POLI 200C: States and Markets

Spring 2022, W 12:00-2:50 pm, SSB104

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Office Hours: W 10:00 am-12:00 pm, SSB 388

A. Introduction

This graduate seminar provides an overview of the normative and positive issues associated with decentralized (market) and centralized (state) mechanisms of allocation. It is motivated by two questions at the heart of the political science: (1) What is the appropriate role of government in the economy? (2) How do we explain the actual role of government in the economy?

Substantial portions of the readings are from economics, including canonical papers from industrial organization and welfare economics. Topics covered include efficiency, social welfare, market failures, public goods, asymmetric information, moral hazard, adverse selection, government failures, regulation and rent-seeking, property rights, inefficient redistribution, time inconsistency, and political business cycles.

B. Requirements

1. **Weekly Memo—Reflection & critiques of readings**. You will submit a short weekly memo to all course participant on Canvas: https://canvas.ucsd.edu/ **by Tuesday at 5:00pm**. The memo should be one or two paragraphs in length and contain either (i) a critique of some of the readings, (ii) possible discussion questions for the class meeting *and* your (tentative) answers, or, (iii) interesting ways to compare and contrast readings. The memo should not be a summary of readings.

2. **Mid-term and Final papers.** There is one midterm and one final exam. The midterm will be distributed at the end of class on fourth week and is due at the beginning of class on fifth week. The final will be given out at the end of class on tenth week and is due on Wednesday of finals weeks at 5:00pm. Each exam is a take-home essay. Each paper should be 5-10 pages, 2 space, and 12 font. Late papers will be penalized 20% per day.

C. Grades: Final grades will be awarded on the following basis:

1. Participation in course activities (30% of grade). This includes:
    a. Discussion of each week's assigned readings
    b. Weekly Memo

Please do not miss more than one class.

2. Take two exams, midterm and final (30% and 40% of grade, respectively).

D. Reading assignments

All readings will be posted to the course webpage.

Week 1: Markets and States as Mechanisms of Allocation

How do we evaluate and compare alternative allocation mechanisms (i.e. systems for producing and exchanging resources)?

While markets are generally effective in the efficiency with which they allocate resources to their most valued uses, markets do not always work well. Moreover, they can produce equity outcomes that will not necessarily be supported by all members of a community. This segment of the course introduces the normative and positive aspects of markets and states as allocation mechanisms.

Discussion Questions:

- What is an "allocation mechanism"?
- How should we evaluate alternative allocation mechanisms?
- How relevant are normative concerns?

Readings:

- Lerner, Abba P. 1972. "The Economics and Politics of Consumer Sovereignty." *American Economic Review* (May): 258-66.
- Okun, Arthur M. 1975. *Efficiency vs. Equality: The Big Tradeoff.* Washington DC: Brookings (abridged, pp. 1-16).
- Hopkin, Jonathan, and Mark Blyth. 2012. "What can Okun teach Polanyi? Efficiency, Regulation and Equality in the OECD." *Review of International Political Economy* 19:1.
- Bonica, Adam, Nolan McCarty, Keith T. Poole, and Howard Rosenthal. 2013. "Why Hasn't Democracy Slowed Rising Inequality?" *Journal of Economic Perspectives* 27 (3): 103-124.
- Sandal, Michael J. 1998. "What Money Can't Buy: The Moral Limits of Markets." The Tanner Lectures on Human Values. Delivered at Brasenose College, Oxford, May 11 and 12, 1998.
- Elias, Julio J., Nicola Lacetera, and Mario Macis. 2019. "Paying for Kidneys? A Randomized Survey and Choice Experiment." *American Economic Review* 109 (8).

Week 2: Market Failures and the Political Foundations of Economic Systems

What are the political foundations of a market economy? How do these preconditions differ with other forms of economic organization (e.g., traditional/cultural allocation, socialism, and communism)? Certain preconditions are associated with competitive markets, including the provision of property rights. In addition, markets work or fail for a variety of reasons, having to do with information, culture, and institutions.

