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?

"Society needs to keep the market in its place. The domain of rights is part of the checks and balances on the market designed to preserve values that are not denominated in dollars…society diversifies its mechanisms for distribution and allocation." (Okun 1974)

Michael Sandel explores the limits of markets as allocation mechanisms (Sandel 1998). It's likely that many people share Sandel's intuition that at least some voluntary transactions ought to remain beyond the reach of markets. But as Sandel explains, if we privilege our intuitions in this way we risk lapsing into essentialism – the idea that the purposes and ends of social practices are in some sense fixed by nature. In a pluralistic world, essentialist claims frequently seem implausible. Value pluralism has made us uncomfortable with explanations that rely on notions of "fitting" or "proper" uses, because we rightly understand that these can change across cultures and over time.

Sandel suggests that we solve this problem using arguments by analogy – that is, to compare moral intuitions across various areas, revising our intuitions as needed. He then gives three examples of this process in action. In all three cases, he argues that marketizing the practice in question would "corrupt an ideal the practices properly express and advance." However, notice that all three of Sandel's examples—military service, voting and wealth distribution—have direct political consequences. Sandel argues that if we begin with a republican conception of citizenship we can conclude that citizens must conduct their own military service, cast their own votes and avoid the negative civic consequences of a vast wealth gap in order to truly be engaged in self-rule.

But since all these practices relate directly to citizenship, the original concern remains. How are we to justify Sandel's corruption argument without appeal to particularist principles? Is there any pluralist justification of nonmarketization that does not depend, as Sandel's examples do, on the rules of the game? In other words, it may be undesirable for us to sell our votes because this would undermine self-government, but does this really apply to all the other cases he raises, such as surrogacy, postage stamps, or other activities outside the political sphere? Is the set of nonmarketized practices in a pluralist society limited to those practices with implications for democratic government? Or might there be other legitimate reasons to demarketize a practice?

My tentative answer to this question is that a lot of inputs are involved in producing good citizens. What makes someone a good citizen of a republic may hang on how they would behave in a variety of nonpolitical situations. It may be the case that, for instance, a refusal to rent one's internal organs to others at any price is a necessary characteristic of a good citizen. Construed in this way, it's possible to expand Sandel's civic republicanism argument to cover many of the explicitly apolitical cases he describes. However, this would seem to set a very high bar for good citizenship, which is in tension with our goal of broad participation in politics.

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?

Russell Hardin rejects the public goods explanation for state formation because he thinks it is impossible to overcome the bootstrapping problem – that if we find it impossible to collectively create a public good, we cannot simply create another public good (government) to solve the problem. But if we understand government purely as a mechanism for public goods provision, does it make sense to call it a public good? I agree that aspects of government like the rule of law are public goods, but these are the very public goods we're inclined to create government to provide. It seems to be a category mistake, like confusing a machine for the product it produces. I think government is better understood as a procedural mechanism for guaranteeing the collective provision of public goods and the sanctioning of free riders.

However, assuming that the bootstrapping problem is a genuine obstacle, we need not accept Hardin's socio-evolutionary explanation. It seems hard to believe that collective goods are not involved in state generation. After all, collective defense is one of the few genuine public goods Hardin is prepared to acknowledge. In addition, our comparative safety may blind us to the urgency and importance this goal may have taken on in past centuries. It seems much more likely that as governments were established to provide limited security within a small, face-to-face reciprocal network which could monitor free-riders, their mere existence generated positive externalities for others in the vicinity, who thus desired to associate themselves with the incipient government. Once established, it must have become apparent that these governments could confer other public goods as well. Hardin's survival mechanism seems plausible, but his origins mechanism seems needlessly restrictive.

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?

Harold Demsetz argues that property rights are best understood as a mechanism for shaping incentives, specifically for the purpose of internalizing externalities when the gains of such internalization outweigh its costs. On his account, property rights emerge post-hoc as a solution to specific externality problems (consider his example of the fur trade and its differential impact on native peoples in North America). However, he does not deny a cultural (and ultimately normative) source for a given community's "preference for private ownership". So property rights develop to internalize externalities, but only to the extent that a community prefers to use private ownership to redress these problems.

