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Political Economy: Introduction

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Political Economy

by Allan H. Meltzer, Alex Cukierman
and Scott F. Richard

In all democratic, market economies the size of government increased in the years after World War II. This conclusion holds for most broad measures of size such as tax collections or spending as a share of total output or government employment as a share of total employment. One of the main tasks of political economy is to explain why this is so.

Most explanations point either to specific features of the social or political process or to specific laws or constitutional provisions. Staff work by Congressional committees, attitudes of the press, power of the bureaucracy or desire for increased span of control, are examples of explanations based on process. Passage of the 16th amendment, authorizing a progressive income tax is an example of a constitutional provision that increased the size of government. Yet, the growth of government is common to many countries, so it cannot depend solely on particular processes or arrangements or on specific laws and regulations.

In philosophy, the size of government, the tax rate, tax progressivity and similar topics are discussed as issues about justice, fairness or equity. This approach recognizes that a main activity of modern governments is income and wealth redistribution. In economic theory, redistribution has a minor role. The emphases is on efficiency, and policymakers are presumed to choose policies that increase efficiency.

Taxation and Redistribution

Political Economy treats the size of government, tax progressivity and income redistribution as outcomes of the political process. One of the book’s themes is that political outcomes must be consistent with voters’ choices. Some voters want higher taxes, greater tax progressivity, and more income redistribution. Others want the opposite. Typically, those who succeed in the economic process favor lower taxes,
less tax progressivity and less redistribution. And those who have relatively low incomes or wealth typically prefer the opposite outcomes.

Two processes are at work in democratic market economies. One is the market, where allocations are made by agreement and there is unequal distribution of wealth. The other is the political process, where allocations are made by majority rule and everyone has an equal vote. It is not surprising that the interaction of the two processes produces different outcomes and allocations from either process acting alone.

If the voters were unconstrained by incentives, or disincentives, and market responses and didn't care about the future, the political process would transfer wealth from the rich to the poor until incomes were equalized. Democratic market economies do not reach this outcome. The reason is that voters recognize the disincentives in any system of taxes and transfers that would equalize income. By raising taxes and increasing redistribution, a majority can increase their current consumption. Higher taxes, however, reduce investment and effort, so future income and consumption are reduced. If the majority vote to reduce taxes and transfers, aggregate consumption may increase while current consumption for the majority falls. The political problem is to find an equilibrium that the majority accepts. The idea, from welfare economics, of having the gainers compensate the losers would make the democratic process of redistribution futile. Instead, the majority chooses a tax rate that maintains equilibrium in the polling place and that redistributes income both currently and intertemporally.

The political-economic process produces a stable equilibrium outcome in many democratic countries, but there is no evidence suggesting convergence to a unique equilibrium tax rate common to all democratic countries. Actual tax rates, redistribution, and other features of the political-economic process differ over time and across countries. The political economy model implies that the differences should be related to differences in voting rules, distributions of ability and productivity, past experiences as they affect attitudes to work and leisure, and incentives or disincentives arising from regulation, details of tax and subsidy arrangements, and the like.

Political economy differs from standard economics in two respects. First,
political economy does not introduce a social utility function or rely on a social planner to determine the amount or kind of redistribution. Once a voting rule is selected, the equilibrium combination of output and redistribution is determined by the voters given their personal positions in the income or wealth distribution and some structural features of the economy. Second, countries do not adopt optimal taxes, optimal regulation, optimal tariffs, compensation arrangements, or other implications of standard economic analysis. Government, acting in response to voters, engages in redistribution and coercion.

Economists have proposed a negative income tax as a more efficient means of redistributing income. A negative income tax would pay transfers in kind, replacing the many costly programs to redistribute the costs of health care, food stamps, and many other in-kind programs with a check payable to the recipient. The political economy model implies, however, that voters do not choose programs based solely on their efficiency.

The negative income tax has not been adopted anywhere. Cash payments are typically limited to persons who do not work for reasons of age, infirmity, or unemployment. A large share of the transfer budget pays for in-kind transfers of goods and services such as health, food, housing and education. Rules restrict recipients from trading these goods and services to achieve a preferred bundle. Although the rules cannot be fully enforced, they have an effect.

To finance spending for redistribution and other activities, governments use taxes that introduce distortions. Progressive income taxes, though widely used, are difficult to reconcile with standard analysis. Widespread reliance on progressive taxes is puzzling for traditional analysis.

This puzzle, too, can be resolved in a political-economy model. With universal suffrage and mean income sufficiently above median income, a majority favors redistribution and progressive income taxes even if the choice is socially costly. A majority is willing to pay a positive price to increase its own current consumption through redistribution.

We find many conditions under which taxes will be progressive. Several of the conditions have intuitive appeal. Progressivity is more likely the larger the spread of
the distribution of income or if there are many high-income individuals whose hours and efforts are relatively insensitive to taxes.

A common practice in all developed countries requires the current generation of workers to provide pensions for retired persons. In return, they receive pensions that are paid by a future generation. This rule, or social contract, is clearly redistributive. In the U.S., low-wage workers benefit disproportionately.

Another type of decision considered in Political Economy are policy problems, where information or its lack is of paramount importance. Policymakers reveal less than full information about their objectives, actions, or changes in policy objectives. Their actions and statements are ambiguous and not fully credible to voters. The costs arising from ambiguity and credibility about policy actions is part of the cost of democratic government.

Our aim has been to develop frameworks applicable to problems that arise in many countries. The increased size of government in the postwar years is the issue that first attracted our attention to political economy. The size of government increased under very different political and administrative arrangements. Taxes rose as a share of income or output in countries with parliamentary or presidential systems, single-member constituencies or proportional representation, unicameral or bicameral legislatures, full-time or part-time legislators, mainly direct or mainly indirect taxes, and many other features. That the same event occurred in different institutional environments suggests a common process at work, even if the details of this process vary with time, place, and institutions. Similarly, the problem of monitoring, assessing, and using information about policies or actions arises in all political and economic systems.