Government decision making process (1)

- Analysis of government decision making process – public election
- One of the procedures for collecting information about citizen preferences – the electoral procedure
- Voting - in democratic societies the most important procedure for aggregating different individual preferences into social preferences, for the sake of the implementation of social decision making
- At the same time, for individuals, voting is a chance to exercise some control of the political process
- Measures of economic and fiscal policies are a result of the political process of decision making

Government decision making process (2)

- Public choice explores mechanisms with the help of which collective decisions about the collection of public revenue, the purpose of public spending, transfer payments, regulation and other fiscal policies are made.
- In the private sector individuals make individual decisions that are adjusted on the market; individuals make choices about how much they spend, firms about the extent of their production, and the price system ensures that the amounts consumers want are really produced by the corporate sector.
- The procedure for making collective decisions is complex, because decisions about goods and services that are non-existent on the market have to be made. That is why in the political process decisions are to be made that will pay account of voter interests and wishes.
- For this purpose, various models of voting system are used, such as the 
  unanimous voting system, the ordinary majority and the two-thirds electoral system.
Political economy

- Political economy is the area of economic theory in which the political decisions making process is analysed by economic principles.

- Political economy models assume that individuals see the government as a mechanism for the maximising of their own interests.

- On the other hand, it is also assumed that people in the government attempt to maximise their own interest.

- Decision making about public expenditure in democratic societies can be observed in the case of direct democracy and in the case of representative democracy.

Direct democracy (1)

- Economists have studied numbers of ways for determining the quantity of the consumption of public goods
  - Lindahl’s prices – selection of quantity of public goods by unanimous decisions
  - Majority voting
  - Logrolling (vote trading)

- Lindahl prices – if individuals bear their price for a unit of public good, depending on their tax share, there is a quantity of supply of public goods that suits everyone, and this quantity is Pareto efficient.

- Problems in application: it is assumed that people vote sincerely, and until mutually acceptable tax shares are found a long time can pass, so that unanimity is difficult to achieve.

Direct Democracy - Unanimity Rules

The Lindahl Model
Direct democracy (2)

- The majority voting system rules – more than half the voters have to approve a certain measure for it to be adopted.

- In a majority voting system, it might happen that, although the preferences of voters are consistent, the preferences of the community are not – the voting paradox.

Majority voting

- Unanimity is hard to achieve, others systems are desirable.

- The majority voting rule – more than half the voters have to vote.

Preferences of voters that lead to equilibrium

- 3 voters (Cosmo, Elain, George), decision to buy arms

  A – small
  B – medium
  C – large quantity of arms

Voting preferences that lead to an equilibrium

<table>
<thead>
<tr>
<th>selection</th>
<th>Cosmo</th>
<th>Elain</th>
<th>George</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>A</td>
<td>C</td>
<td>B</td>
</tr>
<tr>
<td>II</td>
<td>B</td>
<td>B</td>
<td>C</td>
</tr>
<tr>
<td>III</td>
<td>C</td>
<td>A</td>
<td>A</td>
</tr>
</tbody>
</table>

- if they decide for A or B, B wins 2:1
- if they decide for B or C, B wins 2:1 again
- however they vote, the moderate variant of B wins irrespective of the order of voting
Voting preferences that lead to cycling

<table>
<thead>
<tr>
<th>Selection</th>
<th>Cosmo</th>
<th>Eleine</th>
<th>George</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>A</td>
<td>C</td>
<td>B</td>
</tr>
<tr>
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<td>B</td>
<td>A</td>
<td>C</td>
</tr>
<tr>
<td>III</td>
<td>C</td>
<td>B</td>
<td>A</td>
</tr>
</tbody>
</table>

Voting paradox – each individual voters preferences are consistent, the community’s are not.

Direct democracy (3)

- For the final result of voting with preferences the order of the votes is crucial.
- Hence the adjustment of the order is the procedure for organising the order of voting so as to ensure the desired result – agenda manipulation.
- Voting in pairs can go on indefinitely without achieving an electoral result – cycling.

Graphing Preferences

Single-peaked preferences

Double-peaked preferences

Utility

Missiles

A

B

C

Single-peaked preferences

Double-peaked preferences

Cosmo

George
Double peaked preferences

*Double peaked preferences* – by distancing from the outcome that the voter is most inclined to the utility at first falls, and then rises again.

*Single peaked preferences* – utility continually falls as the voter distances from the point that gives the most utility.

When there is a private substitute for a publicly provided good, the likelihood of preferences with several peaks increases.

When the voting is for different things, multiple peaked preferences are very common.