It seems clear that private ownership internalizes a class of externalities. We might ask, however, whether private ownership itself generates additional externalities. Demsetz's account suggests that he would view, for instance, the enclosure movement that privatized the English commons with approval. However, from the perspective of an individual freeholder the enclosure movement was a cataclysm. Grazing land that had heretofore been held in common was no longer accessible to graziers without the appropriate connections. In general, while the overuse of a particular common resource will indeed lead in time to losses to those who employ it, privatization will worsen their situation despite preserving the resource. This explains, *inter alia*, local resistance to EU fisheries policy.

Another interesting implication of Demsetz's argument is that while private property simplifies negotiations, an increase in the number of owners *complicates* them and increases the costs of internalizing externalities (p.357). While motivated by efficiency, Demsetz seems pleasantly surprised to discover that the pursuit of efficiency leads him in directions of which he quite approves – away from collective ownership and towards private property, for instance. However, an uncomfortable implication of the efficiency argument is that a small number of private property owners would make for a substantially more efficient system than the widely-dispersed ownership of property that we are inclined to approve of. Our current arrangement, on Demsetz's account, seems much less efficient than a narrow Venetian-style oligarchy.

Jean-Jacques Rousseau famously wrote that "the first person who, having enclosed a plot of land, took it into his head to say *this is mine* and found people simple enough to believe him, was the true founder of civil society."[1] I wouldn't go that far. I was trained in economics and I'm deeply sympathetic to the beauty of Demsetz's account. However, it takes insufficient notice of the inefficient and restrictive uses to which property rights have been put. Demsetz closes with an account of the copyright law. He would have done well to review this example. He is perfectly correct that the original statue sought to induce the learned and talented to produce useful works, however the intellectual property industry is a hotbed of rent-seeking and socially-destructive cash-grabs that do nothing either for efficiency or for equity. Any theory that seeks to explain property rights must explain their abuse as well as their promise.

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[1] Jean-Jacques Rousseau. "Discourse on the Origin of Inequality". Part Two, p.60.

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?

Bates and Lien argue that the efficient taxation of mobile assets requires deference to the policy preferences of the asset owners, and Barzel analogizes Parliament's role in war to the beneficiaries of a corporation. At first glance these views sit oddly with the history of royal-parliamentary relations. Monarchs consulted parliament reluctantly and sporadically. As late as the 1630s, Charles I was still ruling for decades at a time without calling Parliament, raising revenues by various expediencies including the infamous "ship money." If Parliament were a mechanism for a revenue-maximizing developer to maximize the proceeds of war, it seems strange that monarchs would resort to Parliament only when pressed, and after making every effort to avoid doing so.

However, by re-endogenizing war and examining the strategic context I think Barzel's argument, at least, is borne out. Consider the interaction of numerous states in a market for land. If they are controlled by monarchs who are the sort of revenue-maximizing agents Barzel describes, then the most risk-tolerant among them may well hit on the idea of empowering their aristocracy to gain an advantage in war. The strategic context might then dictate similar moves by the other participants simply to remain competitive. This analogy to market discipline could explain democratic government as a function of dense strategic competition over time, but it depends on the premise that democratic governments are able to mobilize more resources than autocracies. If we were to define war provision as a public good, at least among the aristocracy, then it is less obvious why Parliament would object to taxation without control, provided that it was fair.[2]

A more fruitful argument might be one from complexity. The historian Moses Finley has argued that increasing social complexity requires the spread of empowerment farther down the social scale to relieve the organizational burden on those at the top. It may be the case that royal grants of land, monopolies and patents were attempts to govern by delegation, and that the proliferating complexity simply passed beyond the capacity of individuals or small groups to grapple with.