Discussion Questions:

- What good is efficiency?
- What purposes should a "social contract" serve?
- When does market failure justify government intervention?
- What are common pool resource problems; can they be resolved without government intervention?

Readings:

- Hardin, Russell. 1997. "Economic Theories of the State," in Dennis C. Mueller, ed., Perspectives on Public Choice: A Handbook, New York: Cambridge University Press, pp. 21-34.
- Coase, Ronald. 1974. "The Lighthouse in Economics." *The Journal of Law & Economics* 17, 2 (Oct): 357-76.
- Coase, Ronald. 1960. "The problem of social cost." *The Journal of Law & Economics* 3 (Oct): 1-44.
- Ostrom, Elinor. 1990. *Governing the Commons.* Cambridge University Press, Chapter 3, pp. 58-102.
- Greif, Avner. "Cultural Beliefs and the Organization of Society." *Journal of Political Economy* 102, 5 (1994): 912-950.
- Callais, Justin and Geloso, Vincent. 2020. "The Political Economy of Lighthouses in Antebellum America." SSRN Working Paper.

Week 3: Incentives in Market Exchange, Part I

How do markets respond to ill-defined property rights and public goods problems? This segment surveys the voluntary market responses to these problems.

Discussion Questions:

- What are property rights and when do they emerge?
- What are the conditions under which property rights can be established and enforced by private actors?

Readings:

- Demsetz, Harold. 1967. "Toward a Theory of Property Rights," *American Economic Review* 57, 2 (May): 347-59.
- Libecap, Gary D. 1996. "Economic Variables and the Development of the Law: The Case of Western Mining Rights," in Alston, Eggertsson and North (eds) *Empirical Studies of Institutional Change*, Cambridge: Cambridge University Press: pp. 34-58.
- Cook, Lisa D. 2014. "Violence and Economic Activity: Evidence from African American Patents, 1870–1940." *Journal of Economic Growth* 19:221-257.
- Kuran, Timur and Jared Rubin. 2016. "The Financial Power of the Powerless: Socio-Economic Status and Interest Rates under Partial Rule of Law." *The Economic Journal*, In Press.
- Skarbek, David. 2011. "Governance and Prison Gangs." *American Political Science Review* 105, 4 (November): 702-716.

Week 4: Incentives in Market Exchange, Part II

How do markets respond to transaction costs and externality problems? This segment surveys the voluntary market responses to these problems.

Discussion Questions:

- Business firms are *institutions*: why do they exist?
- When can markets give rise to opportunism, and how can opportunistic behavior be contained?
- What are the costs and benefits of vertical integration?
- Do firms and states have common origins?

Readings:

- Coase, Ronald H. "The Nature of the Firm." *Economica* 4, 16. (Nov., 1937): pp. 386-405.
- Klein, Benjamin. "Fisher-General Motors and the Nature of the Firm." *Journal of Law and Economics* 43, 1 (April 2000): 105-42.
- Alchian, Armen A. and Harold Demsetz, "Production, Information Costs, and Economic Organization." *American Economic Review* 62, 5. (Dec., 1972):777-795.
- Barzel, Yoram. 1997. "Parliament as a wealth-maximizing institution: the right to the residual and the right to vote." *International Review of Law and Economics* 17: 455–474.
- Bates, Robert and David Lien. 1985. "A note on taxation, development, and representative government." *Politics and Society* 14:53-70.
- Dincecco, Mark. 2015. "The Rise of Effective States in Europe." *The Journal of Economic History* 75 (3): 901-918.

Week 5: Incentives in Market Exchange, Part III

How do markets respond to informational problems and other sorts of uncertainty in economic exchange? This segment surveys these problems and the associated market responses.