The Median Voter

* The median voter theorem says that while all preferences are single peaked, the result of majority voting reflects the inclinations of the median voter.

* The median voter – that voter whose preferences lie in the centre of the group of preferences of all voters

<table>
<thead>
<tr>
<th>Voter</th>
<th>Costs, in mil kn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tea</td>
<td>5</td>
</tr>
<tr>
<td>Lara</td>
<td>100</td>
</tr>
<tr>
<td>Silvia</td>
<td>150</td>
</tr>
<tr>
<td>Aime</td>
<td>160</td>
</tr>
<tr>
<td>Marko</td>
<td>700</td>
</tr>
</tbody>
</table>

* Since multiple peaked preferences can be important in many real life situations, we cannot always rely on majority voting for the achievement of a result in line with public choice.

* To reveal the intensity of preferences and the establishment of a stable equilibrium it is possible to use logrolling (vote trading).

Logrolling systems – improve welfare

<table>
<thead>
<tr>
<th></th>
<th>Tea</th>
<th>Silvia</th>
<th>Marko</th>
<th>Net benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital</td>
<td>200</td>
<td>-50</td>
<td>-55</td>
<td>95</td>
</tr>
<tr>
<td>Bridge</td>
<td>-40</td>
<td>150</td>
<td>-30</td>
<td>80</td>
</tr>
<tr>
<td>Highway</td>
<td>-120</td>
<td>-60</td>
<td>400</td>
<td>220</td>
</tr>
</tbody>
</table>
**Logrolling – lower welfare**

<table>
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<td>-270</td>
<td>-140</td>
<td>400</td>
<td>-10</td>
</tr>
</tbody>
</table>

**Direct democracy (4)**

- Arrow (1951) proposed that in democratic countries the rule for making decisions should satisfy the following conditions:
  1. Decision can be made irrespective of the configuration of voting preferences
  2. It must be possible to rank all the results
  3. The rule for making decisions must respond to individual preferences
  4. The rule must be consistent (A>B and B>C then A>C)
  5. Social ranking of A and B is dependent only on individual ranking of A and B
  6. Dictatorship is not allowed

**Arrow’s impossibility theorem**

*Arrow’s impossibility theorem* - it is not possible to find a rule that will surely guarantee the satisfaction of all criteria - so democratic societies cannot always be expected to make consistent decisions

- Logrolling (vote trading) enables voters to express the strength of their preferences.
- In this way the minority can sometimes get what it wants at the expense of the majority that will have to bear the costs.
Representative democracy (1)

- Direct choice – can be applied only when a decision about individual questions has to be made
- The advantage of direct choice – all persons who bear the consequences of some decision take part in the voting and can express their preferences
- Disadvantage – after some level the costs of constant decision-making about individual issues significantly increase
- When it is not possible to decide via direct choice, institutions are necessary (representatives, parties) that make individual preferences visible and coordinate them for the sake of the decision making process
- Representative democracy – political system in which there are general elections, in which two or more parties or persons compete for the votes of the constituency

Representative democracy (2)

- In a representative democracy, the right to vote is restricted to the choice of representatives, during which parliament, in collaboration with the Government and the bureaucracy, actually makes the choice of supply of goods.
- The political process of decision making is commonly analysed with a model in which Government, parliament, parties and the bureaucracy are taken to be institutions composed of self-seeking individuals.
- Parties are interested in maintaining or winning political power.
- In the two-party system, parties choose the median voter (on the scale of voter preferences) as the most desirable point.

Representative democracy (3)

- The explanation of the behaviour of government requires the study of the interactions of elected politicians, civil servants and special interest groups.
- Government (state) has no interests of its own, it is neutral and benign.
- Government is run by people [in the Government, Parliament, ministries], all of whom have their own agendas.
- Alas, they do not rule only for the good of all, but attempt to maximise their own personal utility.
- We shall observe: elected politicians, civil servants, special interest groups.
Elected government politicians

Let us imagine presidential elections. And let us assume:

- Only two candidates
- All voters have single-peaked preferences
- All voters want to maximise their own utility
- The two candidates want to win the max. no. of votes
- The candidates thus attempt to adjust themselves to the median voter - that voter whose preferences are in the centre of the scale.

