



Democracy, populism, and (un)bounded rationality

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ABSTRACT

In this paper we aim to understand how bounded rationality affects performance of democratic institutions. We consider policy choice in a representative democracy when voters do not fully anticipate a politician's strategic behavior to manipulate his reelection chances. We find that this limited strategic sophistication affects policy choice in a fundamental way. Under perfect sophistication, a politician does not make any use of his private information but completely panders to voters' opinions. In contrast, under limited sophistication, a politician makes some use of private information and panders only partially. Limited sophistication crucially determines how welfare under representative democracy compares to welfare under alternative political institutions such as direct democracy or governance by experts. We find that, under limited strategic sophistication, representative democracy is preferable to the other institutions from an ex ante perspective.

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1. Introduction

How does bounded rationality affect the performance of democratic institutions? We analyze policy choice in a representative democracy when voters have limited cognitive abilities to anticipate a politician's strategic behavior. In particular, voters may not fully acknowledge a politician's incentive to bias a policy choice towards their opinions, that is to engage in populism. A politician's incentive to bias a policy choice in this way originates from the fact that it may make voters believe that he is competent and thus improve his chances to get reelected. We compare political outcomes and the resulting level of welfare under representative democracy with direct democracy and a form of government where decision making is delegated to experts. We show that the welfare-ranking of the three institutions is crucially affected by bounded rationality.

The existing political economy literature that aims to understand the working of democratic institutions is almost exclusively based on the assumption of perfect rationality (Besley, 2006). As put by Besley (2006, p. 172) "going forward it would be interesting to understand better what the differences are between behavioral models of politics and the postulates of strict rationality." In this paper we study how democratic institutions work under bounded rationality. We thus contribute to a small but growing literature on how deviations from perfect rationality shape policies.

We focus on bounded rationality in the form of limited strategic sophistication. In particular, our analysis is based on a model of limited strategic thinking, dubbed *k*-thinking. This model was introduced by Stahl and Wilson (1994, 1995) and Nagel (1995). Since then, a sizeable literature has developed that explores *k*-thinking theoretically and empirically, including Ho et al. (1998),

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Costa-Gomes et al. (2001), Crawford (2003), Camerer et al. (2004), Costa-Gomes and Crawford (2006), Crawford and Iriberry (2007a), and Goldfarb and Yang (2009), among others. The literature has found strong experimental support for k -thinking.

As a result of their empirical success, models of k -thinking have been used to study the performance and design of institutions when agents are boundedly rational rather than infinitely sophisticated, as assumed in standard analysis. For instance, Camerer et al. (2004) discuss speculation and price setting from the perspective of k -thinking. This is important for the analysis of financial market regulation and central bank policy. Crawford and Iriberry (2007b) and Crawford et al. (2009) study the performance of auctions, an important institution for an efficient allocation of resources. By focusing on the political domain, our paper contributes to studying the performance of social institutions under level- k thinking.

Apart from bounded rationality, the framework we consider is a fairly standard one. Our framework is reminiscent, for instance, of Maskin and Tirole (2004). In particular, a representative voter is endowed with an opinion about which policy maximizes his expected utility. We will refer to the representative voter simply as “the voter”. Importantly, the voter's opinion may be wrong. There is a politician who observes the voter's opinion. Moreover, the politician receives a signal indicating which policy maximizes the voter's utility from an ex-ante point of view. There are two types of politicians dubbed competent and incompetent, respectively. The competent type's signal perfectly reveals the optimal policy (from an ex ante point of view), whereas the incompetent type's signal is noisy. As in career concern models (for instance, Holmström, 1999; Prat, 2005), politicians do not observe their type. This captures the fact that it may be very difficult to objectively prove whether one policy choice dominates another.

There are two office periods. An incumbent politician selects a policy for the first period. At the end of the first period, an election takes place where the incumbent may get reelected or replaced by a challenger. Then, a policy is chosen for the second period. The voter's aim is to (re)elect the politician whom he believes to be most competent.

In order to get reelected, a politician has an incentive to pander to the voter's opinion. This incentive to pander may potentially be mitigated by the voter receiving a (noisy) signal about which policy has been optimal before the election takes place. The voter uses this signal to judge the incumbent politician's competence. Crucially, however, the voter's judgment is also (rationally) influenced by his prior opinion about which policy is optimal. This induces an incentive for a politician to pander to the voter's opinion because it will make him look more competent in the voter's eyes and increase the chance of getting reelected.

Beliefs of limited strategic sophistication refer to the voter's limited ability to anticipate the politician's strategic incentives to pander to the voter's opinion. Since this inability may concern different orders of strategic behavior, these beliefs will be defined in a recursive way. We refer to them as sophistication- k beliefs or, simply, k -beliefs.

The recursive definition of k -beliefs works as follows. If a voter is fully naive, he has a 0-belief. This means that he believes that a politician chooses a policy in a way to maximize the voter's welfare. This belief reflects the case where the voter takes the constitutional role of politicians in a democracy, as managers of the state on behalf of the people, literally. As we will show, under this naive belief, a politician faces an incentive not to fully maximize the voter's welfare but to partially distort the policy towards the voter's opinion. If the voter has a 1-belief, he anticipates the politician's incentive to deviate from the voter's 0-belief. This, however, induces a second-order incentive for the politician to deviate from the voter's 1-beliefs. If the voter also anticipates the politician's second-order incentive to deviate, he is endowed with a 2-belief etc. Iterating forward in this way, we finally end up with perfect rationality as the limit case of an ∞ -belief.

We take the voter's level of k as given. The empirical evidence suggests values for k of one or two (Camerer et al., 2004; Crawford and Iriberry, 2007b). This stands in sharp contrast to the requirement of unlimited rationality for anticipating strategic reactions for infinitely many orders. A salient example of how difficult it is in practice to anticipate higher-order strategic reactions is provided by the chess game.

Whether k is to be seen as a low number, as suggested by the behavioral literature, or rather infinitely high turns out to crucially matter for our results. First, we find that the higher the voter's degree of sophistication, the *stronger* the incentive of a politician to pander. The intuition for this result is that a more sophisticated voter *expects* the politician to pander more. As a result, the politician will indeed pander more. Under perfect sophistication (or rationality), the voter expects the politician to fully pander and the politician does so, in turn. This entails that the politician will not make use of any private information. Overall, the politician's incentive to pander is crucially affected by limited strategic sophistication. Thus, a representative democracy yields different policy results under bounded rationality, compared to the case of perfect rationality.

Under a broad range of circumstances, the fact that the politician will not make use of any private information under perfect rationality is deteriorating for welfare. Under these circumstances, welfare is higher under limited strategic sophistication than under perfect rationality. This challenges the common wisdom that deviations from full rationality are mostly detrimental for welfare.

Our analysis proceeds with comparing the desirability of representative democracy in comparison to other political institutions in the case of bounded rationality. In particular, we compare representative democracy to direct democracy and to the case where policy making is fully delegated to independent experts. We show that the welfare-ranking of the three institutions is crucially affected by beliefs of limited strategic sophistication. We also show that, from the ex ante perspective of a constitutional designer, beliefs of limited strategic sophistication give representative democracy an edge over direct democracy and over delegation to experts.

The remainder of this paper is organized as follows. Section 2 discusses the related literature. Section 3 introduces a model of representative democracy. In Section 4, we formally introduce beliefs of limited strategic sophistication and solve the model. In Section 5, we compare representative democracy to the case of direct democracy and to the case of delegation of policy making to independent experts. We discuss supporting evidence as well as the robustness of our findings in Section 6 and conclude in Section 7. Proofs are contained in the Appendix A if not stated otherwise.

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