Introduction to public choice

Lecture 1

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Economics and Political science

- Aristotle ✹ man a political animal ✹political science
- Smith ✹ man inclined to trade and exchange ✹ economics
- 2 sciences different for:
  - Subject matter
    - PS: political arena
    - Economics: market
  - Methodology
    - PS ✹ *homo politicus* motivated by public interest
    - Economics ✹ *homo oeconomicus* motivated by private interest

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Public Choice

- Public Choice: economic analysis of non market decisions (essentially political decisions)
- Subject matters of political science, methodology of economics (*rational choice*: optimization and equilibrium principles)
- *Rational choice* already used in political philosophy (Hobbes, Spinoza, Hume) and political science (Madison, Tocqueville)
- Public Choice is a science: new analytical models then adopted by economics (e.g., P/A)

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History of public choice: SWF

- 1930s: Great Depression spreads skepticism about the functioning of the market ✹ government can be as efficient if not more (Hayek vs. Kaldor; the innovation of the 5 year plan)
- Bergson (1938) Social Welfare Function ✹ aggregates the individual optimization processes in a plan-type of context ✹ a guide on how to govern the state

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History of Public Choice: Arrow and Social Choice

- Arrow (1951) studies how a SWF can be obtained✹ problem of the aggregation of the individual preferences into a SWF ✹ impossible
- Social choice: given individual preferences what kind of SWF should be chosen ✹ normative approach
- Sen, Nozick, Rawls ✹ study of optimal constitutions and concept of liberty

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Birth of Public Choice

- Positive version of social choice
- Given the individual preferences and the existing decision making rules ✹ which decision (outcome) emerges as an equilibrium?
- Decision making rules work as a constraint
- Different decision making rules generate different types of decisions ✹ Institutions matter
- Critique of Keynesian macroeconomic theory and political economy well before modern political economics

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Alternative history: PC and Public Finance

- Critique of the market in the 1930s suggest that state should perform 2 tasks:
  - To supply public and private goods where market fails (allocative function)
  - To correct distributive inequalities (redistributive function)
- Development of the theory of market failure (public goods, externalities, scale economies ✹ Samuelson, Pigou)
- Birth of a normative theory
  - Of the origin of the state
  - Of the proper domain of state intervention into the economy

Contributions of public choice

- If state exists to supply PG and eliminate externalities ✹ must act as a preference revealing mechanism just as the market does for pg
- PC studies how the state performs such function
- 3 stages approach:
  - Same behavioral axioms of economics
  - Preference revealing mechanism in politics similar to that of the market
    - Vote trading
    - Demand function revealed through voting process
    - Choice expressed through exit from clubs ✹ federalism
  - Same problems of economics (do equilibria exist? Are they stable? Pareto efficient? How are they attained?)

Voting rules and direct democracy

- Vote system=non market decision making process
- Models of direct democracy:
  - state is a decision making rule (black box)
  - Voters' preferences are inputs
  - Choice is output
- Unanimity ✹ allocative, efficiency enhancing choices (Pareto optima)
- Simple majority✹ redistributive choices
- First studies of the effects of majority voting, voting cycles, median voter, logrolling and voting stability
- Complex alternatives to simple majority
- Voting=voice option; moving=exit option (Hirschman, 1970)

Representative democracy

- Downs (1957) reaction to Arrows (1951)
- Competition between parties for votes has same desirable effects as competition between forms for costumers
- In Downsian model state is not a black box, but institution with agents (voters, representatives, bureaucrats) with incentives, constraints and relations

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Features of representative democracy models

- State with various government levels ✹ federalism
- Competition among 2 parties ✹ deterministic vote model (Downs) ✹ fails to solve the impossibility theorem
- Probabilistic voting model
- Multiparty system
- Voting paradox

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Other public choice models

- *Rent seeking* between redistribution and regulation
- Economic theory of bureaucracy: theory of how the public administration and the executive works
- Characterization of incentives and constraints in 3 government branches
  - legislative
  - executive
  - judiciary
- Other government systems: theory of dictatorship

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Public Choice, "Nirvana state" and interest group

- In 1960s the idea that government solves market failures at zero costs was popular ✹ Nirvana model
- Normative analysis of the role of the state
- PC introduces analysis of "government failure" ✹ positive analysis of how government works
- Example: Keynesian stabilization policies based on market failure ✹ lack a model of how government works ✹ PBC provides evidence that PC was correct
- Electoral systems fail to represent voters preferences (rational ignorance, *bundling*) ✹ interest groups profit of this slack in P/A relationship
- Olson (1970): logic of collective action

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Other research fields

- Theory of secular growth of the public sector
  - Demand-led models
  - Redistribution
  - Interest groups and bureaucracy
- Effects of government intervention in the economy
  - PBC
  - Growth ✹ *Rise and decline of nations*
  - Black market and corruption

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Beyond Public Choice

- 1990s and *political economics* (Alesina, Tabellini et al.)
- According to Persson e Tabellini (2001) 3 origins:
  - New Classical Macroeconomics (Lucas, Kydland and Prescott)
  - Public Choice
  - Political science

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New Classical Macroeconomics

- Lucas: agents hold rational expectations ✹ *policy impossibility* ✹ focus on strategies of macroeconomic policies rather than single issues ✹ rules
- Kydland and Prescott (1977): only "*time consistent*" policies are credible
- NCM literature pays little attention to political institutions and political exchange

Public Choice

- 3 contributions to political economics
  - Theory of interest groups
  - Agency problems in political relations, especially rational ignorance
  - Rules and constitutions
- Limits:
  - Rationality hypothesis not always respected
  - Limited use of game theory models

Political science

- 2 Contributions
  - Attention to institutional detail and structure of the collective decision making process
  - Extensive use of noncooperative game theory
- Limit: not all political science converted to *rational choice paradigm* (e.g. Italian political science, Sartori)

Synthesis

- Common paradigm (rational choice) and the idea that types rules and institutions determine types of decisions (outcomes) generates area of overlap between PC, PE and PS
- Social sciences differ for their methodology, not subject matter ✹ political economics, public choice and political science are in fact quite similar today
- Differences public choice/political economics
  - Attention to functioning of institutions (PC) – macroeconomic policies (PE)
  - Marshallian approach (PC) vs. Walrasian approach (PE)
  - Marshallian approach more amenable to empirical testing
  - Some topics still specific to PC (dictatorship, bureaucracy, size of nations)
- It's the scientific progress, stupid!

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