Representative Democracy - Elected Politicians

Number of Voters

Liberal  Conservative

Problems with the median voter

- It’s not easy always to determine the median voter, which depends on the issue at hand (capital investment, arms, pensions, abortion...)
- Ideology – some candidates for ideological reasons cannot adjust to the median voter.
- Voters are not always realistic, and politicians can be personally attractive or repulsive.
- In this model, candidates adapt to voters, but it is not always like this - sometimes there are leaders who can affect preferences, and the masses follow leaders who set them off.
- Voting decision – people often do not turn out, because the candidates don’t offer anything to make them happy; some people are alienated and not interested in voting.
- People are often uninformed; some think a single vote changes nothing; in some countries the voter turn-out is very low (USA v Scandinavia); many ask why people don’t vote, but the real question is, why do they vote at all?
- All this means that the median voter theory doesn’t always work.
Civil servants

- Legislation passed by Parliament, but enforcement depends on civil servants – the bureaucracy
- Government depends on civil servants – and they last longer than elected politicians anyway
- In the private sector the pay of employees rises with the growth in corporate income
- But civil servants' wages doesn’t depend on profit
- The power and status of civil servants depends on the size of the budget they deploy, hence their interest is always to maximise the size of this budget

Niskanen model of bureaucracy (1)

- Pareto efficiency require production at MC=MB, no total costs = total benefits.
- Bureaucrat's desire to build as large and empire as possible leads to an inefficient large bureaucracy.
- State servants affects development and realization of economic policy.
- Niskanen - bureaucrat’s try to maximize the size of their budget resulted in significant increase their service supplied.

Niskanen model of bureaucracy (2)
Citizens

- Citizens influence by voting at elections, party contributions, and bribes
- Citizens can be united in interest groups:
  - Depending on how they make their income (capital or labour – taxes that concern them most)
  - How much their income is (rich – reliefs for purchase of artworks, poor – welfare programmes)
  - Where they live (Istrians – tax relief for tourism, Slavonians – subsidies for farming)
  - Age (pensioners – pensions, young – housing investment, employment)
  - Gender (for higher maternity benefits)

The Iron Triangle

The Iron Triangle - collaboration among legislators who pass a programme, officials who enforce it, and special interest groups that benefit from it. In the RC example – the civil engineering lobby (Ministry, Parliament, civil engineering industry), tourist lobby etc.

- Members of the iron triangle have information and are well organised, but all those who bear the costs (the taxpayers, us) are not organised, and do not even know what is going on; we think we are powerless to influence anything, we think our share is too small anyway.
- Unlike members of the public, the utilities of members of an iron triangle are well concentrated, and it is worth organising them

Lobbying

Lobbying is the use of the government to obtain returns higher than normal. Such returns are rents, and hence the English word rent-seeking.

Fiscal decisions can also be influenced by:

- Judiciary (eg, repayment of pensioners’ debt, assets of Volksdeutschers)
- Journalists (questions of amount of tax burden, tax rates, budget &c)
- Experts (from ministries during the presentation of proposed legislation, and NG scientists)
Determinants of government activities (1)

- Wagner's Law - the oldest known statement about the trends in public expenditure in the area of public finance.

- Wagner's Law - (Adolph Wagner) - government spending growth rate higher than income growth rate.

- According to Wagner (turn of the 19th and 20th century), cultural progress regularly leads to expansion of government activities, from which comes the absolute and relative enlargement of government expenditure.

- What can determine the size of public expenditure (government activities)?

Determinants of government activity (2)

1. time shifts - first more is spent for private and then for public consumption; from rise in income, first investment is financed, and then public goods; democratic institutions need time to develop.

1. Structure of public expenditure - those activities of the state in which the qualifications of the employees must be high tend to grow

2. Distribution of functions among levels of government

3. Population trends - collective activity is necessary to remove effects deriving from conglomerations of population, changes in the age structure of the population

4. Form of government decision-making process - level of supply of public goods, independent of costs and decisions amount of tax

5. Redistribution

Control of government spending

Possibilities

Private Sector competition

- Change in incentives for bureaucrats - Niskanen thinking that bureaucrats are to blame for the rise in government spending proposes financial incentives to bureaucrats, such as pay rises in return for cutting spending (dangerous, for they might reduce the budget below the point at which MC=MB), e.g., a welfare worker might get higher pay by cutting his/her clients' benefits.

- Changes in budgetary procedure. The Parliament for example might set of objectives to reduce budget or deficits in a given period, e.g., in 2016-2018, reduce the budget to some % of GDP; and so much every year; in the USA - this was done by the Gramm-Rudman-Hollings Act)
Good and bad side

- Good side - MPs can justify themselves to the electorate
- Weakness – automatic reduction of all programme expenditures by an equal percentage
- Constitutional restrictions - e.g. expenditure = receipts; receipts must not be greater than growth of GDP.
- Problem areas:
  - Economists’ forecasting not reliable, and differs, according to which data are taken, and GDP can be manipulated (in the RC for example)
  - Definition of receipts and outlays contentious; bookkeeping manipulations

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