. Economic growth and political stability are deeply interconnected.

On the one hand, the uncertainty associated with an unstable political environment may affect productive economic decisions, such investment, production or labor supply, i.e. by reducing investment and the pace of economic development. A high propensity of a change of government is associated with uncertainty about the new policies of a potential new government; risk-averse economic agents may hesitate to take economic initiatives or may “exit” the economy, by investing abroad. Conversely, foreign investors prefer a stable political environment, with less policy uncertainty and less uncertainty about property rights. Such uncertainty will lead to economic inefficiencies. Furthermore, the possibility of a government collapse leading to a new government prone to tax capital and productive activities implies a substitution of productive domestic investments in favor of consumption and capital flight, and thereby leads to a reduction of domestic production. A different argument leading to a similar relation, implied by Grossman’s (1991), in countries where rulers are relatively weak, i.e. more easily overthrown, the probability of revolutions is higher and the citizens have higher incentives to engage in revolutionary activities rather than productive market activities. On the contrary, a strong ruler who makes a revolution unlikely to succeed discourages revolutionary activities in favor of market activities. A related line of research, emphasizes the negative effects of rent-seeking activities on economic growth. A weak government constantly under threat of losing office may be particularly sensitive to the need of pleasing lobbyists and pressure groups, thus leading to a more direct effect of rent-seeking activities on policy decisions. Two objections to these arguments are worth mentioning. The first one is that a high propensity of a government change may be viewed favorably by economic agents if the current government is incompetent and/or corrupt and its possible successors are viewed as an improvement. Second, if the propensity of government change is large, an increase of it may actually reduce political uncertainty, since it becomes more certain that the current government will collapse. However, if the characteristics, or even the identity of the successor of the incumbent



government are not known with certainty, an increase of the propensity of a political change may lead to an increase in policy uncertainty. In fact, it implies an increase of the propensity of substituting a well-known (even though, possibly, inefficient) government for a less known one.

On the other hand, A study of the effects of political instability on economic growth needs to deal with the problem of joint endogeneity: even if it is true that a high propensity of having frequent government changes reduces growth, it may also be the case that low growth increases the probability of a government change. That is, poor economic performance may lead to government collapse and political unrest. However, political stability can be achieved through oppression or through having a political party in place that does not have to compete to be re-elected. In these cases, political stability is a double edged sword. While the peaceful environment that political stability may offer is a desideratum, it could easily become a breeding ground for cronyism with impunity. Such is the dilemma that many countries with a fragile political order have to face. The effect of growth on government changes is likely to be observable in both democracies and in dictatorships. In democracies, a vast empirical literature has established that high growth in pre-election years increases the likelihood of reelection of the incumbent government: voters do not reelect incumbents if they perceive that the latter have mismanaged the economy. Specifically, voters appear to pay particular attention to income growth immediately before elections. In non-democracies the likelihood of coups may also decrease with both the level of GDP per capita and its rate of growth. Low growth may increase popular dissatisfaction and create incentives for anti-government political action.

Whether Democratic Institutions are Harmful or Conducive to Growth

A related issue is whether democratic institutions are harmful or conducive to growth. A rather popular argument is that democratic institutions may be harmful to growth. The basic idea underlying this view is that policy makers in democratic government are subject to the pressures of interests groups, and thus shortsightedly follow opportunistic policies to enhance their chances of reelection instead of policies that enhance long term growth. However, these arguments against democracy are not necessarily conclusive. First of all, dictators may also need to be opportunistic if their survival in office is threatened. Second, authoritarian regimes are not a homogenous lot: they include “technocratic” dictators and “kleptocratic” ones. While the apparent association of high economic growth with authoritarian regimes is suggested by the experience of several authoritarian “technocratic” regimes (such as those in Korea, Taiwan, Indonesia, Turkey, Chile) it is as well evident that for each “benevolent” dictator one can observe at least as many “kleptocratic” and/or inept authoritarian regimes whose rule has led to systematic economic mismanagement and eventual political and economic collapse of their countries.’ One can therefore conclude that, both on theoretical and empirical grounds, there is no obvious relationship between democracy and growth.

In fact, the empirical cross-country evidence on the relation between democracy and growth is quite mixed. Some early studies argue that democratic regime tend to slow economic growth while authoritarian regimes tend to stimulate it.” However, others show that there is no systematic relation between long term growth and the democratic/ authoritarian nature of the political regime.”

