Presentation notes, chapter 2

INSTITUTIONS AND GOVERNANCE
What are “institutions”?

Why do institutions matter?

- A society’s institutions establish rules and incentives of personal and political conduct
- Institutions persist independently of the identity of individuals
- Institutions determine whether government can improve on market outcomes
2.1 THE POLITICAL PRINCIPAL-AGENT PROBLEM

2.1 A. Asymmetric information

- Political decision makers have personal objectives
- A political principal-agent problem arises when principals (taxpayers and voters) cannot ensure that agents (political decision makers) will act in the best interests of the principals
- The principal-agent problem occurs because of asymmetric information between voters and political decision makers
Examples of policies not in the public interest sought by interest groups

- Forestalling environmental policies that would increase producer costs
- Protectionist policies
- Agricultural and other producers may seek subsidies
- School administrators and teachers in government schools may resist subsidies for private schools and parental choice among schools
- Lawyers may seek unlimited rights to propose class action cases and no limitations on damages that courts can assign
- Various organizations may seek tax-exempt status
- Groups may seek particular public spending
- At the local government level, rezoning of land

There are also interest groups that seek socially beneficial responses from political decision makers
A government budget

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public goods and other</td>
<td>Taxes of different types</td>
</tr>
<tr>
<td>public investment</td>
<td></td>
</tr>
<tr>
<td>Income transfers (welfare payments)</td>
<td>Borrowing from the</td>
</tr>
<tr>
<td>Government spending on</td>
<td>public through sale of</td>
</tr>
<tr>
<td>itself (wages and</td>
<td>government bonds</td>
</tr>
<tr>
<td>salaries of the</td>
<td></td>
</tr>
<tr>
<td>bureaucracy and other</td>
<td>Fees and user prices</td>
</tr>
<tr>
<td>expenses of the branches of</td>
<td></td>
</tr>
<tr>
<td>government)</td>
<td>Transfers from other</td>
</tr>
<tr>
<td>Payment of interest on</td>
<td>governments</td>
</tr>
<tr>
<td>government bonds</td>
<td>Other revenue sources</td>
</tr>
<tr>
<td>Repayment of past</td>
<td>such as lotteries</td>
</tr>
<tr>
<td>borrowing</td>
<td>Inflationary financing</td>
</tr>
<tr>
<td>Transfers to other</td>
<td>(not shown in the budget)</td>
</tr>
<tr>
<td>governments</td>
<td></td>
</tr>
</tbody>
</table>
Reasons for asymmetric information

- Information provided to taxpayers and voters through the government budget is incomplete

- Information as a public good
  Individual taxpayers and voters confront the incentive to free ride on information acquisition and political monitoring

- Rational ignorance of taxpayers and voters
B. Political support and public policy

- A politician has an objective of winning elections
- Principled political candidates prefer not to accept campaign contributions from special interests

The prisoners’ dilemma facing principled political candidates

<table>
<thead>
<tr>
<th>Politician 1</th>
<th>Politician 2 refuses to accept special-interest contributions</th>
<th>Politician 2 accepts special-interest contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refuses</td>
<td>3,3</td>
<td>1,4</td>
</tr>
<tr>
<td>Accepts</td>
<td>4,1</td>
<td>2,2</td>
</tr>
</tbody>
</table>
Public finance for political expenses

Can public finance for political expenses solve the prisoners’ dilemma?

The form of public finance of political expenses:

- Public finance for political expenses according to political representation in parliament

- Matching public finance as a subsidy for private political contributions, which benefits special interests, whose political contributions are subsidized by public money

Matching public finance for private political contributions
Special-interest groups have advantages over voters
- Group size and collective action
- Stakes in policy outcomes
- In general, not all issues can be decided by voters

The role of asymmetric information:
- Special interests have a comparative advantage in providing money
- Voters have a comparative advantage in providing votes
- Voters’ rational ignorance allows special-interest groups to have political influence

The paradox of political spending and advantages of special interests

Voters determine the outcome of elections but special interests provide money that political candidates use to persuade voters how to vote
Compulsory voting solves the voter coordination problem.