Discussion Questions:

- What are the sources of uncertainty that arise in economic exchange?
- How do markets respond to informational problems in economic exchange?
- How do voters and politicians respond to informational problems in political exchange?

Readings:

- Akerlof, George A. 1970. "The Market for "Lemons": Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics* 84, 3 (August): 488-500.
- Spence, Michael. 1973. "Job Market Signaling," *The Quarterly Journal of Economics* Vol. 87 #3 (August): 355-374.
- Fearon, James D. 1999. "Electoral Accountability and the Control of Politicians: Selecting Good Types versus Sanctioning Poor Performance." In Adam Przeworski, Susan C. Stokes and Bernard Manin (eds.), *Democracy, Accountability, and Representation*. pp. 55-97. Cambridge: Cambridge University Press.
- Snyder, James M., and Michael M. Ting. 2002 "An Informational Rationale for Political Parties." *American Journal of Political Science* 46 (1):90-110.
- Fearon, James. 1997. "Signaling Foreign Policy Interests: Tying Hands versus Sinking Costs." *Journal of Conflict Resolution* 41 (1): 68–90.

Week 6: Incentives in Politics

What are the similarities and differences between economic and political markets? This segment surveys a range of economic arguments that have been applied to political topics, highlighting the usefulness and the limitations of the approach. We cover some of the most prominent approaches (bulleted below) as well as the distinctive features of politics that complicate, or defy, economic analogy.

Discussion Questions:

- What are the incentives of politicians and why do they matter?
- Why do we need to control bureaucrats and how do we do it?
- How does the structure of political institutions affect public policy?

Readings:

- Weingast, Barry R and William J. Marshall. 1988. "The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets." *Journal of Political Economy* 96 (1): 132-63.
- Moe, Terry. 1990. "The Politics of Structural Choice: Toward a Theory of Public Bureaucracy." In *Organizational Theory from Chester Bernard to the Present*, ed. Oliver Williamson, 116-153. Oxford UP.
- McCubbins, Matthew D., Roger G. Noll, and Barry R. Weingast. 1987. "Administrative Procedures as Instruments of Political Control." *Journal of Law, Economics, and Organization* 3: 243-277.
- Simmons, Beth A. 2005. "Rules over real estate: trade, territorial conflict, and international borders as institutions. *Journal of Conflict Resolution* 49 (1):823–48
- Lake, David A. 1996. "Anarchy, Hierarchy, and the Variety of International Relations." *International Organization* 50, (1):1-33.

Week 7: Political Failure I—Credibility and Policy

Why is it that even a benevolent social planner would produce sub-optimal economic policies? This segment introduces the concept of credibility and incentives to adopt automatic rules and delegation schemes to conduct policy. It also relaxes the benevolent dictator assumption and considers the credibility problem in the context of real-world politicians with electoral and/or partisan ambitions.

Discussion Questions:

- What are possible solutions to the time inconsistency problem in economic policy?
- Under what conditions can reputation promote optimal economic outcomes?
- Can political institutions resolve commitment problems?

Readings:

- Drazen, Allan. 2000. "The Time-Consistency Problem," and "Laws, Institutions, and Delegated Authority," (chapters 4-5) in Alan Drazen, *Political Economy in Macroeconomics* (Princeton, NJ: Princeton University Press):101-165.
- North, Douglass C. 1993. "Institutions and Credible Commitment." *Journal of Institutional and Theoretical Economics*. 149, 1 (March): 11-23.
- Brender and Allan Drazen. 2005. "Political budget cycles in new versus established democracies.' *Journal of Monetary Economics* 52: 1271–1295
- Posen, Adam S. 1995. "Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence." *NBER Macroeconomics Annual 1995*, edited by Ben S. Bernanke and Julio J.

Rotemberg, MIT Press.

- Clark, William R. and Vincent Arel-Bundock. 2013. "Independent but Not Indifferent: Partisan Bias in Monetary Policy at the Fed." *Economics & Politics* 25 (1): 1–26.

