

## Principles of Macroeconomics

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## A Note on Economists and Politics

- ▶ Economists are not pro-business!  
Pro-business stances destroy markets, hurt consumers, and lead to cronyism and patronage
- ▶ Economists are pro-market!  
Markets involve competition, which improves quality, lowers prices, and increases production, all of which help consumers.  
Economists are for consumers (since every individual is a consumer)

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## Applying Economics to Politics

Why doesn't the world look like economists believe it should?

- ▶ Why do governments block free trade?
- ▶ Why are there still price ceilings and floors?
- ▶ Why are certain industries subsidized heavily (or taxed heavily) and others not at all?

"If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary."

James Madison, 1751-1836



The assumption:  
incentives matter in politics as well

The big question: When does the self-interest of politicians and voters align with the social interest and when do these interest collide?

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## Public Choice

- ▶ A symmetry of assumptions between private and public choices.
- ▶ Just like in private choice settings (markets):
  - ▶ Government is composed of real, imperfect people
  - ▶ Government is not composed of selfless angels/dispassionate philosopher-kings who only operate in the public good
  - ▶ Political agents are self-interested individuals who care about their own private interests
- ▶ The only difference is that these same self-interested exchanging people are operating under a different set of institutions (incentives)
  - ▶ market institutions vs. political institutions

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## Democracies typically face these problems:

Do you vote?

Does your vote count?

- ▶ Voter ignorance
- ▶ Special interest power
- ▶ Political business cycles

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## Rent Seeking

“But how is this legal plunder to be identified? Quite simply. See if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime.

Everyone wants to live at the expense of the state. They forget that the state lives at the expense of everyone.”

Frederic Bastiat, *The Law*, 1848



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## Voters and the Incentive to be Ignorant

- ▶ Rational Ignorance exists when the benefits of being informed are less than the costs of being informed.
- ▶ Voters are rationally ignorant about politics; the incentives to be informed are low.
- ▶ Ignorance about political matters is important for three reasons.
  1. Ignorance makes it difficult to make informed choices.
  2. Ignorance can lead to bad policy.
  3. Not everyone is rationally ignorant.

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## Special Interests and the Incentive to Be Informed

## The US sugar quota

- ▶ Some people have a lot at stake in a policy decision.
- ▶ Such voters tend to be rationally informed – their benefits from gathering information and influencing politicians are much greater than the costs of such efforts.

Do you support the right for corporations to donate as much as they want to political campaigns?

- ▶ Due to a sugar import quota the price of sugar in the US is 3-4 times the world market price.
- ▶ Who is worse off with the quota?
- ▶ Who benefits from the quota?
- ▶ How is the political decision maker affected?

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If everyone in the world gave you a penny, you'd become fantastically rich.

This insight is at the core of modern politics.

Sort the following government policies into “concentrated benefits” and “diffuse benefits.”

- a) Social Security
- b) Tax cuts for families
- c) Social Security Disability Insurance for the severely disabled
- d) National Park Service spending for remote trails
- e) National Park Service spending on the National Mall in Washington, DC
- f) Tax cuts for people making more than \$250,000 per year

Which beneficiaries are likely to stay better informed?

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## Diffuse Costs, Concentrate Benefits

*divide et impera*

- ▶ In, e.g., the sugar quota case, the self interest of politicians does not necessarily align with the social interest.
- ▶ Those who are harmed are rationally ignorant and have little incentive to oppose the policy.
- ▶ Those who benefit are rationally informed and have strong incentives to support the policy.
- ▶ A self-interested politician may support a policy that damages many.

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# Voter Myopia and Political Business Cycles

- ▶ There may be other ways for a politician to increase his chances of re-election (particularly presidents.)
- ▶ Observe: voters tend to vote for the party of the incumbent when the economy is doing well and vote against the incumbent when the economy is doing poorly.
- ▶ Voters appear to be short-sighted (“myopic”) about a politician’s record.

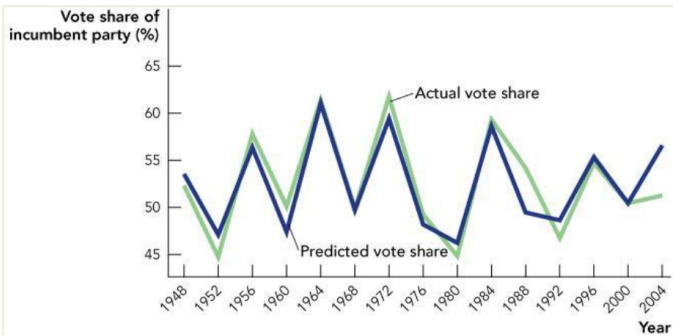
# Political Business Cycles

The data from each U.S. presidential election since 1948 suggest that voters are particularly sensitive to three key variables.