The voter coordination game:

<table>
<thead>
<tr>
<th>Voter 1 votes</th>
<th>Voter 2 votes</th>
<th>Voter 2 does not vote</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voter 1 votes</td>
<td>2,2</td>
<td>0,1</td>
</tr>
<tr>
<td>Voter 1 does not vote</td>
<td>1,0</td>
<td>1,1</td>
</tr>
</tbody>
</table>
The media and the principal-agent problem

- Are the media objective?
- Objective media reduce asymmetric information that underlies the political principal-agent problem
- With bias evident, voters know that they cannot rely on the media for information that will assist in making informed voting decisions
Regulation of campaign contributions

- Buying votes directly from voters is illegal
- Money indirectly buys votes through political advertising
- There are impediments to effective regulation of campaign contributions: legal entities as funnels for personal campaign contributions
The monetary value of endorsements

- The value of political support expressed through media endorsements is not subject to regulation
- Endorsements for political parties and candidates can also be provided by celebrities: why are voters influenced by the endorsements of “celebrities”?
- The value of an endorsement from a “celebrity” and the limit on legally allowable campaign monetary contributions
- Political bias when regulation excludes the value of endorsements from the media and celebrities
Term limits

- Term limits are intended to prevent entrenched political power by political incumbents
- Term limits also make clear to politicians that they eventually need to be able to be self-reliant
- Another view: term limits are undesirable because politicians need time to build a reputation with voters for honesty – politicians who would be socially benevolent act in self-interested ways because of the term limits
- Term limit introduce conflicts among voters in different constituencies
C. Rent creation and rent seeking

A rent is a benefit obtained not productively but through influencing the decisions of others.

A rent is a personal benefit that would not be obtained in a competitive market.

How are rents obtained?

- Privileged benefits from public spending and the privilege of paying no or low taxes
- Public policies
- Family and friends
Rent seekers do not ask “how can I productively earn income today?” They ask themselves “how can I convince someone to do something for me today?”

There is an efficiency loss from rent seeking through unproductive use of resources when rents are contested.
Rent seeking as a prisoners’ dilemma

Participation in a rent-seeking contest is personally rational

The prisoners’ dilemma and rent seeking

<table>
<thead>
<tr>
<th>Person 2 does not rent seek</th>
<th>Person 1 engages in rent seeking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Person 1 does not rent seek</td>
<td>3,3</td>
</tr>
<tr>
<td>Person 1 engages in rent seeking</td>
<td>4,1</td>
</tr>
</tbody>
</table>

Both people are drawn by a prisoners’ dilemma into rent seeking that there is neither personally nor socially advantageous
Lobbyists and rent seekers

- The rent-seeking prisoners’ dilemma describes two people with equal access to rent-seeking opportunities.
- Often access to rent seeking is not equal or symmetric.
- Rent seekers might delegate rent seeking to professional lobbyists who are insiders and have earned the trust of political decision makers.
- The lobbyists can be trusted because they earn their incomes from the persistence of rent seeking.
Political benefit and rent creation

Why do political decision makers create rents to be assigned through rent seeking?

• Political benefit can be personal (which can entail corruption) or through advantage gained for the political party
• Political decision makers cannot directly use public finance or public policy for personal benefit
• By using public finance and public policy to create and assign rents, political decision makers can exchange public money for personal money or for political benefit
The social losses due to rent creation and rent seeking

\[ MC = AC \]

\[ F \]

\[ C \]

\[ QC \]

\[ V \]

Efficiency loss due to rent seeking when rent dissipation is complete

Efficiency loss due to rent creation

DEMAND (MB)

The inefficiency of rent creation and rent seeking
Measuring the social loss from rent seeking

Problems of measuring the social loss due to rent seeking

- Rent seeking is generally unobservable
- Successful rent seekers in general propose that their benefits have been obtained on merit
- The social loss from rent seeking includes resources used in rent seeking by unsuccessful rent seekers

The example of the thieves shows:

The social cost of rent seeking is incurred before the identity of the successful rent seeker is known.
Inferring the social cost of unobserved rent seeking

The value of the rent is often visible

Can the observed value of a rent be used to infer the value of resources used in rent seeking?

Rent dissipation is

\[ D \equiv \frac{R}{V} \]

Rent dissipation is complete when \( D = 1 \).

When rent dissipation is complete, the observed value of a rent is a proxy for the social loss due to use of resources in rent seeking.

Complete rent dissipation resolves the problem of non-operability of rent seeking.
Is rent dissipation complete?

We can identify circumstances in which rent dissipation would be complete

**Competitive rent seeking**

If each of \( n \) rent seekers spends \( x \) in seeking a rent (and the behavior of rent seekers is not affected by risk)

\[
\lim_{n \to \infty} D \equiv \frac{nx}{V} = 1.
\]

*Competitive rent seeking results in complete rent dissipation.*
We do not expect rent-seeking contests to be competitive:

- Political decision makers cannot allow open access to rent seekers but rely on approaches from trusted lobbyists
- Not everybody wants to participate in rent seeking
- Some people have a comparative advantage in rent seeking while other people have a comparative advantage in (or ethically limit themselves to) being productive
Strategic behavior in rent-seeking contests

The Nash equilibrium of a rent-seeking contest depends upon the rule that identifies the successful rent seeker.