Finally, we could view political participation as a direct function of service in war. Groups of people who are counted on as soldiers quickly tend to acquire political rights. Athens only became an elite democracy when that elite became indispensable as armed infantry, and it only became a mass democracy when the common people were needed to row in the navy. The emergence of genuine parliamentary democracy in Britain coincided with an unprecedented demand for military and civil service talent. This line of argument blends nicely with Barzel's model if we extend it to include the personal service of his parliamentary "shareholders" in war.

[2] Except perhaps on the basis of personal competence.

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?
- Who bears and who should bear the information costs in market exchange?

Readings:

• Varian, Hal A. "Asymmetric Information," in Hal A. Varian, *Intermediate Microeconomics: A Modern Approach*, 5th ed (W.W. Norton, 2002): 642-662.

• 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.

• Lohmann, Susanne. 1994. "The Dynamics of Informational Cascades: The Monday Demonstrations in Leipzig, East Germany, 1989-91." *World Politics* 47 (1): 42-101.

• Martin, Lisa. 2005. "The President and International Commitments: Treaties as Signaling Devices." *Presidential Studies Quarterly* 35 (3): 440-465.

James Fearon disabuses his readers of any lingering attachments to the pure theory of retrospective voting. He convincingly demonstrates that citizens in modern democracies select leaders at least partly on the basis of propensity to pursue the public interest (the leader's type) rather than merely sanctioning them for performance at the next election. To those without deep commitments to the theory of retrospective voting, however, Fearon's piece has little to say. Retrospective sanction as performance inducement has always struck me as a little odd, particularly since my home state permits only single terms for its governor and lieutenant governor. The mere existence (and persistence) of such one-term systems ought to have indicated to enthusiasts of retrospective sanction that their mechanism was incomplete. Accountability on the basis of retrospective voting also should have been undermined by the observation that US Presidents would seem to be totally unaccountable during their second term, at least since the passage of the 22nd amendment in 1951.

A tacit assumption in Fearon's piece is that some politicians desire to serve the public interest, while others do not. This idea seems problematic, for two reasons. First, as has been amply demonstrated, the public interest is not unitary. Fearon would no doubt admit that simplification into types is a crude heuristic, but I think it's actually an improper representation of human psychology. Fearon appears to be falling into something like the "a few bad apples" trap when he writes of a widespread desire to identify the "public-spirited actors" and entrust them with government. His reasoning recalls Socrates' parable of the sea-captain[3] – that if a ship were to lose its captain at sea, control of the tiller would pass to the loudest and most aggressive sailors, rather than those patiently studying the tide, wind and stars, to the detriment of the whole crew. Second, even if the public interest *were* unitary it seems unlikely that some politicians would be exogenously motivated to pursue it while others would not. It seems far more likely

[3] Plato, *Republic* Book VI 488a–489d

that most politicians wish both for the state to thrive and to thrive themselves. They differ only in preference intensities.

Fearon adverts to Arrow's theorem, but seems to ignore its consequences. If consistent preference aggregation is impossible, then it is incoherent to speak of a unitary "public interest". It is therefore absurd for voters to look for politicians who will faithfully implement this putative public interest. Voters seem to me to look for politicians who will implement *their* (the voter's) interests. Fearon equivocates on this point, at times claiming that voters are looking for public-spirited politicians, and at others arguing that a "good type" for any given voter simply means a politician with similar preferences to the voter's own. It seems much more productive to take a Madisonian view of politicians as imperfect and in need of institutional guidance to produce prosocial outcomes. Ambition must be made to counteract ambition, and self-interest must be trammeled to redound to the public good.[4] It is entirely consistent with this view to claim, as Fearon does, that voters would like to choose those politicians who require the fewest inducements toward good behavior.

[4] Madison, Hamilton, Jay, *The Federalist Papers* #10

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?

