What is Political Economy?

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- Government extremely important part of the economy. We need to understand the how policies are shaped.
- Many open questions of first order importance.
  - Literature developed later.
  - Difficulties in terms of finding exogenous variation and quantifying parameters we’re interested in.
Some Major Questions

How do individuals decide who (if anyone) to vote for?

How will political candidates compete for office? What policies will they choose if elected?

How are politicians/bureaucrats incentivized to work hard and follow the interests of the electorate?

How can special interests influence policies?

Conflict: what determines when wars, rebellions, revolutions happen and their duration?
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Unique Equilibrium: Both candidates propose $p_i = 0$ and so locate at the median voter’s most preferred outcome.

This the Median Voter Theorem.
How Robust is The Median Voter Theorem?

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- What if policy motivated and uncertain?
  - Then some divergence.
  - However this disappears quickly as candidates become office motivated or uncertainty becomes small.
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- APSA’s Committee on Political Parties (1950) authored “Toward a More Responsible Two-Party System” complaining that parties were too similar, and didn’t offer voters enough choice.
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- APSA’s Committee on Political Parties (1950) authored “Toward a More Responsible Two-Party System” complaining that parties were too similar, and didn’t offer voters enough choice.
- Lack of polarization this era (approx 1945-1970) was atypical. [Note: this is polarization between the parties not within parties].
- Now political scientists and commentators worry there is too much polarization (e.g. Fiorina 2010).
Empirical Evidence of Polarization

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- The standard way is to look at votes by legislators.
- Idea being that legislators who vote together more often are closer together.
- Use this to map the ideal points of legislators into ideological space.
- Greater polarization if less overlap between the parties.
Assume legislator $i$ is voting to maximize an ideal point $y_i \in [-1, 1]$, for each legislator $i = 1, \ldots, n$. 

Each bill $j = 1, \ldots, k$ has an ideological component $b_j$, and index $\omega_j \in \{-1, 1\}$ for which side is the right and which is the left. Each legislator votes consistent with their ideology, plus some noise. Maximum likelihood estimation:

$$L(y, e, \omega) = \prod_{i=1}^{n} \Pr(\omega_j(y_i + \epsilon_i) \geq b_j)$$

Estimates ($\hat{y}, \hat{e}, \hat{\omega}$) maximize the likelihood of observing the votes. $n + 2k$ parameters to estimate with $nk$ observations.

Polarization steadily increasing since the 1970s.
Estimating Polarization

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Political Economy

Richard Van Weelden
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How To Explain Divergence?

- Downsian prediction doesn’t hold in practice.
- Many explanations have been put forward.
- Among them: threat of third party entry, primaries, heterogeneous candidate quality, interaction with rent-seeking.
- Most compelling rationale: It simply isn’t possible for candidates to make binding commitments that spell out exactly what they are going to do in office.
Accountability and the Agency Model

- Large economic literature on principal agent models.
- Examples: Employee works for company, CEO for shareholders, real estate agent for sellers, etc.
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- Examples: Employee works for company, CEO for shareholders, real estate agent for sellers, etc.
- There are several important features of political agency environments.
  - Contracting is almost never possible.
  - No flexibility with regards to the wage.
  - Incentives must be provided through re-election.
  - The “principal” is a heterogeneous electorate which may have relatively low information.
Moral Hazard and Accountability (Ferejohn 1986)

- Incumbent politician chooses “effort” $e \in \mathbb{R}_+$. 
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Equilibrium

- Politician’s problem (Bellman equation):

\[ V = \max_{e \in \mathbb{R}^+} \delta(B - e) + (1 - \delta)\Phi\left(\frac{e - \bar{u}}{\sigma}\right) V \]
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- Determine \( \bar{u} \) to maximize \( e(\bar{u}) \), maximizes the amount of politician effort.
- Here voters are indifferent between re-electing and not. Richer (but much more complicated) model allows voters to learn from outcomes.
Comparative Statics

- Exert more effort when:
  - paid more (re-election is more valuable).
  - more patient (elections more frequent).
  - more easily monitored ($\sigma$ smaller).
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Does Transparency Increase Effort?

To answer that question requires finding exogenous variation in transparency.

- Representatives in districts with greater overlap with media markets face greater transparency.
- Higher transparency results in: voting record more aligned with the district's preferences, involvement in more committees, and secure more federal funding for their district.
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- But politicians may have information and expertise the voters don’t have (e.g. classified information, closed door negotiations, or simply because voters have less incentive to acquire information).
- This is leads to the concern about “pandering”.

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Maskin and Tirole (2004)

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- Politician can be “congruent”, in which case shares policy preferences of the voters or “non-congruent” so wants the opposite.
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After period $t = 1$, an election with voters deciding whether to replace the incumbent with a random challenger.
In second period the congruent politician will take action the voter wants, non-congruent the opposite.
Equilibrium Pandering

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- Voters update that the incumbent is more likely to be non-congruent if the first action is $p_1 = 0$. 

Tradeoffs between incentivizing hard work and fear of pandering.
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Research Questions

- How to maximize the good parts of accountability while minimizing the distortions.
- Incorporating parties, differences in candidates, and reputation.
- Merging electoral competition and accountability.
- Among many other questions.