There are two basic rules:

(1) lottery
(2) all-pay auction
**Lottery**

With two contenders making political investments of $x_1$ and $x_2$, the probability of rent seeker $i$ winning a Tullock contest is

$$\rho_i(x_1, x_2) = \frac{x_i}{x_1 + x_2}, \quad i = 1, 2.$$  

Each rent seeker chooses a political investment $x_i$ to maximize expected benefit, which is given by

$$EB_i = \rho_i(x_1, x_n)V - x_i = \left(\frac{x_i}{x_1 + x_2}\right)V - x_i$$

Because of symmetry, the rent seekers choose the same $x$

Rent dissipation is given by

$$D \equiv \frac{nx}{V} = \left(\frac{n-1}{n}\right).$$
**All-pay auction**

There is no Nash equilibrium in pure strategies

The mixed-strategy Nash equilibrium is a probability distribution from which rent seekers draw their rent-seeking expenditures

The probability distribution extends over \( \{0, R\} \)

In the mixed-strategy Nash equilibrium, there is complete rent dissipation on average for any number of rent seekers

\[
D \equiv \frac{nEx}{V} = 1 \quad \text{for all values of } n \geq 2.
\]

In rent seeking contests where the rent seeker spending the most wins, rent dissipation is on average complete for any number of rent seekers.

We have a justification for inferring the unobservable value of resources and time used in rent seeking (in total by successful and unsuccessful rent seekers) from an observed value of a rent
Rents endure over time

Monopoly privileges, subsidies, tax concessions, environmental standards, a publicly financed highway or bridge, rents provided through protection from import competition, etc.

How does the persistence of rents affect rent dissipation and thereby the social cost of rent seeking?

Consider rents that would be completely dissipated if the entire rent were provided at a point in time.

Rents will need to be re-contested in the future if
- future political decision makers do not recognize favors provided by past politicians
- future political decision makers altogether eliminate rents, by changing the public policies that created the rents

When future resources used in contesting an enduring rent are taken into account, rent dissipation is complete.
Evaluating rent dissipation requires knowing:

- whether individuals or groups compete for rents
- whether rents are shared or provide collective benefit
- how individual rent seekers in groups are rewarded for their efforts
- whether rent seekers risk-averse
- the number of rent seekers in a contest
- the number of stages in a contest

---- and more
The significance of being able to infer complete rent dissipation

Rent seeking is not observed and not publicized

Governments do not publish the information required to measure resources used in rent seeking in government statistics
Rent creation and the political trade-off

- Political decision makers choose a public policy that is a compromise between the outcomes sought by voters and industry interests.
- Rents are reduced by voter opposition to special-interest policies.
- Rent-seeking incentives are present if political decision makers are perceived as responsive to rent seeking.
A culture of rent seeking

- People principally spend their time not on productive activity, but on networking and seeking (and giving) favors
- Admission to university or college is a rent-seeking contest and not be based on personal merit
- Students find that professors are open to persuasion through personal favors when assigning grades for courses
- The professors who teach the students were also in their day as students not admitted to study on personal merit

In a rent-seeking culture, assignment to jobs is not through the personal merit that is the basis for personal comparative advantage
Ambiguities of behavior

• Rent seeking can be an excessively cynical concept

Awareness of rent seeking

• Rent seeking suggests a hidden side of an exchange when people are observed to benefit systematically from privileged favors
• Why do some people benefit from privileged favors while others do not?
Two types of competition

- In competitive markets, incentives are only to be productive and people need neither give nor seek favors
- In competition for rents, behavior is unproductive and favors are given and sought.