McCubbins, Noll and Weingast (1987) argue that political control of administrative agencies is a principal-agent problem, and that this problem can be redressed (with deadweight losses) via rewards and sanctions. They also identify administrative procedures as an alternative mechanism for inducing compliance. The authors argue that neither judicial review nor legislative oversight will be sufficient to solve the principal-agent problem, because these ex-post mechanisms fail to elicit the agent's private information. Administrative procedures, by contrast, are ex-ante in the sense that they shape the environment in which agency decisions are made. The authors think that a phenomenon called "deck-stacking" can occur when administrative procedures structure the influence of diverse interests in the agency's policymaking, controlling the future distribution of benefits "long after the coalition behind the legislation has disbanded."

This doesn't seem to sit easily with assumption #1 in McCubbins and Marshall (1988) that members of Congress represent the politically responsive interests located in their district. In the same way that the potential gains from exchange motivate the creation of enforcement mechanisms, those potential gains should also motivate the timely rearrangement ("deck shuffling"?) of administrative procedures in line with changes in legislative coalitions. Committee membership is supposed to explain the persistence of these procedures, but changes in the majority should change both a committee's membership and its priorities regarding administrative procedures. If the members of Congress are responsive to their district and if the members with the largest interests in the committee's issue area are on the committee, then we should expect deck stacking to endure only as long as it is in the interests of the committee's members.

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. 7

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?

I was very impressed by Drazen's two chapters, but I don't fully follow the connection between his theory of self-binding and actual observable instances of self-binding in the world. His theory seems to generate false positives. Consider the case of pre-election social policy. Ruling parties have strong incentives to disburse cash benefits to citizens immediately prior to an election (ex. Turkey, Indonesia, India, all in 2019), despite the fact that this largesse is not in the state's (or the citizens') long-term interests. All the conditions for a time-discounting problem would appear to be in place: conflict of interests, ex-post heterogeneity, and sequential policymaking. We should expect to see governments voluntarily binding themselves, giving up control over social policy in pre-election windows to achieve the kind of unambiguous benefits that Drazen credits central bank independence with delivering (lower inflation with no output costs). This doesn't appear to have happened, and we can clearly see why – those who would be responsible for the self-binding are quite happy with the status quo and see no need to change.

Self-binding seems inherently paradoxical, even in the core example of central banking. Drazen's exquisitely detailed formulae don't seem to explain how independent central banks ever came to be set up in the first place. [5] He can point to the long-run benefits and the efficiency gains (for society as a whole), but he can't give persuasive self-interested reasons for an executive to ever bind itself in this way. This is a nice illustration of how instrumental rationality shades into enlightened self-interest without the kind of hard demarcation that would be useful in modeling. It was absolutely in the very long-term interests of the 63rd Congress (see note #1) to pass the Federal Reserve Act – it protected their wealth and made their children's prosperity more likely. It was just as unambiguously *not* in their short-term interests – they derived great momentary advantage from control over monetary policy. Their votes will thus depend on their discount rates. Following this line of reasoning, I expect that self-binding will be more common where time horizons are longer and discount rates are lower. I think that Drazen's idea of "fooling people" to take action that redounds to their benefit is an unsatisfying way to grapple with this concept, particularly in the context of legislative choice.[6] Jon Elster, in his magnificent "Ulysses and the Sirens" (1985) sets out five criteria for successful self-binding, and criterion #4 involves precisely this matter of discount rates. Differing discount rates are exogenous to most models, and the moral and social premises that determine them are difficult to treat analytically, though they have been explored by political theorists. Perhaps this is why Drazen cites Elster more than a dozen times.

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[5] In the United States, control over monetary policy was a function of Congress before 1913, but the Panic of 1907 prompted the creation of a geographically-decentralized lender of last resort, whose board would be appointed by the President. Both decentralization and presidential appointment were seen at the time as mechanisms for circumventing the negative influence of regional bankers. Congress approved the Federal Reserve Act because they retained residual control over the agency. When it was brought into the executive branch in 1933, Roosevelt chose not to alter the Federal Reserve Board's independent authority to set interest rates. The United States appears, once again, to have been lucky.

