Political Economy and the Firm

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The outcome is determined by the median voter rule.

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Meyer, Milgrom, and Roberts (1992) (MMR) argue that rent seeking can take place within private sector firms. Weaker divisions may lobby the head office for subsidies. Such lobbying is undesirable because it risks shifting investment from more to less productive divisions. Moreover, the resources used in lobbying are wasted. MMR argue that this rent-seeking and the associated influence costs may be reduced by divesting the weaker divisions. Evidence shows that it is usually the less profitable divisions which are divested. The buyer is typically either a management buyout or a firm in a related line of business. Sometimes the most high performing division is divested.
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There is a one dimensional policy decision, for instance to determine the level of provision of a public good. The policy $x$ is chosen from a policy space $X$.

There is a set $I$ of $2n$ individuals, divided into two equal sized groups, high agents $H = \{H_1, \ldots, H_n\}$ and low agents $L = \{L_1, \ldots, L_n\}$.

Individual $i$ has a strictly concave utility function $u_i : X \rightarrow \mathbb{R}$.

Individual $i$ has ideal level of public good provision $x_i^* \in X$.

Higher numbered individuals from the $H$-group (resp. $L$-group) want higher (resp. lower) levels of public good, i.e.

$$x_{H_n}^* > x_{H_{n-1}}^* > \ldots > x_{H_1}^* > x_{L_1}^* > \ldots > x_{L_n}^*.$$
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- Define \( v_i(\Lambda) = u_i(x(\Lambda)) \).
- Then if \( i \in \Lambda \), individual \( i \)'s marginal benefit of participating is given by \( \Delta_i(\Lambda) = v_i(\Lambda) - v_i(\Lambda \backslash i) \).
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- Individual \( i \) will choose to participate if \( \Delta_i(\Lambda) > c_i \).
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Then if $i \in \Lambda$, individual $i$’s marginal benefit of participating is given by $\Delta_i(\Lambda) = v_i(\Lambda) - v_i(\Lambda \setminus i)$.

Individual $i$ will choose to participate if $\Delta_i(\Lambda) > c_i$.

There is strategic complementarity between groups. However there is free riding within a group, which means this is also partly a game of strategic substitutes.
Examples

Median Voter Rule

- Number individuals so that the ideal points of members of $\Lambda$ satisfy $x_1 < \ldots < x_{|\Lambda|}$.
- The chosen outcome $C(\Lambda)$ is the median of $\{x_\ell : \ell \in \Lambda\}$ if $|\Lambda| = 2m + 1$, i.e. $C(\Lambda) = x_{m+1}$.
- $C(\Lambda) = \frac{1}{2}(x_m + x_{m+1})$, if $|\Lambda| = 2m$. 
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- \( C(\Lambda) = \frac{1}{2} (x_m + x_{m+1}) \), if \( |\Lambda| = 2m \).

Menu-Auction Lobbying

- Divisions lobby the CEO to make decisions in their favour.
- The CEO charges as if (s)he is a perfect price discriminator.
Assumptions I

Assumption

Marginal benefit is increasing in $k$, i.e.

1. If $H_j, H_\ell \in \Lambda$, with $j > \ell$ then $\Delta_{H_j}(\Lambda) > \Delta_{H_\ell}(\Lambda)$.
2. If $L_j, L_\ell \in \Lambda$, with $j > \ell$ then $\Delta_{L_j}(\Lambda) > \Delta_{L_\ell}(\Lambda)$.

The following assumption says that adding two groups with equal and opposite preferences does not affect the marginal benefit of a third party.

Assumption (Matched Pairs)

Suppose that $H_{\bar{k}} \notin \Lambda, L_{\bar{k}} \notin \Lambda, k \neq \bar{k}$ then $\Delta_{H_k}(\Lambda) = \Delta_{H_k}(\Lambda \cup H_{\bar{k}} \cup L_{\bar{k}})$, for all $k \neq \bar{k}$.
Assumptions II

Assumption

Marginal benefit is greater the more opponents there are. Similarly marginal benefit is higher the fewer people who are on your own side.

1. if $L_j \notin \Lambda, H_k \in \Lambda, \Delta_{H_k} (\Lambda \cup L_j) \geq \Delta_{H_k} (\Lambda)$;
2. if $H_j \notin \Lambda, L_k \in \Lambda, \Delta_{L_k} (\Lambda \cup H_j) \geq \Delta_{L_k} (\Lambda)$;
3. if $H_j \notin \Lambda, H_k \in \Lambda, \Delta_{H_k} (\Lambda \cup H_j) \leq \Delta_{H_k} (\Lambda)$;
4. if $L_j \notin \Lambda, L_k \in \Lambda, \Delta_{L_k} (\Lambda \cup L_j) \leq \Delta_{L_k} (\Lambda)$. 
Assumptions III

Assumption (Higher Rank)

If \( \hat{k} > \tilde{k} \) and \( H_{\hat{k}} \in \Lambda \), and \( H_{\hat{k}} \notin \Lambda \), and \( H_k, L_k \in \Lambda \), then
\[
\Delta H_{\hat{k}} (\Lambda) \geq \Delta H_{\hat{k}} \left( (\Lambda \setminus H_{\hat{k}}) \cup H_{\tilde{k}} \right) \text{ and } \Delta L_k (\Lambda) \leq \Delta L_k \left( (\Lambda \setminus H_{\hat{k}}) \cup H_{\tilde{k}} \right).
\]

In a lobbying game, a higher ranked individual would have a more benefit from public goods and so would lobby harder. Under the median voter rule a higher ranked individual joining would cause the median to shift by more.