1. Growth in personal disposable income (income after taxes) in the election year
2. The inflation rate in the election year
3. The duration of party incumbency in the election year

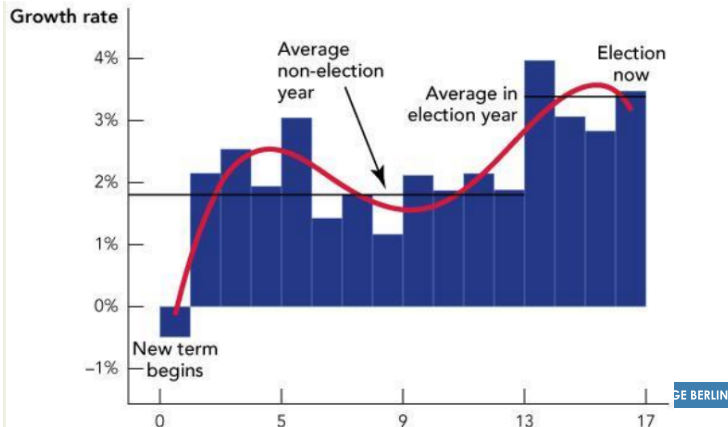
# Political Business Cycles

The incumbent party generally wins elections when personal disposable income is growing, inflation is low, and when the incumbent party has not been in power too long.



# Do presidents manipulate the economy so income expands during re-election years?

Growth in Disposable Personal Income Peaks in Election Years, 1947-2007



# Two Cheers for Democracy

“Democracy is the worst form of government, except all those other forms...”  
—Winston Churchill

An initiative on Arizona’s 2006 ballot would have handed out a \$1 million lottery prize every election: The only way to enter the lottery would be to vote in a primary or general election.

How do you think a lottery like this would influence voter ignorance?

- ▶ True, democracy has flaws.
- ▶ These flaws are worst when the policy problems (and solutions) are complex and when the issue isn’t highly visible in the press.
- ▶ When an issue is in the news and affects many, voters are more likely to exert their power.

# Who gets their way in a democracy?

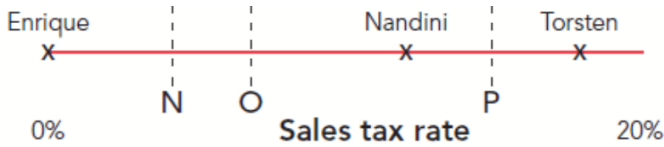
## The Median Voter Theorem

The Median Voter Theorem argues that the median voter rules:

When voters vote for the policy that is closest to their ideal point on a line then the ideal point of the median voter will beat any other policy in a majority rule election.

# The Median Voter Theorem

- ▶ Implications:
  - ▶ Politicians seek to represent the "median voter" to get elected.
  - ▶ Policy won't change unless the median voter views change.
- ▶ Exceptions:
  - ▶ If no candidate presents views close to the median voter, voters may refuse to vote for anyone.
  - ▶ When there are two or more issues at stake, there may not be a predictable outcome.
- ▶ The quality of the democracy we get depends on the wisdom (or rational ignorance) of the (median) voters behind it.

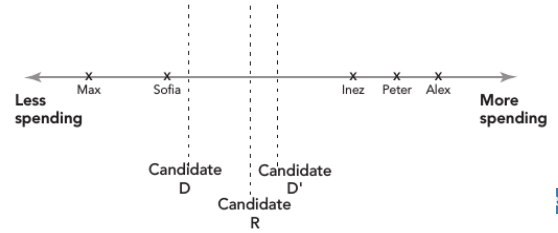


O drops out of the campaign after the local paper reports that he hasn't paid his sales taxes in years. P enters the race, pushing for higher taxes, so it's N vs. P. Voters prefer the candidate who is closest to them.

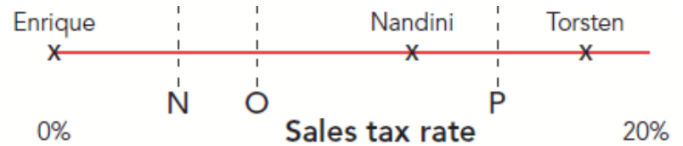
Who will vote for N? Who for P? Who will win? Who will lose?