Lobbyists and lawyers

- Lobbyists are an indication of rent seeking
- Lawyers are instruments of contestability

Rent seeking and social justice

- Rent seeking is the source of inefficiency.
- Assignment of privilege through successful rent seeking can be expected to be unjust
D. Rent extraction and corruption

Rent extraction is political activity of obtaining benefits

Corruption

*Corruption is the illegal use of the authority of government for direct personal benefit.*

Bribes and rent seeking

Bribes become sources of social loss in rent seeking contests when the job or position of the person receiving the bribes is contestable.
2.2 GOVERNMENT BUREAUCRACY

“Government officials,” “bureaucrats,” and “civil servants” are interchangeable terms

A. Incentives and behavior in a bureaucracy

Monopoly rents

- Government bureaucracies are in general monopolies
- In the private sector, a monopoly rent consists of excess profits
- In government bureaucracies, rents take the form of low effort and stress and other benefits associated with on-the-job quality of life
Costs
- Government bureaucracies cannot become bankrupt
- Incomes of government bureaucrats are assured from tax revenue

Incentives
- Owners of a private monopoly have incentives to minimize costs of production to increase profits
- Incentives in a government bureaucracy can be precisely the opposite: to maximize costs, since costs include bureaucrats’ salaries
- Bureaucrats’ benefits increase with the size of the budgets that they control

Asymmetric information about activities inside bureaucracies
- Taxpayers cannot know
- Rational ignorance

The principal-agent problem

A normative vision of how bureaucrats should ideally behave
B. Demand creation by bureaucracies

- Bureaucrats have incentives to create demand for their services
- Administrators of an unemployment compensation program
- Government social workers
- Officials in the state department or foreign service
- Asymmetric information prevents taxpayers from knowing
C. Measurement of bureaucratic output

- Inability to measure accurately bureaucratic output compounds the problem of asymmetric information
- In the private sector, there are incentives for private monitoring and evaluation of the worth of employees’ activities
- Profitability cannot be a criterion for evaluating bureaucratic efficiency: the output of government agencies and departments is generally not valued in markets
- Inability to measure accurately bureaucratic output can lead employees in bureaucracies to focus their efforts on activities that are unproductive but visible
D. Solutions to the bureaucratic principal-agent problem

Performance incentives

- The performance incentives and monitoring in the private sector cannot be applied to government departments and agencies: the departments and agencies are funded from government revenue and face a soft budget.

- A contract that provides incentives for a bureaucracy to make decisions that are in the interest of taxpayers: give the head of the bureaucracy a share of efficiency savings?
Monitoring by elected political representatives

- Asymmetric information between bureaucrats and political appointments
- Criteria for political success and for advancement in a government bureaucracy differ: a senior career bureaucrat responsible for economic issues usually requires formal qualifications
- A politically appointed head of a bureaucrat may be focused on further political advancement

The Thomas-à-Becket effect

The culture of the bureaucracy
2.3 LIFE WITHOUT MARKETS AND PRIVATE PROPERTY

- Minimal government consists of competition and rule of law

- Maximal government: no private property and no markets
  Communist principles were set out by Karl Marx (1818 – 1883) and Frederick Engels (1820 – 1895) who wrote the *Communist Manifesto*, which was published in 1848

- Communist societies had laws but not the rule of law
  Lavrentiy Pavlovich Beria (1899-1953): “show me who you want and I shall find the crime”

- Maximal political and bureaucratic principal-agent problems are present when government is maximal
A. Incentives and human nature

Under communism:
- There was no personal claim to anything that a person produced
- People were asked to regard work as a value in itself and not as a means of earning personal income
- Work was to be a means of personal expression of self-worth and self-identity
- The communist solution to the incentive problem was to attempt to change human nature

Hayek (1899-1992), Nobel Prize in economics in 1974
- An evolutionary argument for the failure of communism
- The fatal conceit
B. Information and efficiency

The information limitations made change for government bureaucrats risky: incentives encouraged avoiding risk
C. Equality and envy

Theft and social justice
- Collective property reduces ethical inhibitions to theft
- Bribes were principally payments in kind
- Injustices persisted, since not everybody had equal means of seeking bribes through providing favors.

Women
Friedrich Engels (1884): *The Origin of the Family, Private Property and the State*

Envy
- Collective property was predicted to end envy
- With all benefits are personally assigned through government, envy persisted
Rent seeking

- Rent seeking is maximal when personal outcomes depend on privilege and all personal benefits have become rents.
- Personal effort and ability are directed at rent seeking through networking and establishing and maintaining personal relationships.
- A person’s valuable asset is the personal ability to please others who hand out favors.
2.3 D. Personal freedom

The vanity and the dangers of people who want to “impose order” rather than allowing people to decide for themselves

Hayek (1988):

*Imagining that all order is the result of design, socialists conclude that order must be improvable by better design of some superior mind.*

Adam Smith (1776):

*The statesman who would attempt to direct private people in what manner they ought employ their capitals, would ... assume an authority which could be safely trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.*
Hayek (1944) in *The Road to Serfdom*
Communal property resulted in megalomania:

*collectivists must create power – power over men wielded by other men – and their success will depend on the extent to which they achieve such power* (1944, p. 144).

