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Econ 812

Week 14: Economics of Politics

I.   The Median Voter Theorem
        A.   Assume that voters' preferences are "single-peaked." This means
                 that voters have an "ideal point" (aka "bliss point"), and their utility
                 declines monotonically as policy moves away from it.
        B.   Suppose we have a two-party (or two-candidate) election. Voters
                 care about and are perfectly informed about party positions on
                 exactly one issue: liberalism versus conservatism.
        C.   The electoral rule is "winner-takes-all" - whoever gets more votes
                 wins.
                 1.   Assume ties are resolving by flipping a coin.
        D.   Assumption about party/candidate motivation: They want to win,
                 and care more about that than everything else put together.
        E.   The two parties compete in exactly one way: By taking a stand on
                 the issue.
        F.   The electorate may be divided into three groups: those who
                 definitely vote for the more liberal party, those who definitely vote
                 for the more conservative party, and the people in the middle, who
                 pick whichever party is closer to them.
        G.   In equilibrium, parties' platforms cannot be different, because both
                 parties gain votes by moving closer to each other. $P_D = P_R$.
        H.   Thus, equilibrium platforms "converge." But to what?
        I.   Could the equilibrium platform ever be one where both parties are
                 above the median of the distribution of voter preferences? No.
                 Why? Because one party would get more than 50% of the votes by
                 moving a little closer to the median. So $P_i \leq P_{med}$.
        J.   Could the equilibrium platform ever be one where both parties are
                 below the median of the distribution of voter preferences? No, for
                 the same reason. So $P_i \geq P_{med}$.
        K.   Could the equilibrium platform *be* the median of the distribution?
                 Yes! If both parties are at the median, then staying there gets you
                 50% of the votes, but moving a little to the left or right gets you
                 fewer than 50%. Thus, we arrive at the famous **Median Voter
                 Theorem**: $P_D = P_R = P_{med}$.
II.   Rational Ignorance and Special Interests
        A.   How much do voters know about politics? Search theory suggests
                 that we look at the marginal cost and expected marginal gain of
                 acquiring political knowledge.
        B.   But the probability one vote changes an electoral outcome is
                 approximately zero. So the expected marginal gain of info is 0.

C. With positive MC and 0 MB, what is the privately optimal quantity of political information to acquire? None. Hence the concept of **rational ignorance**. When knowledge gives you no practical benefit, and time is money, ignorance (the decision not to acquire knowledge) is rational.

D. Empirically, this is not exactly true, but it is not far from the truth.

E. The Median Voter Model makes no room for "special interests." Voters get what they want.

F. Still, observers have frequently argued that "special interests" - small groups of activists "behind-the-scenes" - foil the majority's wishes. But how?

G. Simple idea: Special interests are well-informed because they have so much riding on the political outcome. Regular voters aren't informed because they have so little riding on it. "Concentrated benefits, diffuse costs."

III. The "Miracle of Aggregation"

A. A number of economists and political scientists have admitted the ignorance of individual voters, but still defend the quality of the **electorate's** decisions.

B. The argument:
1. Individual voters are poorly informed, and thus their votes are highly random.
2. But elections are based on *aggregate* opinions of millions of voters.
3. A basic principle of statistics is the Law of Large Numbers: random errors tend to "cancel each other out" (in percentage terms).
4. Thus, even if there is a large component of randomness in individual voting, the principle of aggregation ensures, for all practical purposes, that outcomes still make sense.

C. Suppose 90% of all voters are uninformed and vote randomly. The remaining 10% are perfectly informed. What happens? Whichever candidate wins the support of a majority of informed voters also wins the election.

D. This result has been named "the miracle of aggregation." It seems *miraculous* because it implies that a highly uninformed electorate may - at the aggregate level - act "as if" it were perfectly informed.

IV. Voter Ignorance, Principal-Agent Problems, and Optimal Punishment

A. The politician-voter relationship is easy to analyze as a principal-agent problem.

B. Simple model: politician does what voter wants iff: $B_v > B_s - pD$, where B_v are the benefits a politician gets from doing what voters want, B_s are the benefits of shirking, p is the probability of being caught shirking, and D is the punishment for shirking.

C. Many believe that rational ignorance allows politicians to shamelessly and repeatedly violate voter trust.

D. But as Becker observed, when information is available but costly, a natural way to align incentives is (as in the efficiency wage model) *random monitoring combined with harsh punishment*. Most obviously, set $D > \dfrac{(B_s - B_v)}{p}$.

E. Ex: If the media catches a politician taking a $1 bribe, voters could decide to never vote for him again, or even give him jail time.