[6] Indeed, we might heed Drazen's advice: "a weakness in the political economy literature is an overreliance on models from other areas of economics such as industrial organization, because they are formally attractive, rather than really relevant" (p.132).

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?

Adam Przeworski and Michael Wallerstein (1982) offer a model of class compromise resulting in the maintenance of capitalism, demonstrating that class interests are not (contra Marx) irreconcilably opposed. Crucially, no direct negotiation is necessary for their strategically-interdependent model to operate. Their model incorporates class-differential risks – the risk to a particular class resulting from a particular choice – but these risks are exogenous and are considered to be features of the moment in which decisions are being made. Przeworski and Wallerstein discern four possible outcome scenarios, and the scenario resulting from a given compromise will reflect the parties relative certainty about the future.

Iteration of their model will thus depend on vectors of risk factors given at time $t = \{0,1\ldots t\}$. Extending their model by endogenizing the risk factors would involve making the risk factor a function of the success or failure of past compromises, incorporating an estimate of counterparty credibility. We see at once that past compromises will affect future compromises in two ways. First, a series of past compromises will indicate a notional reservation value of both classes – the value below which compromise will be rejected. Second, and more important, an unbroken history of successful compromise will lead both sides to hope to modify the arrangement by increasing their share (r and s, respectively). Such a process will turn crucially on the value of class-differential risks, which as I have noted are exogenous in this paper. Class-differential risks will incorporate information about determination and credibility. For compromise to occur, the dangers of non-compromise must be apparent and probable. Each class must have a good idea of the damage that the other could inflict for iterated compromise to make sense.

Ironically, this paper was written at the precise time that a long process of compromise between capital and labor in the United States was breaking down. Workers' purchasing power has not increased since 1978 (Pew 2018), and the share of profits accruing to labor has steadily decreased. In their eponymous production function, Cobb and Douglas took as given something called "the law of the constant wage share" (also known as Bowley's law), which they estimated to be approximately 75%. Despite holding for nearly a century, in the late 1970s this relationship began to shift markedly, and the proportion of the wage share accruing to workers decreased dramatically in the ensuing four decades.

I offer two thoughts concerning this transformation. First, the possibility of even a modest transition to socialism was precluded in the United States by political factors, including adoption of capitalism as a sort of nationalist ideology. This information was taken into account by "capitalists," who consequently increased their reservation value in view of opposition weakness. The threat of (socialist) revolution was simply not credible after 1950, and the ensuing evisceration of the working class may simply reflect their evaporated bargaining power. Second, Przeworski and Wallerstein's game assumes a closed system, where capitalists must negotiate with their own working class. Their model does not afford capitalists an exit option – the option to go negotiate with another nation's proletariat if their own has become insufferably truculent. Capitalists now have this option, either by bringing foreign workers to the factory (immigration) or sending the factory to a foreign country (outsourcing). Why bother making an acceptable offer to your own workers when 1) you can negotiate with someone else instead, and 2) your own workers can't credibly threaten revolution?

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?

Peltzman emphasizes that legislative regulation can favor either producers or consumers, depending on a) the potential gains to industry and b) the potential costs to the legislator, in the form of electoral sanction by voters. The legislator's utility function is shaped by power relationships among producers and consumers. Sanction on the legislator depends on two factors – consumers noticing the transfer of wealth to producers, and consumers choosing to hold the legislator accountable for this transfer.

An initial observation is that the Peltzman model is likely to make better predictions in majoritarian systems. In systems of proportional representation featuring a multiplicity of small parties and government by coalition, attribution of responsibility to any particular legislator is likely to be difficult, because such votes can be explained away as merely the exigencies of coalition.

