

Crony capitalism as an electoral outcome

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Motivation

- ▶ If property rights is poorly secured crony relation i.e the tight connection between the owners of major firms and the government are the main informal mechanism to secure property.
- ▶ However, this institutional framework creates high entry barriers for outsiders and lowers creative destruction process.
- ▶ Why in democracies the majority of voters may prefer this type of institutions?
- ▶ The paper gives a theoretical explanation for three empirical facts
 - ▶ failure of democratization to create inclusive economic institutions.
 - ▶ middle-income trap phenomenon.
 - ▶ the rise of populist policies.

Alternative explanations

High barriers to entry remains persistent during the transition to democracy because of the following mechanism

- ▶ The rich elite captures democracy by investing in the de-facto political power (Acemoglu and Robinson (2008))
- ▶ High barriers to entry are beneficial for special interests groups (Djankov et al. 2002, 2008)
- ▶ Voters can tolerate a certain amount of corruption in order to benefit from a certain amount of redistribution (Acemoglu et al. 2013)

Contribution

- ▶ We analyse the political economy of creative destruction process
- ▶ We show why the high-redistribution no-entry policy can be electoral outcome, supported by the most rich and the least educated members of the society.
- ▶ In this circumstances middle class (high-educated workers) becomes the political outsiders
- ▶ The rise in income and skills inequality not only increases the preferences towards higher redistribution, as predicted by political economy literature (Meltzer, Richard, 1981, Alesina, Rodrik, 1994, Person, Tabellini, 1992) but also decreases the political support for a free-entry policy.

Basic assumptions

- ▶ A society consists of N capitalists (an elite), N entrepreneurs (entrants) and L workers, agents maximize one-period pay-off.
- ▶ Each capitalist has a firm, which is a monopolist on its own market and gets profits π
- ▶ Workers differ in the level of skills. Wages are proportional to the level of skills. Distribution of skills is exogenous.
- ▶ Workers preferences are defined as

$$EU_j = Ec_j - \rho\mu(h_j), \quad (1)$$

where Ec_j is expected consumption of the agent j , which is equal to agent j expected income, ρ is an endogenous probability of the adoption of new technology, h_j is the skill level of worker j and μ are the costs of adoption to new technologies for worker j .

$$\mu'(h_j) < 0, \mu(h_j) > 0 \quad (2)$$

Political set-up

- ▶ Two policy variables: the (binary) level of barriers to entry (B, NB) and the profit tax rate (τ).
- ▶ All collected taxes are distributed to workers as lump-sum transfers.
 - ▶ The maximum tax rate is restricted by $\delta \leq 1$.
- ▶ Two ideological parties (populist and reformist (P, R)), their position relative to the level of barriers of entry is fixed .
- ▶ Capitalists have more political power in the political system than other voters ($\beta > 1$)
- ▶ In autocracy $\beta N > S/2$ and in democracy ($L > S/2$), where S - number of total votes.

Economic framework of creative destruction

- ▶ Given the political choice each incumbent firm is capable to invest in the project (I).

The expected profits from the project equal to $\lambda\gamma\pi(1 - \tau) - c\pi$, where λ is a probability of success, c -costs of innovations

- ▶ In the *NB*-regime for each industry there is one new entrant, who is capable to invest in the same project with the same probability of success λ .
- ▶ Incumbents have the first-mover advantage. If they invest, they are immune to entry
- ▶ All industries are symmetric. If investment projects are realized wages, tax payments and lump-sum transfers also increase by the same size γ .

Higher skilled workers gets more benefits from technological progress (because of higher wages and lower costs of adaptation).

Timing

1. Two ideological parties (R, P) sets their policy platforms.
2. Elections hold and the winner is determined by the majority of votes;
3. Each incumbent firms' owner (a capitalist) decides either to invest or not (I, NI)
4. In the free-entry regime for each sector new entrants (entrepreneurs) decide either to invest or not (I, NI)
5. All firms decide whether to hide profits from taxation.
6. All operating firms produce goods and pay wages to workers and after-tax profits to their owners.
7. Finally, redistribution occurs and agents get their final pay-offs.