F. Main point: Theoretically, even rationally ignorant voters remain able to control politicians. They could just massively punish all observed dishonesty.

V. Wittman's Challenge to Orthodox Public Choice

A. Critics of the economic approach to politics usually dislike its "economistic" assumptions and its anti-democratic conclusions.

B. Donald Wittman of UC Santa Cruz offers a radically different critique of public choice economics.

C. Wittman does **not** object to public choice's "economistic" approach.

D. Instead, Wittman complaint is that so much of public choice is simply bad economics.

E. He claims that standard public choice arguments generally depend upon extremely dubious assumptions:
    1. "Extreme voter stupidity"
    2. "Serious lack of competition"
    3. "Excessively high negotiation/transfer costs"

F. Wittman's conclusion: The standard tools of microeconomic analysis show that political markets work just as well as economic markets. The political failures emphasized in public choice theory are largely imaginary.

VI. "Extreme Voter Stupidity"

A. Many public choice arguments, according to Wittman, assume "extreme voter stupidity."

B. Normally, of course, public choice economists talk about "ignorance" or "lack of information," rather than "*stupidity*." But Wittman argues that the assumption of voter stupidity is implicit.

B. Wittman's Principle #1: *Voter ignorance is not a serious problem*.

C. Why? **First**, the *amount of information held by voters has been underestimated*.
    1. Party labels are "brand names" that drastically reduce information costs.
    2. Politicians pay to inform voters by advertising, giving speeches, and so on; voters don't have to pay to inform themselves.

D. **Second**, *informed judgments can be made with little information*.
    1. Voters have many "cognitive shortcuts." Voters can simply ask their preferred experts for information. If I like guns, I just vote the NRA line; if I don't like guns, I follow the advice of Citizens for Gun Control.

E.   **Third**, *the deleterious effect of biased information has been overstated.*

      1.   Ignorance does not mean *systematic* bias. The Miracle of Aggregation shows that even if people are highly ignorant, their random errors will cancel out.

      2.   "To be uninformed about a policy does not imply that voters have biased estimates of its effects. For example, to be uninformed about the nature of pork-barrel projects in other congressional districts does not mean that voters tend to underestimate the effects of pork barrel - it is quite possible that the uninformed exaggerate both the extent and the negative consequences of pork-barrel projects."

      3.   Voters can discount, or simply ignore, information from biased or questionable sources. If the media has a "liberal bias," then voters can easily adjust.

F.   **Fourth**, *the effect of unresolved asymmetric information in politics is to make government inefficiently small, not inefficiently large.*

      1.   Just as it is naive to think that asymmetric information helps used car dealers sell cars, it is naive to think that asymmetric information helps politicians create Big Government.

G.   Wittman's bottom line: To reach their standard conclusions about political failure, then, ignorance is not enough. They need to assume that voters are "stupid" or **irrational** - that RE fails.

VII.   "Serious Lack of Competition"

C.   Wittman's Principle #2: *Politics, like the market, is competitive.*

D.   Why? **First**, *reputation matters.*

      1.   If politicians break promises, voters hold it against them. If they do a good job, they reward them. Even if politicians only stay in one office for a few years, they want to build up a good name in order to rise to higher offices.

      2.   Remember the theory of optimal punishment: Voters can adjust for a small probability of detection with over-punishment. Politicians can destroy their whole reputation with one mistake.

E.   **Second**, *political races are at least as competitive as markets.*

      1.   Politics is full of "political entrepreneurs" who want to stage a successful "takeover" (gain power) by locating unpopular policies and campaigning to change them.

      2.   High rates of reelection prove NOTHING. "The main reason for high rates of incumbent success is... They are the best. That is why they won in the first place and why they are likely to win again."

      3.   Similarity of platforms also proves NOTHING. Similar prices are actually a sign of competition in markets; so are similar platforms in politics.

4. Alleged "barriers to entry" are usually minimal. Third parties can't win because voters don't like them, not because "the system" is against them.

F. **Third**, *empirical evidence shows a strong link between voter preferences and legislative behavior.*

G. Wittman's bottom line: In markets, economists are usually skeptical about collusion. Why are they less skeptical in politics? How is the grand electoral conspiracy maintained?

VIII. "Excessively High Negotiation/Transfer Costs"

A. Finally, public choice economists often argue that transactions costs prevent more efficient policies from replacing the status quo.
   1. Ex: A special interest "blocks" changes harmful to its interests, and it is "too hard" to buy them off.