Measuring Political Instability

The literature concerning political instability has employed many different variables to reflect the unobserved concept of political instability. While every single indicator probably reflects some information about political instability, none of them is perfect. In other words: political instability indicators contain measurement error. To solve the measurement problem, researchers have



frequently calculated one dimensional indexes using discriminant analysis or principal components analysis. Others have tried to predict the propensity of government change using binary choice models in which the occurrence of government transfers is related to various economic, political and institutional variables.

A shortcoming of the studies that combine indicators into a single index, is the assumption that political instability is a one dimensional concept. This would not be too problematic if all (relevant) sub dimensions would behave similarly and would affect the economy in a similar fashion. However, this is unlikely on theoretical grounds.

One commonly used composite index is the political stability index. The index is a composite measure as it is based on several other indexes from multiple sources including the Economist Intelligence Unit, the World Economic Forum, and the Political Risk Services, among others. The underlying indexes reflect the likelihood of a disorderly transfer of government power, armed conflict, violent demonstrations, social unrest, international tensions, terrorism, as well as ethnic, religious or regional conflicts.

However, it should be note that the multidimensional nature of political instability requires several political indicators and measures to be collected and used in the econometric analysis of the interactions between instability and economic performance.

Definition and Historical Background of Trade Wars

A trade war is a side effect of protectionism that occurs when one country (Country A) raises tariffs¹² on another country’s (Country B) imports in retaliation for Country B raising tariffs on Country A's imports. Usually the imposition of tariffs is as a sort of deterrence on a certain country as a coercive tool to stop a certain action or preventing its occurrence.

The first Trade war started in 1839 between China and Britain called “opium war” till 1860. Economic deterrence actions started during the 1960th when USA imposed Economic sanctions on Cuba, Vietnam and turkey. During the past few years USA was the most country using the economic sanctions such as on Iran, North Korea.

Figure (1) Targeted Sanctions Consortium



Recent facts

In January 2018, the US announced higher trade tariffs on solar panels that are imported mainly from China. They then announced in March 2018 that they would increase trade tariffs on steel

¹² Note: A tariff is a tax imposed on imported goods and services.



and aluminum, including for the EU and NAFTA countries. These measures were temporarily deferred for some countries (e.g. Canada, Mexico and the EU) but finally imposed on June 1st. After this announcement, most partners reacted to these US tariffs by announcing retaliatory tariffs of their own. For example, the EU has provided the WTO with a list of US products that will face 25% additional tariffs when entering the EU (WTO, 2018). Similar measures have been announced by Canada and Mexico. Moreover, in a separate policy action in April 2018, the US announced it would impose additional tariffs on Chinese imports for a broader set of products. These US tariffs are on top of the steel and aluminum (S&A) tariffs and respond to different strategic decisions by the US --i.e. reduce its trade deficit with China and negotiate better market access to US firms and issues related with intellectual property rights. In turn, the Chinese administration announced retaliatory measures. However, the state of the trade policies is still in flux. For instance, the US and China were negotiating possible solutions, until on June 15th the US decided to impose the tariffs it announced in April, while China retaliated the day after with its own tariffs on June 16th. The US is also currently involved in trade negotiations regarding changes to the NAFTA agreement it has with Canada and Mexico. After the EU announced its retaliatory measures, the US administration threatened to impose a 25% duty on motor vehicle imports from the EU. Therefore, the outcome regarding announced and retaliatory tariffs is uncertain and this makes it difficult to design concrete policy scenarios. In addition, there is also the possibility of an escalation of these trade wars.

World System Analysis

The distribution of power capabilities in the international system determines the number of the great powers and, consequently, the polarity of the international system. If the great powers are more than two, the system will be multi-polar. After the collapse of USSR, the USA enjoyed full hegemony over the unipolar world system till the economic crisis in 2008 where new emerging powers floated to the surface of the international politics.

The Political Economy of TWs

This analysis makes it clearer that trade wars between USA, China, EU are politically more than economically to face the rising power of the new emerging international powers specially China. The other illustration of these wars is the rise of populist movements and parties, specially the speeches of Anti-Globalization, protectionism, and stopping the migration.