Week 8: Structure of Interests in Society

How efficient are political markets when societies are composed of actors with heterogeneous interests and asymmetric incentives to act politically? This segment covers the relationship between individual, group, class, and societal incentives and the consequences for political competition.

Discussion Questions:

- Is social class the basis of democratic policy-making?
- What determines the size of government?
- What determines the level of redistributive fairness in public policy?

Readings:

- Przeworski, Adam and Michael Wallerstein. 1982. "The Structure of Class Conflict in Democratic Society," *American Political Science Review* 76: 215-236.
- Meltzer, Allan H. and Scott Richards. 1981. "A Rational Theory of the Size of Government" *Journal of Political Economy* 89, (5): 914-927.
- Acemoglu, Daron. 2003. "Why Not A Political Coase Theorem? Social Conflict, Commitment, and Politics." *Journal of Comparative Economics* 31(4): 620-652.
- Hibbs, Douglas. 1977. "Political Parties and Macroeconomic Policy." *American Political Science Review* 71: 1467-87.
- Gilens, Martin and Benjamin Page. 2014. "Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens." *Perspectives on Politics* 12 (3): 564-581.

Week 9: Political Failure II– Special Interest Politics

Does the structure of interests in society help or hinder the government to maintain an appropriate role in the economy? Governments may overstep their legitimate role in the economy due to an exchange between (re)election-seeking politicians and special interests, involving campaign contributions.

Discussion Questions:

- What types of societal groups are politically influential and why?
- What conditions foster rent-seeking regulation?
- Does competition between interest groups ensure efficient provision of regulation?
- Why do governments sometimes fail to choose the least costly method of redistribution?

Readings:

- Stigler, George J. 1971. "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science* 2 (1): 3-21.
- Peltzman, Sam. 1976. "Toward a More General Theory of Regulation." *The Journal of Law & Economics* 19: 211-240.
- Becker, Gary. 1983. "A Theory of Competition among Pressure Groups for Political Influence." *Quarterly Journal of Economics* 98: 371-400.
- Daron Acemoglu and James Robinson. 2001. "Inefficient Redistribution." *American Political Science Review* 95 (3): 649-661.
- Rogowski, Ronald and Mark Andreas Kayser. 2002. "Majoritarian Electoral Systems and Consumer Power: Price-Level Evidence from the OECD Countries." *American Journal of Political Science* 46 (3): 526-539.
- Bombardini, Matilde and Francesco Trebbi. 2020. "Empirical Models of Lobbying." *Annual Review of Economics* 12:391-413.

Week 10: Political Failure, Part III – Predatory Government

What prevents government from overstepping its proper role and extracting resources for itself? Why is control over politicians problematic? With so much power over allocation, politicians face incentives to exploit their positions for personal enrichment, to the detriment of society. This segment covers the topic of political rent-seeking and the associated policies that hinder economic performance.

Discussion Questions:

- Can political corruption be prevented?
- What kinds of societies are most prone to predation?
- To what extent does democracy check predation?

Readings:

- Olson, Mancur. 1993. "Dictatorship, Democracy, and Development." *American Political Science Review* 87 (3):567-576.
- Acemoglu, Daron, Simon Johnson, and James A. Robinson. 2002. "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution." *The Quarterly Journal of Economics* 117 (4): 1231-1294.
- Stasavage, David. 2002. "Credible Commitment in Early Modern Europe: North and Weingast Revisited." *Journal of Law, Economics, and Organization* 18 (1): 155-186.

- Sokoloff, Kenneth L. and Stanley L. Engerman. 2000. "History Lessons: Institutions, Factors Endowments, and Paths of Development in the New World." *Journal of Economic Perspectives* 14, 3 (Summer): 217-233.
- Nikolova, Elena. 2017. "Destined for Democracy? Labour Markets and Political Change in Colonial British America." *British Journal of Political Science* 47 (1): 19-45.