B. This brings us to Wittman's Principle #3: *Political bargaining can eliminate any remaining significant inefficiencies.*

C. Why? *Democracy is <u>designed</u> to have low transactions costs.*
   1. Majority rule is cheaper than the unanimity required by markets.
   2. Representative democracy (as opposed to direct democracy) drastically reduces transactions costs. Instead of 250 M Americans bargaining, we have a few hundred Congressmen and Senators bargaining. (The same logic holds for committees).
   3. Log-rolling can turn efficient but unpopular policies into efficient AND popular policies.

IX. Rational Irrationality

A. What reasons are there to believe that the rational expectations assumption is true?

B. One of my main research ideas: Just as economists think of agents weighing the costs and benefits of *information*, so too can we think of agents weighing the costs and benefits of *rationality*. Just as it is sometimes rational to be *ignorant* (have little information), it may sometimes be rational to be *irrational* (deviate from full rationality).

C. In other words, we can think of irrationality as a normal good. Why does anyone want this "good"?
   1. Big reason: People derive comfort, security, and sense of identity from their belief structure.
   2. Moreover, rational thinking is often hard, painful, discouraging work.
   3. Indirect reason: Other people you depend on may treat you differently depending on your beliefs.

D. What is the "price" of irrationality? It is the material success that you give up in order to retain systematically mistaken beliefs.

E. Writing down an individual's "demand for irrationality" curve for a given issue is easy. Just put quantity of irrationality on the x-axis, and the implicit price of irrationality on the y-axis.

F.   When the price of irrationality is high - as it often will be - people consume less. Perhaps they consume none at all - on at least some issues, they might be fully rational.

G.   When the price of irrationality is low, people consume more. When irrationality is completely free, people stick with whatever belief makes them most happy, however crazy.

H.   Remember the probability of voter decisiveness?

I.   Immediate implication: The expected price of voter irrationality is essentially zero, so we should not be surprised if voters hold highly irrational beliefs!

J.   I take my work on systematically biased beliefs about economics as a natural implication of rational irrationality. We get stupid economic policies because voters have stupid beliefs about economics.

X.   Irrationality as Political Pollution

A.   Economists' efficiency calculations must count the consumption value of irrationality as a benefit. However, this hardly implies an efficient outcome.

B.   Why? Voters enjoy the full benefit of their own irrationality, but pay only an infinitesimal fraction of the cost. Each voter subconsciously thinks "My irrationality makes no perceptible difference on policy, so I might as well believe whatever makes me feel best."

C.   If enough voters rely on systematically biased beliefs to decide how to vote, disastrous policies may be adopted.

F.   Just as all polluters can be better off if everyone polluted less, all voters can be better off if everyone consumed less irrationality.

G.   Application: protectionism. Public choice economists have typically seen protectionism as a product of special interests taking advantage of the public's rational ignorance.

H.   Big puzzle for this theory: Protectionism is popular!

I.   My alternative theory: People hold rationally irrational beliefs about trade policy. Politicians offer protectionist policies to get their votes.

J.   Empirical support: On the *SAEE*, the public is much more pessimistic about foreign trade than economists, controlling for everything else.

K.   The real puzzle: Why isn't policy far more protectionist than it is?

XII.   Caplan's Critique of Wittman

A.   I say: Yes, public choice arguments frequently assume "extreme voter stupidity," as Wittman charges. But so what? Voters - even smart ones - *become* extremely stupid ("irrational") when they deliberate on political/economic questions.

B.   Voter irrationality is both:
1.   Plausible in theory
2.   Easy to detect empirically on a large scale

C.	Key asymmetry between politics and markets: Incentives for rationality. In markets, ignorant actors do their best with what they know. In politics, they scarcely try.
D.	Rational irrationality helps explain why politicians cater to voters' prejudices rather than trying to "educate" them. Voters like candidates who share their confusions, not pedants who lecture them.
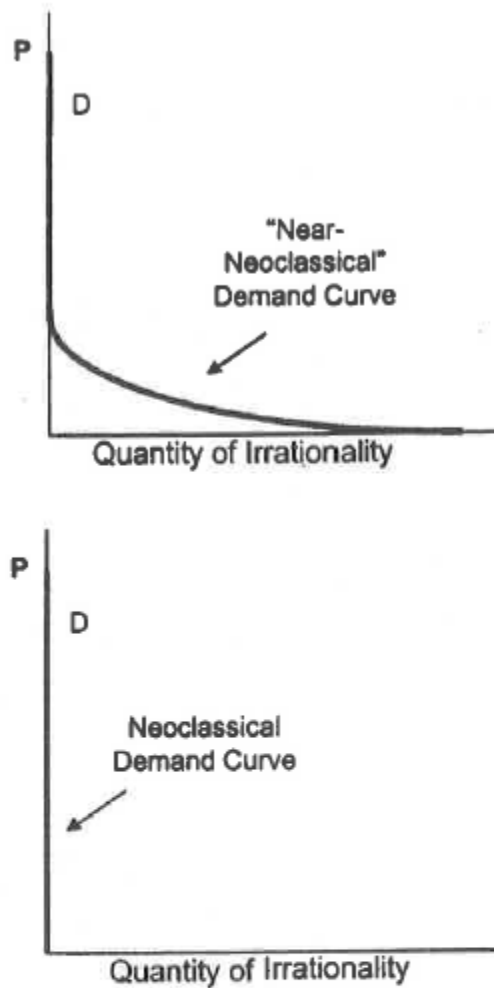
Diagram 2. Neoclassical vs. "near-neoclassical" demand for irrationality.