Leon Trotsky (1879 – 1940)

“where the sole employer is the State, opposition means death by slow starvation. The old principle: he who does not work shall not eat, has been replaced by a new one: who does not obey does not eat”. 
Supplement S2

S2A: Rent seeking and rent dissipation

Participation condition: Initial wealth $A$, rent seeking outlay is $x$, rent $V$, $n$ identical contenders

$$EU = \left(\frac{n-1}{n}\right)U(A-x) + \left(\frac{1}{n}\right)U[A-x+V] > U(A).$$

With risk-neutral rent seekers (Hillman and Katz, 1984):

$$\lim_{n \to \infty} \frac{nx}{V} = 1.$$

In the discriminating all-pay auction (Hillman and Samet, 1987)

$$D \equiv \frac{nEx}{V} = 1 \quad \text{for all values of } n \geq 2.$$
Different valuations \( \{V_1 > V_2 > \cdots > V_n\} \)

- In discriminating contests, only the 2 highest-valuation contenders are active (Hillman and Riley, 1989)
- The active contenders choose their rent-seeking outlays from a distribution over the range of \( \{0, V_2\} \)
- The low-valuation contender makes a strictly positive outlay with probability \( \frac{V_2}{V_1} \)
- The expected value of total rent-seeking expenditures is
  \[
  E\tau_1 + E\tau_2 = \left(\frac{V_2}{V_1}\right) \left(\frac{V_2 + V_1}{2}\right). 
  \]
- Rent dissipation is always on average incomplete with respect to the lower valuation \( V_2 \) because
  \[
  E\tau_1 + E\tau_2 = V_2 \left(\frac{V_2 + V_1}{2V_1}\right) \quad \text{where} \quad \left(\frac{V_2 + V_1}{2V_1}\right) < 1
  \]
  \( D \to 1 \) as \( V_2 \to V_1 \).
Asymmetric information when contenders may not know how other contenders value the rent-seeking prize

Valuations are independently drawn from the uniform distribution with $V \in (0, V^*)$

If contenders’ spending levels are increasing in valuations of the prize, then total expected outlays are (Hillman and Riley, 1989)

$$E\left(\sum_{j=1}^{N} x_j\right) = \left(\frac{n-1}{n+1}\right)V^*.$$ 

As the $n$ increases, each contender judges that, even if he or she has a high valuation, there will now be increasing numbers of others who also have high valuations, and hence more has to be spent to win, so rent dissipation increases
Tullock probabilistic contests (Tullock, 1980)

\[ \rho_i(x_1, \ldots, x_n) = \frac{x_i^r}{\sum_{j=1}^{n} x_i^r} \]

If the highest bid wins, \( r = \infty \)

\[ EU_i = \frac{x_i^r}{\sum_{j=1}^{n} x_i^r} V - x_i \]

In a symmetric Nash equilibrium, \( x = \left( \frac{n-1}{n^2} \right) rV \).
The second-order condition requires

\[ r < \left( \frac{n}{n-2} \right). \]

Expected utility from participation in the contest is strictly positive if

\[ r < \left( \frac{n}{n-1} \right). \]

It follows that, if the second-order condition is satisfied, it is worthwhile participating in the Tullock contest.

With \( r=1 \), rent dissipation is

\[ D \equiv \frac{nx}{V} = \left( \frac{n-1}{n} \right). \]

\( D \rightarrow 1 \) as \( n \rightarrow \infty \). When \( n = 2 \), rent dissipation in the Nash equilibrium is 50 percent.
Supplement: Institutions and natural monopoly

Natural monopoly

\[ C = F + cQ \]

\[ AC = \frac{F}{Q} + c \]
Different outcomes
(1) Maximum profits
(2) The self-financing price
(3) Efficient supply through a subsidy

\[ MB = P_E = MC(=c) \]

\[ \pi = Q.(P - AC). \]

The case against subsidies
- Choice of effort
- Misrepresentation of costs
- Capture
Competitive bidding

Subsidies can be avoided by a public policy of competitive bidding for the price at which supply will take place

- Revenue maximization
- Incomplete contracts
- Transfer of infrastructure ownership
- Open access
- Waste management
- Ownership by government and privatization
Supplement: Labor self-management

Objective: equality for workers

Employers view wage payments as a cost but members of a labor cooperative view wage payments as a benefit to be maximized.

Employment with labor self-management
The self-managed labor cooperative is another case of incompatibility between objectives of efficiency and equality.

Incentives and monitoring