In addition, it seems that the Peltzman model demands that consumers posses more than merely instrumental rationality. Legislative transfers to producers have nugatory effects on individuals. Personal opposition to wealth transfers can only be founded on collective notions, such as the public interest. Attempts to ground public-spirited decisions on the cold logic of self-interest have so far failed (Riker 1982). There also does not seem to be a reason for individuals to act unless they believe that their personal sanction will make a difference – in other words, they must already be the median voter (and perceive themselves to be) for Peltzman's incentives to apply to them.

Finally, the decision to hold a legislator accountable only makes sense on the assumption that others will also notice the transfer and act to impose accountability. This asks a lot of consumers. Retrospective sanction will require individual sacrifice – holding a legislator accountable for transfers to producers might involve diminishing a legislative majority with which a particular consumer agrees, for instance. Acting in this principled way requires the perception that others will act that way as well. It is, fundamentally, a prisoner's dilemma. If this perception diminishes, the Peltzman model's sanction mechanism will fail to operate even in cases where consumers understand that they are receiving the short end of the stick.

It seems epistemologically unsatisfying to take models from a world of solved political problems—business firms—and apply them to the political process itself. As Acemoglu (2003) points out, the transaction costs inherent in politics cannot be assumed away without radically traducing (and vitiating) our very concept of politics. In essence, the word 'politics' seems to be definitional – it is our definition of a situation where enforcement costs are at their maximum – that is to say, with minimal enforcement mechanisms. It is a situation where the bargaining space has been reduced to a minimum, and where transaction costs generally are maximized. As such, fitting models that assume a world where these mechanisms have been largely remediated is a frustratingly Procrustean exercise.

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?

In *Dictatorship, Democracy and Development* Mancur Olson bases an account of the emergence of democratic government on rational self-interest. His explanation seems initially to directly contradict the transaction costs literature with which we are now familiar (North 1981, Barzel 1991), but after some consideration I think they can be reconciled. Olson's major critique of the transaction costs literature is a rejection of the assumption that government "arose out of some kind of voluntary choice." Instead, he tells the story in terms very reminiscent of Hobbes – we begin with a rational, self-interested, revenue-maximizing bandit, who concludes that she can maximize revenue more effectively by monopolizing violence within a given territory. This monopoly allows non-bandits in the vicinity to form rational expectations regarding the future, permitting investment and productive economic activity.

We learned in Weeks 3-4 that the reasons for the formation of political order can be dramatically different from the reasons for which it is continued and expanded (e.g. Libecap 1978, Demsetz 1967). In this paper, Olson gives us a reason for government's emergence that complements North and Barzel's explanation of its expansion. He even adverts to the potential credible-commitment advantages of self-binding by monarchs, though he does not explore this further. Briefly, the idea that government might emerge from the rational calculations of a self-interested bandit does not preclude later developments that induce the bandit to self-bind in order to increase tax revenue.

The transition Olson describes also recalls Marx's concept of surplus value. The rational bandit will spend on public goods until a marginal increase in this expenditure will generate an equivalent gain for the bandit herself. Another way of putting this is that an autocracy will extract the maximum possible surplus value from its population. A democratic government, by contrast, will maximize its total income with a lower revenue-maximizing tax rate because the factions within the democratic government gain more from productive economic activity than a single autocrat would have.

Olson considers one extreme case, arguing that as their time horizons collapse stationary bandits turn simply into roving bandits. It is instructive to consider another type of extreme case. The "encompassing interest" which Olson describes can be possessed by a single autocrat or by the factions in a democratic society. As the number of such factions increase, the revenue-maximizing tax rate will become ever-lower. At the limit, we can imagine a world of personalized factions – informed citizens making individualized political choices. This society would extract the minimum possible amount of surplus value – its members wouldn't even be able to justify paying themselves a salary.[7] Factional redistribution would become impracticable, and the only taxation that could command a majority would be taxation for objectives aimed at the public interest. Olson gives us the tools to reconcile the transaction cost literature with the historical fact of the violent origins of political order.

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[7] It's worth noting that this is precisely the arrangement that Plato envisions in the *Republic* for his guardian class – even as they govern the state, they are to be forbidden from owning private property.