politics will have a negative impact on his wealth by leading him to vote against his own interests is no greater. However deluded one more person is, democratic outcomes will almost certainly not change (Akerlof, 1989). It is the *marginal* cost of systematic political error that must be considered: even though protectionist policies tend to reduce the wealth of protectionists, one cannot avoid paying a tariff by changing one's mind about the validity of the law of comparative advantage. The institutional structure of politics tends to peg the price of irrationality at zero. Note that this does *not* imply individuals consume an infinite quantity of irrationality: When the price of irrationality is zero, people adhere to their bliss belief, consuming irrationality until they are "satiated" (Diagram 3).
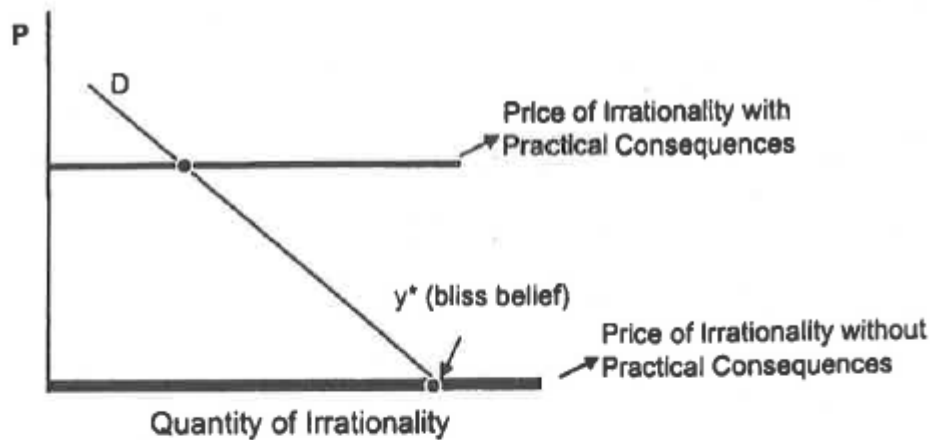
P

D

Price of Irrationality with
Practical Consequences

y* (bliss belief)

Price of Irrationality without
Practical Consequences

Quantity of Irrationality

Diagram 3. Price-sensitivity of the demand for irrationality.

In contrast, systematic errors about non-political issues often have large private, marginal costs. Over-estimating your job performance while intoxicated makes you more likely to lose your job and ruin your career. Under-estimating the rate of inflation leads to poor portfolio choices. In cases like this, the price of irrationality is strictly positive: the expected wealth of an agent who becomes a little bit more irrational definitely falls. As Diagram 3 shows, this reduces the quantity of irrationality demanded. With near-neoclassical demand for irrationality, a moderate price is sufficient to induce rational expectations.

If people derive utility from holding irrational beliefs, what is the connection between irrationality and political failure? The problem is that for political irrationality, the private and social costs of irrationality are different. Even though the private cost of irrationality is zero, the social cost can be enormous. Just as the divergence between private and social cost of polluting leads a group of identical polluters to a suboptimal, high-pollution outcome, so too does the divergence between the private and social cost of irrationality lead to a suboptimal, high-irrationality outcome. Note further that while rationally ignorant individuals admit they are ignorant, rationally irrational individuals believe that they know the truth. The former admit they have a problem and can take steps to compensate for it; the latter, in contrast, make no effort to adjust for a problem they deny exists. For example, if voters are rationally ignorant about the specifics of trade policy, they can still support general procedures to curtail protectionist pressures. But such procedures would win no favor from voters who affirmatively favor protectionism due to their rationally irrational overestimates of the social benefits of protectionist policy.[3]