Assumption (Replacement)

Assume that \( \hat{k} > \tilde{k} \). If \( \Lambda \) is such that \( H_{\hat{k}} \notin \Lambda \) and \( H_{\tilde{k}} \in \Lambda \) then
\[
\Delta H_{\hat{k}} ((\Lambda \setminus H_{\tilde{k}}) \cup H_{\hat{k}}) > \Delta H_{\tilde{k}} (\Lambda).
\]
Consider a symmetric lobbying game $\Gamma$, which satisfies Assumptions 2 (opposite pairs), and 3 (MB-opponents). Then $\Gamma$ has a symmetric equilibrium in pure strategies. Existence follows from Nash' s theorem. This result also characterises the equilibrium and establishes existence in pure strategies.
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In equilibrium, the $k^*$ individuals with the most extreme preferences from the $H$-group and the $k^*$ individuals with the most extreme preferences from the $L$-group, participate in the political process.
Existence of Equilibrium

Theorem

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\[ H_n \quad H_{n-1} \quad H_{n-2} \quad H_1 \quad L_1 \quad L_{n-2} \quad L_{n-1} \quad L_n \]
Imagine the cost of lobbying, $c$, is initially very high and is gradually lowered.
Comparative Statics

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- Initially no group will lobby.

Allowing for non-uniqueness, a reduction in the cost of lobbying will increase the size of the largest and smallest equilibrium lobbies.

Theorem
Consider a symmetric lobbying game $\Gamma$, which satisfies Assumptions 1, 2, 3, 4, and 5. Then the size of the largest and smallest equilibrium lobbies are a decreasing function of the cost of lobbying $c$. 
Comparative Statics

- Imagine the cost of lobbying, \( c \), is initially very high and is gradually lowered.
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- As the cost is lowered we shall get to a point where the two most extreme groups, \( H_n \) and \( L_n \) lobby. The two groups will enter simultaneously.
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**Theorem**

Consider a symmetric lobbying game $\Gamma$, which satisfies Assumptions 1, 2, 3, 4, and 5. Then the size of largest and smallest equilibrium lobbies are a decreasing function of the cost of lobbying $c$. 
In general, we would not expect the equilibria to be unique due to strategic complementarity.

Assumption 3 (MB-opponents) implies $\Delta_{H_n}(\emptyset) < \Delta_{H_n}(H_n, L_n)$.

Thus if the cost of voting, $c$, is such that

$$\Delta_{H_n}(\emptyset) < c < \Delta_{H_n}(H_n, L_n)$$

there will be two equilibria one where nobody votes and one where both $H_n$ and $L_n$ vote.
The following result demonstrates that any equilibrium lobby must contain an equal number of \( L \) and \( H \) individuals.

**Definition**

A lobby \( \Lambda \) is balanced if it contains an equal number of \( L \) and \( H \) individuals.

**Proposition**

If \( \Gamma \) is a symmetric lobbying game, which satisfies Assumption 3 (MB-opponents), then an equilibrium lobby must be balanced.
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Differential Costs of Voting

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- Decisions are made by the median voter rule.
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**Proposition**

Assume that $H$’s face zero cost of voting. Provided the cost of voting for the $L$’s, $c_L \geq \tilde{c} = v_{L_n} \left( x_{H_p}^* - x_{L_n} \right) - v_{L_n} \left( m_H - x_{L_n} \right)$ then in equilibrium:

1. none of the $L$-group votes,
2. the outcome is the median of the $H$-group, $m_H$. 

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\[ H_{2m} \quad \quad H_{m+1} \quad H_m \quad \hat{X} \quad \hat{H}_1 \quad L_1 \quad L_2 \quad L_n \]
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On-line voting may be better if it makes the opportunity cost of voting more equal.
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- However any bias was not great. Australia was viewed as being a full member of the group of western democracies during this time.
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- Rent seeking within organisations. Meyer, Milgrom, and Roberts (1992) consider a multi-division firm. Then the divisions may have an incentive to lobby the centre for transfers. It will be the extreme, i.e. the best and worst performing divisions, which have the greatest incentive to lobby the centre.
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- Suppose a firm incurs influence costs
  - Costs may be reduced by divesting the extreme division.
  - Costs may also be reduced by merging with a division with opposite preferences thus moving the overall political outcome to a more centrist position.
Voting when there is a cost to voting. Policies differ in one dimension, e.g. left-right. As Bulkley and Myles (2001) show, in equilibrium $2k$ individuals will vote. The $k$ with the most extreme left wing views and the $k$ with the most extreme right wing views.
Applications

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- The two types could be men and women. Suppose they have to pay a cost to meet, e.g. by paying for a dating agency/website or by paying to go to the disco. Then the $k$ men most keen to find a partner go to the dating agency, (similarly for the women).
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Volunteer armies. Consider community conflict as in Northern Ireland. Then it is the extremists on both sides who join the paramilitaries.
A common feature of voting and lobbying is that the extremes have the greatest incentive to participate.

Relatively small differences in participation costs can have large effects on outcomes.

Directions for Future Research.

- Extend to a larger more general models of the political process, e.g. lobbying, bargaining etc.
- Explore implications for internal decision-making within firms.
- How do corporate control events such as mergers, takeovers and divestitures affect the internal politics of the firm?