Economic equilibrium

- ▶ in the *NB*-regime
 - ▶ for low level of taxes ($\tau < \tilde{\tau}$) both incumbent firms and new entrants have incentives to invest in new projects
 - ▶ For higher tax rates $\tau' \geq \tau > \tilde{\tau}$ only new entrants invest in projects.
- ▶ in the *B*-regime incumbent firms invest in new projects only if the rate of return is very high and the tax rate is sufficiently low, such that $\tau < \hat{\tau}$.

$$\hat{\tau} < \tilde{\tau} > \tau' < \delta$$

Agents' preferences

- ▶ Capitalists' bliss point is $(B, 0)$ policy
 - ▶ For capitalists it's true that $V_C(B, \tau + \epsilon) > V_C(NB, \tau)$
- ▶ Entrepreneurs bliss point is either $(NB, 0)$ or $(NB, \tilde{\tau} + \epsilon)$ policy

Workers' bliss points

1. For all workers with a low level of skills (L_{LS}), such that $h_k < h_L$, the bliss point is high-redistribution no-entry policy (B, δ) .
2. For all workers with an intermediate level of skills (L_S), such that $h_L \leq h_k \leq h_H$ the bliss point is free-entry moderate redistribution policy (NB, τ') .
3. For all workers with a high level of skills, such that $h_k > h_H$ the bliss point is free-entry low redistribution policy $(NB, \tilde{\tau})$

Simple political outcomes

- ▶ In autocracies capitalists form majority $(B, 0)$
- ▶ In democracies (if all workers are homogenous)
 - ▶ For a very high rate of return and high level of skills the outcome is $(NB, \tilde{\tau})$
 - ▶ For intermediate rate of return (NB, τ')
 - ▶ For a low rate of return and low level of skills the majority of workers prefer (B, δ) policy.
- ▶ In most of the cases for heterogeneous workers there is no simple majority \Rightarrow coalitions should be formed

The equilibrium position of the parties

- ▶ Entrepreneurs and the highest-skilled workers always vote for the reformist party.
- ▶ The lowest skilled workers always vote for populist party.
- ▶ All other agents (capitalists and workers) are **swing voters**.

In the model with ideological parties in democracies, when no single group form a majority

1. If capitalists' political power is sufficiently low, $\beta \leq \bar{\beta}$, the *R*-party sets (NB, τ') policy and the *P*-party sets (B, δ) policy.
2. If capitalists' political power is sufficiently high, $S/2 > \beta > \bar{\beta}$, there is no Nash equilibrium in the game between two parties.

Electoral outcome

The possible winning coalitions are (capitalists, low-skilled workers) or (entrepreneurs, capitalists, high-skilled workers).

The populist party wins election only if

- ▶ the capitalists political power is relatively high (β),
- ▶ The maximum level of redistribution is sufficiently low (δ)
- ▶ the average level of skills is relatively low
- ▶ there is a high-level of inequality in incomes and skills.
- ▶ the rate of return on innovations is sufficiently low

Otherwise, the reformist party wins elections

Alternative specifications

- ▶ majority core voting equilibrium
- ▶ the model with corruption (non-binding conditions of free entry set-up for reformist party)

Comparative statics

- ▶ Democratization shock
- ▶ Rate of return shock
- ▶ The change in the skills level

Conclusion

- ▶ The transition to democracy is not necessarily associated with an elimination of entry barriers.
- ▶ The key factors which determine the results of democratization are
 - ▶ the rate of return on projects and the average skills level
 - ▶ pre-tax income inequality between workers and capitalists
 - ▶ the skewness of human capital distribution
- ▶ Lower return on projects and higher rate of inequality (in skills) among agents leads to the transition from free-entry equilibrium to no-entry equilibrium with a higher tax rate.
 - ▶ This transition is supported by the most richest (incumbents) and poorest (low-skilled workers).