# The Median Voter Theorem

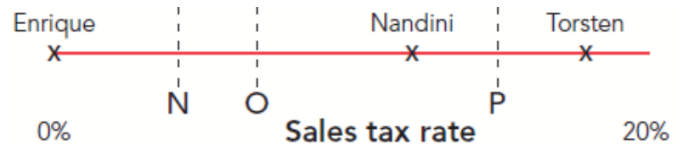
- ▶ Assume 5 voters, each with a preference on Social Security spending.
- ▶ Candidate D will receive 2 votes (Max & Sofia) and candidate R will receive 3 votes (Inez, Peter, & Alex).
- ▶ R could be beaten by candidate D', whose position is closest to the ideal position of the median voter.
- ▶ Over time, competition pushes both candidates toward the ideal policy of the median voter, which is the only policy that can not be beaten.



Suppose there are only two politicians running for office, N and O. Who will vote for N? Who for O? Which candidate will win the election?



1. Enrique and Nandini will vote for N and Torsten will vote for O. N will win the election.
2. Enrique will vote for N and Nandini and Torsten will vote for O. O will win the election.
3. Torsten will vote for N and Enrique and Nandini will vote for O. O will win the election.
4. Nandini and Torsten will vote for N and Enrique will vote for O. N will win the election.



Now, you get a job as the campaign manager for candidate N just a month before election day (O dropped out). You advise her to retool her campaign and come up with a new position on the sales tax.

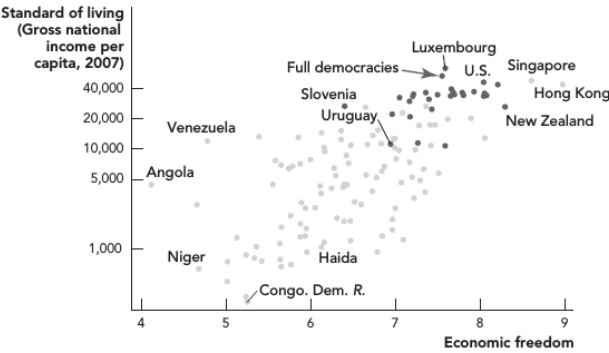
Of course, in politics as in life, there's more than one way to win, so give your boss a choice:

Provide her with two different positions on the sales tax, both of which would beat the would-be winner P. She'll make the final pick herself.

Are the two options you recommended closer to the median voter's preferred option than N's old position, or are they further away?

# Democracy and Non-Democracy

Democracies tend to be the wealthiest countries around the world.

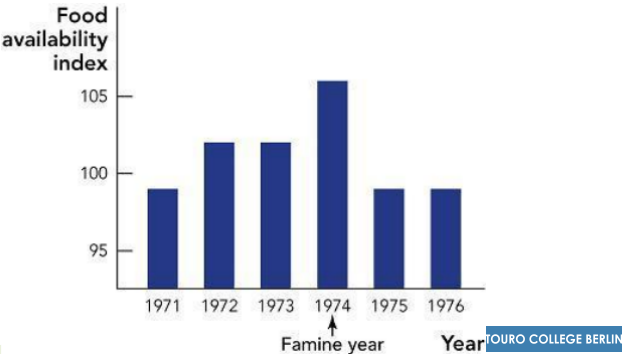


They also tend to have good records for supporting markets, property rights, rule of law and other institutions that support growth. (Full democracies are in dark grey.)

# Bangladesh's unintentional famine of 1974

Democracy and Famine: Democracies are not immune to famines

Poor farmers couldn't afford higher cost rice, and floods had wiped out crops and jobs. Mass starvation erupted, even in the face of high levels of food overall in Bangladesh.



# Democracy and Famine

Many of the famines in the 20th century were intentional.

Stalin's intentional starvation of millions of Ukrainian independent farmers (kulaks).

The Kulaks who survived were sent to gulags (prison work camps)



# Democracy and Famine

**"No famine has taken place in the history of the world in a functioning democracy."** Amartya Sen

Testing the theory in India, two economists find greater government response to food crises when a state has more newspaper circulation (and more political competition).



# Democracy and Growth

- ▶ Democracies have a good record for not killing their own citizens (or letting them starve to death).
- ▶ Often, non-democracies are ruled by a small group of elites (special interests) who use their influence to serve their own agendas at the expense of society.
- ▶ Mass education may run against their agendas, especially if it empowers the population.
- ▶ The more people are given the vote, the more likely the policy will represent society's interests instead of a few special interests.

True or false:

Rational ignorance tends to be voluntary in democracies but public ignorance tends to be more involuntary in non-democracies.