The Rise of Populism

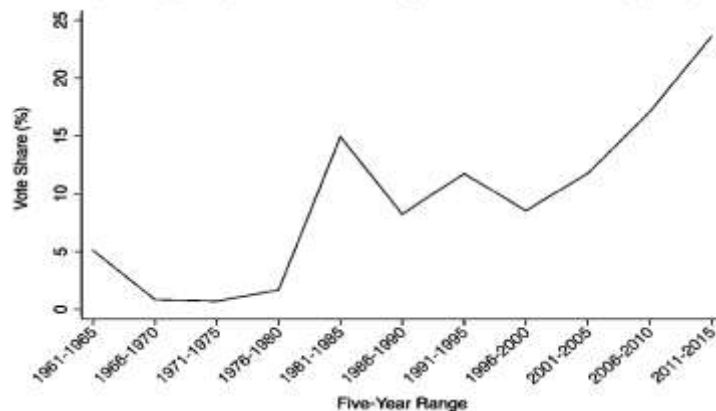
“Populism” is a loose label that encompasses a diverse set of movements. The term originates from the late nineteenth century, when a coalition of farmers, workers, and miners in the US rallied against the Gold Standard and the Northeastern banking and finance establishment. Today populism spans a wide range of political movements, including anti-euro and anti-immigrant parties in Europe, and Syriza and Podemos in Greece and Spain, respectively,

Left-Right Populist Figures

Populist parties can be anywhere on the political spectrum. In Latin America, there was Venezuela's late President Chávez. In Spain, there is the Podemos party, and in Greece the label has also been applied to Syriza. All these are on the left. But, we can observe that "most successful populists today are on the right, particularly the radical right. Politicians "like Marine Le Pen in France, Viktor Orbán in Hungary, and Donald Trump in the US, combine populism with [anti-immigrant] nativism and authoritarianism.



Figure (2) The support for populist parties
Support for populist parties over time among countries with at least one populist party



Trump’s Trade Policy

Trump’s trade approach is protectionism and self-defeating for the contemporary trade order. Trump sees trade as a zero-sum game (i.e., Essentially Mercantilist). He insists on reciprocal and fair trade, yet his only measure seems to be if the US is running bilateral deficits –sufficient proof for him of foreign cheating and/or poorly negotiated trade deals. His focus on goods –primarily industrial and manufacturing– reflects classical thinking regarding value and accumulation. Trump ignores that in the all-important service sectors -finance, banking, insurance, and intellectual property -US providers invariably run surpluses.

Economic Consequences of the Trade Wars

It is well known that, relative to free trade, countries can gain from imposing optimal non- zero tariffs even in the face of retaliation by their trading partners. A trade war occurs when all countries choose levels of protection that maximize their own welfare given the trade barriers of other nations.

A country wins a trade war if it experiences higher welfare in a world of optimal protection than it would under global free trade. The concept of a trade war therefore provides a purely economic rationale for the observed presence of barriers to free trade. If a country wins a trade war, then it will most likely oppose moves to introduce free trade and is unlikely to agree to the abolition of trade barriers without a compensatory transfer payment.

In general, a country can gain relative to free trade from setting a non-zero tariff, even in the face of retaliation by its trading partner. In particular, a country with a sufficiently high elasticity of import demand relative to their trading partner will win a trade war. Of course, the elasticity of import demand is itself dependent on more fundamental country characteristics.

Cases that may justify tariffs are the protection of infant industries, and the correction of market distortions (e.g. export subsidies) imposed by other governments. However, most economists think it is better to attack these distortions head on, rather than indirectly through “offsetting” import tariffs.

Moving into macro-economics, many variables can change in response to tariffs, including the exchange rate, inflation, monetary policy and unemployment. US tariffs on steel imports could cause an increase in domestic production as foreign products are priced out of the American market. As a gross over-simplification, expenditure is, in the first instance, switched from China to the US, leaving global steel production unchanged. Mr Trump seems to believe all this. But the effects on aggregate demand are complex. When the US imposes its tariff, China at first loses net income. In the US, steel producers might gain from greater output, but consumers, both households



and other companies, lose. The government gains from tariff revenues, though these are probably distributed across the economy. The initial effects on aggregate demand therefore depend on how all these gains and losses are translated into expenditure. Such redistributions are similar to the effects of an oil price increase that shifts income away from consumers and towards producers. If the losers cut demand immediately, while the winners spend their gains more slowly, global demand and output will fall in the short term.

Reasons Behind the Recent Wave of Wars

During the 2016 election campaign, Trump promised to protect American jobs and to renegotiate US trade deficits with countries around the world. The US has the world's largest trade deficit – meaning it buys more goods and services from other countries than it sells overseas – worth \$568bn last year. China is responsible for the bulk of the deficit in terms of goods, exporting \$376bn more to the US than it bought from US producers.

What is USA Doing?

It was seriously going through a real thing, the war between USA and China, on the 15th of June Trump administration published two lists of Chinese products it plans to hit with tariffs of 25%, worth \$50bn and some others said \$34bn in 2018.

The first list or wave of tariffs was in 6th of July, but the Chinese replied with their own list, the same as US did, then an American further list of products worth \$200bn that would face tariffs of 10%, and threatened yet another, covering an additional \$200bn of goods.

Examples for the goods that will have tariffs are food, some household goods, clothes, accessories, some minerals and vehicles.

How will the Americans be Affected by the War?

- The increase of day to day prices of the Chinese products (T-shirts, Pants, food, etc.)
- The negative effect on the American Economic system (i.e., the financial system, stock market, manufacturing).
- According to a number of economists in Oxford Uni., the GDP is expected to decrease by 0.3 in both countries.
- According to the World Bank, a worldwide escalation of tensions would lead to some consequences like what happened in 2008 crisis.

Ways Through Which China Could Retaliate in a Trade War

1. Action Against US Companies

US firms generate about \$300 bn of sales domestically in China, so they are a potential target. In particular, China could make life difficult for US companies by slowing down customs clearance for their imports, delaying or denying visa applications, or using health and safety checks as a way of temporarily shutting down a firm's operations. US companies may benefit less from Chinese efforts to open up its services sector (in areas such as finance and healthcare) than European and Japanese counterparts. China could pick out US companies that are not well connected and burden them with all kinds of regulatory red-tape".

2. Restrict Tourism to The US

Although the US has a big trade deficit with China, the US sells more services to China than it buys from them. Its services trade surplus with China hit \$38bn in 2016. Part of that is overseas spending by tourists from China. More than 130 million people travelled out of China in 2016. Those tourists, whose long-haul destinations included the US, spent around \$260bn that



year. So, China could restrict tourism to the US. It wouldn't be the first time China has taken such an action. Last year it banned travel agencies from selling package tours to Korea last year in protest at Seoul allowing a US missile defense system.

3. Devalue the Currency

Lowering the value of the Yuan would help exports by making Chinese goods cheaper for other countries to import and could offset the rise in prices caused by the US tariffs. Analysts say the fact China's central bank has not supported the currency during its recent fall shows they are leaving things to market forces for now.

Given the Yuan has fallen to a one-year low against the dollar, analysts also see little need for the central bank to intervene at this time. "There is obviously some willingness to allow the currency to weaken to dampen the effect of the tariffs," Mr Evans-Pritchard says. "I don't expect them to engineer a major devaluation of the currency."

What is the Role of EU in the War?

The European Union is one of the victims of the trade war between America and China, as European Union is in trouble, as it is under a threat of protectionist measures ordered up by US President Donald Trump.

After the warning of Trump to china, China called on the European Union to form a coalition to stand against US protectionism. But the European Union say directly insisting only that trade conflicts should be resolved at the World Trade Organization.

The European Union and United States are themselves nearly descended into a trade war after Trump threatened to put tariffs on a 25 percent on European steel and 10 percent on European aluminum.

While the Canadian Prime Minister, Justin Trudeau, issued an immediate like-for-like response – announcing tariffs of up to 25% on US imports worth up to 16.6bn Canadian dollars (£9.6bn), which was the total value of Canadian steel exports to the US last year. The tariffs will cover steel and aluminum as well as orange juice, whiskey and other food products.

Can this War End?

There is no obvious evidence that shows that the trade war between US and China will end. According to the worst-case scenario, it may result in a series of measures and counter-measures that could have a major negative impact on consumers and global economies. And according to the best-case scenario, the two sides may reach some sort of an agreement.

The End